Crisis at the Company

The Role of Independent Directors in Steering the Company to Safe Waters

Ballard Spahr LLP

UNIVERSITY OF DELAWARE
WEINBERG CENTER FOR
CORPORATE GOVERNANCE

CASES AND MATERIALS FROM TODAY'S PRESENTATION

1. *Bamford v. Penfold, L.P.*, 2022 Del. Ch. LEXIS 147 (Del. Ch. June 24, 2022)
2. *Bandera Master Fund LP v. Boardwalk Pipeline, LP*, 2021 Del. Ch. LEXIS 266 (Del. Ch. Nov. 12, 2021)
3. *Brookfield Asset Mgmt. v. Rosson*, 261 A.3d 1251 (Del. 2021)
4. *Constr. Indus. Laborers Pension Fund v. Bingle*, 2022 Del. Ch. LEXIS 223 (Del. Ch. Sept. 6, 2022)
5. *Diep v. Trimaran Pollo Partners, L.L.C.*, 280 A.3d 133 (Del. 2022)
6. *Firemen's Ret. Sys. v. Sorenson*, 2021 Del. Ch. LEXIS 234 (Del. Ch. Oct. 5, 2021)
7. *Garfield v. Allen*, 277 A.2d 296 (May 24, 2022)
8. *Gottlieb v. Duskin*, 2020 Del. Ch. LEXIS 348 (Del. Ch. Nov. 20, 2020)
9. *In re Boeing Co. Derivative Litig.*, 2021 Del. Ch. LEXIS 197 (Del. Ch. Sept. 7, 2021)
10. *In re Caremark Int'l*, 698 A.2d 959 (Del. Ch. 1996)
11. *In re Clovis Oncology, Inc. Derivative Litig.*, 2019 Del. Ch. LEXIS 1293 (Del. Ch. Oct. 1, 2019)
12. *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003)
13. *In re Pattern Energy Grp., Inc. Stockholders Litig.*, 2021 Del. Ch. LEXIS 90 (Del. Ch. May 6, 2021)
14. *In re Walt Disney Co. Deriv. Litig.*, 2004 Del. Ch. LEXIS 132 (Del. Ch. Sept. 10, 2004)
15. *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014)
16. *Kahn v. Tremont Corp.*, 694 A.2d 422 (Del. 1997)
17. *Lewis v. Fuqua*, 502 A.2d 962 (Del. 1985)
18. *Lonergan v. EPE Holdings LLC*, 5 A.3d 1008 (Del. Ch. 2010)
19. *Manti Holdings, LLC v. Authentix Acquisition Co.*, 261 A.3d 1199 (Del. 2021)
20. *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019)
21. *McElrath v. Kalanick*, 224 A.3d 982 (Del. 2020)
22. *Noto v. 22nd Century Grp., Inc.*, 35 F.4th 95 (2d Cir. 2022)
23. *Pettry v. Gilead Scis., Inc.*, 2020 Del. Ch. LEXIS 347 (Del. Ch. Nov. 24, 2020)
24. *Pettry v. Gilead Scis., Inc.*, 2021 Del. Ch. LEXIS 156 (Del. Ch. July 22, 2021)

25. *Richman v. Goldman Sachs Group, Inc.*, 868 F. Supp. 2d 261 (S.D.N.Y. 2012)

26. *Sandys v. Pincus*, 152 A.3d 124 (Del. 2016)

27. *Stone v. Ritter*, 911 A.2d 362 (Del. 2006)

28. *UFCW & Participating Food Indus. Empls Tri-State Pension Fund v. Zuckerberg*, 250A.3d 862 (Del. 2021)

29. *Venoco, Inc. v. Eson*, 2002 Del. Ch. LEXIS 65 (Del. Ch. June 6, 2002)

30. *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981)

Bamford v. Penfold, L.P.

Court of Chancery of Delaware

March 25, 2022, Submitted; June 24, 2022, Decided

C.A. No. 2019-0005-JTL

Reporter

2022 Del. Ch. LEXIS 147 *; 2022 WL 2278867

JOSEPH C. BAMFORD and YOUNG MIN BAN, Plaintiffs, v. PENFOLD, L.P.; DELAWARE VALLEY REGIONAL CENTER, LLC; WEST 36TH, INC.; JOSEPH MANHEIM; and REATH & CO., LLC, Defendants.DELAWARE VALLEY REGIONAL CENTER, LLC; JOSEPH MANHEIM; and REATH & CO., LLC, Counterclaim Plaintiffs, v. YOUNG MIN BAN, Counterclaim Defendant.

Notice: THIS OPINION HAS NOT BEEN RELEASED FOR PUBLICATION. UNTIL RELEASED, IT IS SUBJECT TO REVISION OR WITHDRAWAL.

Prior History: Bamford v. Penfold, L.P., 2020 Del. Ch. LEXIS 79, 2020 WL 967942 (Del. Ch., Feb. 28, 2020)

Counsel: **[*1]** David J. Margules, Elizabeth A. Sloan, Brittany M. Giusini, BALLARD SPAHR LLP, Wilmington, Delaware; Timothy D. Katsiff, Fred G. DeRitis, BALLARD SPAHR LLP, Philadelphia, Pennsylvania; Counsel for Plaintiff Joseph C. Bamford.

Jeffrey S. Cianciulli, WEIR GREENBLATT PIERCE LLP, Wilmington, Delaware; Peter N. Kessler, KUTAK ROCK LLP, Philadelphia, Pennsylvania; Counsel for Plaintiff Young Min Ban.

Bruce E. Jameson, Kevin H. Davenport, John G. Day, PRICKETT, JONES & ELLIOT, P.A., Wilmington, Delaware; Marc R. Rosen, Joshua K. Bromberg, KLEINBERG, KAPLAN, WOLFF & COHEN, P.C., New York, New York; Counsel for Defendants West 36th, Inc., Joseph Manheim, and Reath & Co., LLC.

William B. Chandler III, Shannon E. German, WILSON SONSINI GOODRICH & ROSATI, P.C., Wilmington, Delaware; Counsel for Defendants Penfold, L.P. and Delaware Valley Regional Center, LLC.

Judges: LASTER, V.C.

Opinion by: LASTER

Opinion

MEMORANDUM OPINION

LASTER, V.C.

Delaware Valley Regional Center, LLC ("DVRC") manages specialized investment funds that enable foreign nationals to make investments in job-creating projects in the United States. By making a qualifying investment, a foreign national gains priority access to permanent residency status.

Joseph Manheim **[*2]** controls DVRC through West 36th, Inc. ("WestCo"), a Delaware corporation. WestCo serves as the managing member of DVRC, and the board of directors of WestCo (the "WestCo Board") functions as the governing board of DVRC. Manheim owns 70% of the equity in WestCo.

Manheim heard about the visas-for-investment program in 2011. In 2012, he formed DVRC and WestCo. Later that year, Young Min Ban started working with Manheim to develop the business. Joseph Bamford provided startup capital for the business.

In 2018, Manheim terminated Ban. Bamford was already frustrated that DVRC was not paying more in distributions, and he and Ban became allies. After Bamford filed this lawsuit against Manheim, Ban intervened and asserted similar claims.

Bamford and Ban allege that Manheim has committed extensive breaches of his duty of loyalty. The alleged misconduct falls into broad categories:

• Between 2017 and 2020, Manheim caused DVRC to pay excessive management fees to Reath & Co., LLC ("ReathCo"), a company that Manheim and his wife own.

• Between 2018 and 2020, Manheim caused DVRC to pay excessive compensation to his brother, Frank Manheim, who serves as the Chief Operating Officer of DVRC and as a member **[*3]** of the WestCo Board. Bamford and Ban contend that Frank received excessive compensation both due to his familial relationship with Manheim and as an inducement to support Manheim's self-dealing.

• Between 2018 and 2020, Manheim caused DVRC to pay excessive compensation to his friend, Albert Mezzaroba, who serves as general counsel to DVRC and as a member of the WestCo Board. Bamford and Ban contend that Mezzaroba received excessive compensation both due to his relationship with Manheim and as an inducement to support Manheim's self-dealing.

• In 2019 and 2020, Manheim caused DVRC to pay excessive compensation to Paula Mandle, who serves as a member of the WestCo Board, and who treats the job as a sinecure. Bamford and Ban contend that Mandle received excessive compensation as an inducement to approve excessive compensation for Manheim, Frank, and Mezzaroba.

• Manheim has caused DVRC to reimburse ReathCo for unjustified expenses.

Ban seeks a derivative recovery on behalf of DVRC equal to the total of Manheim's alleged defalcations. Bamford seeks an investor-level recovery equal to one third of Manheim's alleged defalcations. Both seek expansive equitable relief divesting Manheim of control **[*4]** over DVRC.

In this post-trial decision, the court finds that Manheim is liable for a portion of the challenged transfers. Judgment will be entered in favor of DVRC in the amount of $2,365,809.22. The court declines to award any remedy other than a derivative recovery for the benefit of DVRC.

I. FACTUAL BACKGROUND

Trial took place on June 8-11, 2021. The parties introduced 2,192 exhibits and lodged twenty-three deposition transcripts. Five fact witnesses and six expert witnesses testified live.[1]

The record presents considerable difficulties. The entities at issue are small and closely held. From 2012 until 2018, Manheim and Ban were the two individuals most heavily involved in the business; Bamford was an outside investor and not involved in the day-to-day operations. Manheim and Ban are now on opposite sides of this dispute, and they offered conflicting testimony on numerous issues. Bamford, Ban, and Manheim all had their credibility impeached successfully on various points.

The documentary record is often unclear. From 2012 until 2016, the first four years of the entities' existence, the business operated in start-up mode. Neither Manheim nor Ban paid close attention to corporate formalities. **[*5]** Their main concern was to structure their affairs to minimize their personal tax liabilities, and the records that exist show efforts to manipulate transactions for that purpose.

In June 2016, Manheim, Ban, and Bamford reorganized the entities and their ownership stakes (the "Reorganization"). Unfortunately, they did so through two poorly drafted agreements that they created themselves, and they backdated one of the agreements for tax purposes so that the first step of the Reorganization appeared to take place in June 2015. Also in 2016, Manheim and Ban hired a law firm to help them clean up their records, but that effort involved the creation of still more backdated documents that sought to fix problems in the entities' corporate structure. A more extensive effort to clean up the entities' records and professionalize their operations took place in 2017 and 2018, and it troweled another layer of documentation onto the edifice.

After trial, in an effort to pare down the case, the court made certain rulings and issued an initial set of post-trial factual findings. Dkt. 349 (the "Factual Findings" or "FF"). The court instructed the parties to treat the Factual Findings as established for **[*6]** purposes of post-trial briefing and argument, recognizing that to resolve the case completely would require additional factual findings.

---

[1] Citations in the form "[Name] Tr." refer to witness testimony from the trial transcript. Citations in the form "[Name] Dep." refer to witness testimony from a deposition transcript. Citations in the form "JX — at —" refer to a trial exhibit with the page designated by the internal page number or, if the document lacked an internal page number, by the last three digits of the JX number. If a trial exhibit used paragraph numbers, then references are by paragraph. The parties reached agreement on a limited number of stipulated facts in the pretrial order. Citations in the form "PTO ¶ —" refer to those stipulated facts. *See* Dkt. 339.

The parties complied with the court's request. At the same time, they found ways to present evidence on the issues that the court already had decided. The parties' efforts have not caused the court to revisit any of the Factual Findings, although the court has sought to clarify certain findings and elaborate on its reasoning.

The following factual account reflects the court's determinations after weighing competing evidence, assessing the credibility of witnesses, and making determinations based on a preponderance of the evidence. The court has not repeated every finding that appeared in the Factual Findings, some of which addressed matters that are no longer at issue. The Factual Findings remain part of the court's post-trial findings of fact.

A. The Idea For The EB-5 Business

In 2012, Manheim was working as the Chief Investment Officer for the Swarthmore Group, a boutique financial advisory firm. FF ¶ 1. As one of its lines of business, the Swarthmore Group managed approximately $2.5 billion in institutional pension fund assets. Several of the firm's **[*7]** clients were Pennsylvania government agencies, including the Southeastern Pennsylvania Transportation Authority ("SEPTA"). Manheim Tr. 452-53, 488. Manheim had a personal connection to SEPTA: Pat Deon, SEPTA's Chairman, was a friend of Manheim's. *Id.* at 488.

During a lunch in Philadelphia at the Union League, Deon and other SEPTA officials discussed a recent debt financing where SEPTA had obtained advantageous terms because the financing involved "selling some Green Cards." *Id.* Manheim asked about the details and received his introduction to the EB-5 immigration program (the "EB-5 Program"). *Id.*

EB-5 is shorthand for "Employment Based Immigration: Fifth Preference." PTO ¶ 53. Administered by the U.S. Citizenship and Immigration Service ("USCIS"), the EB-5 Program enables foreign nationals who make significant job-creating investments in the United States to qualify for permanent residency. Although the minimum investment amount can vary, the standard amount until November 19, 2019, was $500,000. *See id.* ¶ 55. In order to qualify for the EB-5 Program, the investment must be in a commercial enterprise and create or preserve at least ten full-time qualifying jobs. *Id.* ¶ 56.

Foreign nationals **[*8]** do not have to make the qualifying investment directly. Instead, an entity that has been licensed as an "EB-5 regional center" can pool capital on behalf of multiple foreign investors, then make an investment on their behalf. *See id.* ¶¶ 53, 58. An EB-5 regional center is a public or private entity, engaged in the promotion of economic growth, improved regional productivity, job creation, and increased capital investment in the United States, that has been approved by the USCIS to operate under the EB-5 Program. *See id.* ¶ 33.

After the lunch at the Union League, Manheim investigated the EB-5 Program. He learned more about it from Mezzaroba, a Pennsylvania lawyer with connections to senior officials at SEPTA and the Pennsylvania Turnpike Commission ("PTC"), where Deon serves on the board. Mezzaroba knew personally about the EB-5 Program from his stint as President and CEO of the Pennsylvania Convention Center, where he obtained $225 million in financing through the EB-5 Program. Mezzaroba Tr. 777-78.

Manheim learned that most regional centers sponsored investments in real estate. Manheim believed that an investment with a government agency like SEPTA or the PTC would be more attractive **[*9]** to foreign investors because of the lower risk that the investment would carry. One challenge was that government agencies, like SEPTA and the PTC, generally fund infrastructure projects with long-term debt. Foreign investors, by contrast, generally do not want to commit their money beyond the time necessary to receive a green card, which typically takes five years. *See* Manheim Tr. 488-90.

Manheim believed that he could solve the temporal mismatch by giving foreign investors the right to have their investment redeemed through an in-kind distribution of an interest in the loan to the government agency. *Id.* at 490-91. Manheim envisioned that the in-kind interest could be traded, much like a municipal bond, thereby solving the investor's need for liquidity. The structure would enable the government agency to borrow at a lower interest rate because the foreign investors would subsidize the loan to obtain their green cards. *See id.* at 489-91. Manheim described the business model as a plan "to staple a Green Card to a muni bond and sell it onshore in Asia." *Id.* at 494.

After some additional diligence, Manheim decided that his plan could work. Through his connections with Deon and Mezzaroba, **[*10]** Manheim understood that the PTC could deploy the funds if he could assemble the investors. The consensus was that Manheim needed to provide at least $50 million in capital. *See id.* at 495.

B. The Creation Of DVRC And WestCo

Manheim formed DVRC and WestCo on the same day in January 2012. JXs 24-25. He created DVRC as the entity that would become a USCIS-approved regional center, solicit investments from foreign investors, and deploy their capital in visa-qualifying investments with government agencies like SEPTA and the PTC (the "EB-5 Business"). He created WestCo to manage DVRC, and WestCo was the sole member of DVRC. FF ¶ 3(b). Manheim anticipated that WestCo also would pursue other entrepreneurial ventures.[2]

From the outset, Manheim failed to follow corporate formalities and did not keep good records. For example, Manheim did not adopt a limited liability company agreement for DVRC when he formed the entity. FF ¶ 3(c). An agreement exists, but it was not created until March 2016, after the EB-5 Business began to generate cash flow. *See* JX 27 (the "DVRC LLC Agreement"). At that point, Duane Morris LLP drafted a series of entity documents for WestCo, DVRC and the EB-5 Business, which **[*11]** Manheim implemented retroactively. *See, e.g.*, JXs 184-86.

When Manheim formed WestCo, he invited the two owners of the Swarthmore Group to join the business. Mandle, then the CEO of the Swarthmore Group, accepted. The other declined.

Initially, Manheim and Mandle each received 100 shares in WestCo, making them 50-50 owners, and they became WestCo's sole directors. *See* JX 50 at '001, '004. Both were officers, with Manheim serving as President and Treasurer, and Mandle serving as Vice President and Secretary. *Id.* at 3. In March 2012, Manheim and Mandle approved a resolution issuing Manheim 600 shares and Mandle 200 shares, giving Manheim a 70% ownership stake and Mandle a 30% ownership stake. *See* JX 33.[3]

Mandle had no real involvement in the business. Manheim included her because she was his boss at the Swarthmore Group and because the EB-5 Business would benefit from the Swarthmore Group's connections.

C. Bamford Becomes Involved.

Manheim believed that he needed approximately $1 million in capital to launch the EB-5 Business. Manheim Tr. 496. In May 2012, Manheim obtained $500,000 in capital from East 63rd Limited ("EastCo"), a limited company organized under the laws of England and Wales. **[*12]** JX 39.

EastCo was a legacy company from a prior business venture with Bamford. The scion of a wealthy British family, Bamford met Manheim in 1995, when Bamford was sixteen years old, and Manheim was dating Bamford's sister. Several years later, when Bamford joined Alcoholics Anonymous and Narcotics Anonymous, his sister recommended that he ask Manheim to be his sponsor. Manheim agreed and served in that role for a decade. The two became close friends. They socialized regularly and travelled together. Their families also became close, and each named the other as the godfather to his children. Bamford Tr. 14-15; Manheim Tr. 461, 463-64, 607; PTO ¶ 21.

Over the years, Manheim and Bamford made several attempts at business ventures together. *See* Manheim

[2] WestCo did pursue other business opportunities. In 2013, Manheim used WestCo to provide advice to a friend who was trying to secure a contract with SEPTA, knew that Manheim had access to high-level decision makers, and believed that having Manheim involved would help his chances of success. Manheim Tr. 502. WestCo also provided services to Bamford, who paid WestCo to consult on matters relating to his family's business. *Id.* at 503-04. And WestCo engaged in some proprietary trading. *Id.* at 503.

[3] There are notable differences between the style and format of the written consent dated January 5, 2012 (JX 50) and the resolution of the WestCo Board from March 2, 2012 (JX 33). There are also tensions between the documents. The March 2012 resolution appoints Manheim and Mandle to slightly different officer positions than they assumed two months earlier as a result of the January 2012 board consent. Under the January 2012 consent, Manheim was President and Treasurer, and Mandle was Vice President and Secretary. Under the March 2012 resolution, Manheim was President and Managing Director, and Mandle was Treasurer and Secretary. The March 2012 resolution also seems to contemplate an initial issuance of shares, rather than a subsequent issuance of shares. It seems likely that in March 2016, when Manheim and Ban hired Duane Morris to clean up their corporate documents, the lawyers realized that Manheim drafted the March 2012 resolution without having first satisfied the corporate formalities for appointing directors. The law firm created the earlier consents to fill in the gaps.

Tr. 454, 465-66. In 2009, after the financial crisis, Manheim formed EastCo to trade in illiquid, distressed investments. *Id.* at 469-70. Bamford and another wealthy individual each contributed $500,000. In return, they each received 500,000 shares of common stock without voting rights and 33 shares of common stock with voting rights. Manheim held 33 shares of common stock with voting rights. PTO ¶ 41. EastCo thus had 1,000,099 shares outstanding, **[*13]** with Bamford and the other investor holding a fraction less than 100% of the economic interest. FF ¶ 4(b); JX 37. Manheim was its sole director. Manheim Tr. 471; PTO ¶ 42.

By 2012, EastCo had only invested approximately $200,000 of its capital, and it had achieved some gains on some of its investments. Manheim decided that the EB-5 Business would be a suitable investment for EastCo. *See* Manheim Tr. 496-97. After talking with Bamford, Manheim caused EastCo to provide WestCo with a $500,000 line of credit. JX 39 (the "2012 EastCo Loan"). In lieu of repaying the loan, WestCo could convert the borrowings into equity, and if WestCo drew the entire $500,000 and converted the full amount, then EastCo would receive shares equating to 49% of WestCo's fully diluted equity. FF ¶ 4(c).

The 2012 EastCo Loan thus conferred beneficial ownership of 49% of WestCo's equity, but its value was capped. If WestCo's value increased significantly, then Manheim could cause WestCo to repay the loan rather than converting it into equity. After the 2012 EastCo Loan, on a fully diluted basis, Manheim beneficially owned 35.7% of WestCo's equity (70% * 51%), and Mandle beneficially owned 15.3% (30% * 51%). *Id.* ¶ 4(d). **[*14]**

In September 2012, Bamford and Manheim caused EastCo to repurchase the other investor's shares. JX 46; *see* PTO ¶ 43. After the repurchase, Manheim continued to own 33 voting shares, and Bamford owned 500,000 non-voting shares and 33 voting shares. JX 54 at 4. Bamford thus held 99.99% of the economic ownership of EastCo, making him the beneficial owner of virtually all of the 49% of WestCo's equity that EastCo could receive upon conversion of the 2012 EastCo Loan. FF ¶ 4(e). The value of Bamford's ownership remained capped, because if the value of WestCo increased significantly, then Manheim could cause WestCo to repay the loan rather than converting it into equity.

D. Ban Joins The EB-5 Business.

Shortly after Manheim formed WestCo and DVRC, Ban began working at the Swarthmore Group. Manheim tasked him with working on the EB-5 Business. *See id.* ¶ 5; Manheim Tr. 500-01.

In December 2012, Ban paid $100 to acquire 150 shares in WestCo from Mandle, leaving her with 150 shares. JX 49; Ban Tr. 288. Ban replaced her as a director, and he took over her roles as Secretary and Treasurer. *See* JX 28; JX 49. Manheim continued in the role of President and Managing Director. JX 49.

At that point, setting **[*15]** aside the potential dilution from the 2012 EastCo Loan, Manheim owned 700 shares, Ban owned 150 shares, and Mandle owned 150 shares. On a fully diluted basis, assuming the conversion of the EastCo loan, Bamford beneficially owned 49% of WestCo, Manheim owned 35.7% (70% * 51%), Ban owned 7.65% (15% * 51%), and Mandle owned 7.65% (15% * 51%). FF ¶ 7. Bamford's indirect interest remained subject to Manheim's ability to cause WestCo to repay the 2012 EastCo Loan.

E. The Early Days Of DVRC

Manheim did not want to invest the time and money necessary to build the EB-5 Business unless he had a potential investment lined up. He also felt that having a potential investment would help him raise capital. He spent the latter part of 2012 and the first months of 2013 negotiating with the PTC. Manheim Tr. 506-07. With a deal in place, Manheim and Ban filed an application with the USCIS to become a regional center. *Id.*

During this time, Manheim was drawing on the 2012 EastCo Loan. On April 2, 2013, WestCo made the final draw. PTO ¶ 71. As its next source of funding, DVRC obtained a $500,000 loan from the Delaware Valley Regional Economic Development Fund, a non-profit foundation where Mezzaroba serves **[*16]** on the board of trustees. Manheim Tr. 504-05; Mezzaroba Dep. 80-85; PTO ¶ 72.

In May 2014, the USCIS granted DVRC approval to operate as an EB-5 regional center. With the approval in hand, DVRC could start raising money from foreign investors. FF ¶ 8. Manheim and Ban began connecting with agents based in Asia to source investors. Manheim Tr. 507-08. DVRC would need additional regulatory approvals from the USCIS before it could deploy the capital into a qualifying investment.

F. The Ban Profit-Sharing Agreement

With the EB-5 Business entering a new phase, Ban asked Manheim for a written agreement regarding his interest in the EB-5 Business. They jointly drafted and executed a letter agreement dated July 11, 2014, titled "Agreement with Young Min Ban regarding West 36th Incorporated and DVRC." JX 68 (the "Ban Profit-Sharing Agreement"). The agreement is poorly written, and its text is ambiguous. FF ¶ 10.

In substance, Manheim and Ban agreed to an equal division of the economic returns from WestCo and DVRC relating to the EB-5 Business. Ban only asked for 40%, but Manheim believed that it would be more fair and avoid disputes in the future if they had equal shares. Manheim Tr. 508-09. Manheim **[*17]** was not willing to give up control over the business, but he was willing to give Ban half of the economic returns. *Id.* at 509.

To implement that deal, they agreed on the three key points:

• First, they would be reimbursed for items directly related to the business of WestCo and DVRC, i.e., for legitimate business expenses.

• Second, they would true up any expenses not directly related to the business of WestCo and DVRC that they nevertheless ran through the business.

• Third, they would allocate distributions from WestCo and DVRC so that they each received an equal share.

FF ¶ 10.

The second deal point recognized that to obtain favorable tax treatment, both Manheim and Ban wanted to have DVRC and WestCo bear as many of their personal expenses as possible. But that created a risk that one of them would charge more personal expenses to the business than the other. They therefore agreed that "any salary payments and expense reimbursement for items not directly related to the business of West 36th and [DVRC] will be equal." JX 68 ¶ A. They subsequently agreed upon a total draw of $25,000 each per month, or $300,000 each per year. Any expenses that they ran through the business would be credited **[*18]** against this amount.[4]

The third deal point recognized that Manheim had a meaningfully greater equity stake in the business. DVRC's sole member was WestCo, and Manheim owned 70% of WestCo, while Ban owned 15%. Their agreement represented a commitment by Manheim to pay over to Ban a share of the cash flows he received from WestCo or DVRC. FF ¶ 10(c).

As a matter of economic substance, the Ban Profit-Sharing Agreement meant that Manheim and Ban each would receive $300,000 in annual compensation from the EB-5 Business, plus reimbursement of legitimate expenses, plus an equal stake in the profits of the business. *Id.* ¶¶ 10-11. Setting aside the potential dilution from the 2012 EastCo Loan, the agreement meant that Manheim would receive 42.5% of the profits, Ban would receive 42.5% of the profits, and Mandle would receive the remaining 15%. On a fully diluted basis that took into account the 2012 EastCo Loan, the allocation was as follows: Bamford 49%, Mandle 7.65%, Manheim 21.675%, and Ban 21.675%. *Id.* ¶ 11. Bamford's beneficial interest in WestCo remained subject to Manheim's ability to cause WestCo to repay the 2012 EastCo Loan.

G. The Creation Of ReathCo

In November 2014, Manheim formed **[*19]** ReathCo. Manheim Tr. 510. Manheim controls ReathCo, and he and his wife own the equity. PTO ¶ 30.

Manheim initially formed ReathCo to provide investment advice to a friend who had inherited more than $1 billion. Manheim Tr. 513; *see* Bamford Tr. 34; Ban Tr. 209. In return, Manheim's friend agreed to pay ReathCo an advisory fee of approximately $500,000 per year. Ban Tr. 209. Manheim envisioned that ReathCo would become the centerpiece of a larger financial advisory business. *Id.*; Manheim Tr. 514.

By the time he created ReathCo, Manheim's relationship with the Swarthmore Group had changed. He had joined the firm as part of a succession plan that contemplated Manheim buying out Mandle and her co-owner. During 2014, Manheim negotiated to purchase the business, but the two sides could not agree on price. Also during 2014, the EB-5 Business was transitioning from a side hustle into a more significant commitment. The time required to solicit investors for DVRC cut into Manheim's ability to devote time to the Swarthmore Group. *See*

[4] For example, if Manheim caused DVRC to pay the rent for his apartment at a cost of $2,000 per month, then that amount would be credited against his $25,000 and he would receive $23,000 instead of $25,000. The same was true for Ban. *See* JX 81; JXs 97-101; JX 128; Ban Tr. 261.

Manheim Tr. 511-13.

Manheim decided it was time to pursue the opportunities he had with ReathCo and DVRC. In December 2014, Manheim and Ban resigned from the Swarthmore **[*20]** Group.

H. The Management Agreements

By the time they left the Swarthmore Group, DVRC had raised approximately $15 million from foreign investors. *Id.* at 524-25. But those funds could not be released from escrow until DVRC received approval from the USCIS to make a qualifying investment. *Id.* at 518-19. DVRC therefore was not yet generating income.

WestCo had obtained capital from Bamford, and Manheim was using WestCo for some other businesses, but WestCo was not generating income consistently. ReathCo, by contrast, had revenue of $500,000 per year. Manheim therefore decided to use ReathCo as his central business vehicle. That way, ReathCo could issue paychecks to Manheim and Ban, provide them with health benefits, and cover their expenses. As long as WestCo had funds, Manheim would cause WestCo to reimburse ReathCo for those amounts. If WestCo did not have the money, then ReathCo and WestCo would accrue the amounts due as a loan from ReathCo to WestCo. Once DVRC started making money and making distributions to WestCo, then WestCo could pay back ReathCo. *See id.* at 515-17; JX 74.

Manheim and Ban anticipated that after DVRC became successful, then DVRC would pay ReathCo directly in the form **[*21]** of a management fee. They expected that once that day came, they would eliminate the WestCo payment obligation. *See* Manheim Tr. 515 ("And it was envisioned that we would probably end up migrating and getting rid of the West one.").

To document these concepts, Manheim caused ReathCo to enter into two management agreements (the "Management Agreements"). Both were dated December 21, 2014, and made effective as of January 1, 2015.

The first agreement was between WestCo and ReathCo. JX 77 (the "WestCo Management Agreement"). It committed WestCo to pay $600,000 per year to ReathCo. In return, ReathCo agreed to provide "management services to West 36th as necessary for the day to day operations of West 36th." *Id.* The purpose of this agreement was to make WestCo responsible for the compensation that ReathCo was paying to Manheim and Ban. FF ¶ 14; Ban Tr. 215-16.

The second agreement was between DVRC and ReathCo. JX 78 (the "DVRC Management Agreement"). It committed DVRC to pay ReathCo a management fee equal to 0.25% of its assets under management ("AUM"). In return, ReathCo agreed "to provide management services to West 36th as necessary for the day to day operations of DVRC." *Id.*

Manheim picked **[*22]** 25 basis points because he thought it was a reasonable figure. He knew that the Swarthmore Group placed its clients in funds that charged fees ranging from 10 basis points to approximately 1% of AUM. The fees for fixed income investments were around 25 basis points. Manheim admitted that there "[w]asn't too much science attached to it." Manheim Tr. 523. DVRC intended to charge its foreign investors a management fee equal to 25 basis points of AUM, so that amount would act as a passthrough from the funds to DVRC to ReathCo. *See* Ban Tr. 214-15.

DVRC did not yet have AUM, and it would not have AUM until DVRC made its first USCIS-approved investment. By putting the DVRC Management Agreement into place, Manheim and Ban were planning for the future.

Manheim signed the Management Agreements on behalf of ReathCo. Ban signed on behalf of WestCo and DVRC.

Both Management Agreements provided for prorated payments on the first day of the month. Both provided that payments not paid on the due date "will accrue with 10% annual interest." JX 77; *accord* JX 78.

I. Manheim Terminates The Management Agreements.

During the first half of 2015, tension grew between Ban and Manheim. The principal cause was the **[*23]** amount of funds that Manheim withdrew from the business for personal spending. Through the Ban Profit-Sharing Agreement, Manheim and Ban had agreed that they each would receive $300,000 in annual compensation, plus reimbursement of legitimate expenditures, but Manheim could not keep his personal spending within those limits. He withdrew additional amounts unilaterally to support his lifestyle. FF ¶ 20.

In an email sent on June 30, 2015, Ban projected that DVRC would run out of cash by the end of the 2015. JX 111 at 2. Manheim believed that with additional spending cuts, the cash they had was "enough to get the business through to June 2016 on life support." *Id.* at 1. Manheim also thought that if the USCIS did not give DVRC the approvals to make a qualifying investment by April 2016, then DVRC would lose its deal with the PTC, and the EB-5 Business would be a failure in any event. *Id.*

In his June 30 email, Manheim made specific commitments to reduce the cash burn associated with the EB-5 Business:

> As of June 30th (today) West 36th will cease to pay Reath & Company a management fee. I will not be getting compensated in any way by West / DVRC for anything I do going forward in the company. **[*24]** This is a condition of the additional Bamford money coming into the entity. The only thing that will be getting paid for by West 36th will be the Porsche as its lease runs out in April of next year. Reath & Company will be paying the office rent at Rittenhouse square and for both Bloomberg's. Reath will also pay for my healthcare. If I am correct and $620k is the starting cash # for West etc — so please update me on the outstanding payables—then that is circa $51k per month to spend on getting this through the gauntlet. I believe that West has paid more than 6 month's management fee to Reath so far this year—I will check the transfer's [sic] but you probably have that information to hand—whatever is in excess of the $300k paid so far this year to Reath will be a payable back to West 36th from Reath. The timing of this is most likely at year end given cash flow etc etc. Removing the payment relationship between the two companies is also sensible going forward from a management perspective and will provide better clarity for accounting and what not. . . .
>
> We need to regardless of your's [sic] or my personal contractual arrangements move all the employees from Reath to West 36th. They are **[*25]** expense's [sic] of West 36th.

Id.

The parties dispute whether this email memorialized the termination of both Management Agreements or only the WestCo Management Agreement. Manheim maintains that he only terminated the WestCo Management Agreement. Ban maintains that Manheim terminated both Management Agreements.

Both accounts are plausible. Manheim testified that he was taking steps to limit the cash burn that had caused tensions with Ban. He pointed out that the management fee that WestCo paid ReathCo was part of the cash burn. Manheim said he cut off that payment obligation. He explained that the DVRC Management Agreement was not a source of expense because DVRC did not yet have AUM. Terminating the DVRC Management Agreement did not affect cash flow, so he said he had not terminated that agreement.

Ban understood that Manheim's email terminated both agreements.[5] He believed the termination had a broader administrative purpose, as Manheim's email explained. *See* JX 111 at 1 ("Removing the payment relationship between the two companies is also sensible going forward from a management perspective and will provide better clarity for accounting and what not."). He believed that Manheim's email **[*26]** addressed both WestCo and DVRC, not just WestCo. *See id.* ("I will not be getting compensated in any way by West / DVRC for anything I do going forward in the company.").

If the only evidence about what happened with the Management Agreements consisted of Manheim's June 30 email and the witness testimony from Manheim and Ban, then I would find Manheim's account more persuasive. But the parties' subsequent conduct provides convincing evidence to support Ban's version of events. In October 2015, Ban wrote an email to Manheim that referred back to the discussions that led to the termination email and which referenced both WestCo and DVRC, not just WestCo. *See* JX 129 at 2 (October 2015 email from Ban summarizing his understanding of the June 30 email; "I felt that [the] only thing I really won from our issues in June was that you agreed to not take any more money out of DVRC/W36"). Likewise, in April 2017, Ban wrote an email to DVRC's outside accountants in which he instructed them that a transfer of $100,000 from DVRC to ReathCo in December 2015 needed to be treated as a loan. JX 423 at 1. He again referred to both entities, not just WestCo. *Id.* ("Joe and I had previously contemplated a **[*27]** management contract between Reath and West36, but decided to keep Reath not involved in management of

---

[5] Ban Tr. 217 ("[T]hese agreements were canceled."); Ban Tr. 397 ("The Reath—the only DVRC-Reath management agreement that I was aware that actually existed at one point was May of 2014, which we agreed to get rid of and cancel in the middle of 2015.").

[West36] or DVRC."). Ban also cited budgets for the EB-5 Business that did not contemplate any management fees for ReathCo.[6]

Most significantly, as discussed later, Manheim, Ban, and Bamford spent the last months of 2015 and the beginning of 2016 negotiating over the Reorganization. Those discussions specifically addressed the allocation of cash flows from DVRC, and they proceeded on the assumption that (i) Manheim and Ban each were receiving $300,000 in compensation, plus benefits and the reimbursement of legitimate expenditures, and (ii) Manheim, Ban, and Bamford would receive equal shares of the net income from the EB-5 Business, after expenses that included officer compensation. No one mentioned the ReathCo Management Agreement or suggested that ReathCo would receive 0.25% of AUM off the top. In the Factual Findings, the court found that Manheim did not make any misrepresentations in connection with the Reorganization. *See* FF ¶ 51. The court could not make that finding if the ReathCo Management Agreement remained in existence.

As of June 30, 2015, neither the WestCo Management **[*28]** Agreement nor the ReathCo Management Agreement remained in effect. *Id.* ¶ 21.

J. Manheim Obtains Additional Financing.

To help DVRC survive until it received approval to make a qualifying investment, Manheim sought additional capital from Bamford. The cash infusions were documented in 2015 in the form of a second convertible loan agreement between EastCo and WestCo. JX 131 (the "2015 EastCo Loan"). Under its terms, EastCo committed to extend an additional $500,000 in credit to WestCo, with $400,000 of that amount already drawn. EastCo had the option to convert the full amount of the loan into a minimum of 2,900 WestCo shares and a maximum of 4,000 WestCo shares, depending on WestCo's valuation at the time of the conversion. JX 115.

The effect of the conversion right was to give EastCo a greater level of beneficial ownership in WestCo. Because Bamford already beneficially owned virtually all of EastCo's equity (subject to Manheim's ability to cause EastCo to repay the 2012 EastCo Loan), the conversion right also had the effect of increasing Bamford's level of beneficial ownership in WestCo. Depending on the valuation of WestCo, Bamford's beneficial ownership ranged from 67.1% and 79.4% **[*29]** of WestCo's equity.[7] At the upper end of that range, Mandle beneficially owned 3.1% of WestCo's equity (150 / 4,861). Under the Ban Profit-Sharing Agreement, Manheim and Ban shared equally in the remaining 17.6% of the economic returns, for 8.8% each. *Id.* ¶ 18.

Bamford funded the 2015 EastCo Loan by purchasing 500,000 shares of non-voting EastCo B common stock at a price of $1 per share. PTO ¶ 44. Under a stockholders' agreement, Bamford held a mandatory redemption right that enabled him to compel EastCo to redeem his shares if he disagreed with any of Manheim's decisions. JX 107 ¶ 6.6.

K. DVRC Receives Approval To Make Investments.

In February 2016, the USCIS granted DVRC approval to make qualifying investments. That meant that DVRC could deploy the capital it had received from the foreign investors. DVRC also could begin charging fees.

DVRC's first investment fund was DVRC Pennsylvania Turnpike LP ("PTC I"). As of May 2016, PTC I was fully subscribed and closed to new investors. There were 400 investors in PTC I, each of whom contributed $550,000 to the fund. Of that amount, $500,000 was for a qualifying investment under the EB-5 Program, and $50,000 was a syndication fee payable to DVRC, **[*30]** which DVRC had to share with the agents based in Asia who located the investors. In total, the investors contributed $200 million for qualifying investments and $20 million for syndication fees. PTC I loaned the $200 million to the PTC at an interest rate of 2% per annum. The PTC used the funds for a highway construction project. *See* PTO ¶¶ 60-61, 63, 66.

DVRC followed PTC I with DVRC SEPTA II LP ("SEPTA II"), which used the same structure as PTC I. As of

[6] *See* JX 1628; JXs 1716-17; Ban Tr. 220-24, 301.

[7] At the time, WestCo had 1000 shares outstanding and had committed to issue a 49% interest to EastCo if WestCo converted the 2012 EastCo Loan into equity. The 2012 EastCo Loan thus effectively represented an interest in 961 shares. Consequently, on a fully diluted basis, the 2015 EastCo Loan represented beneficial ownership of between 59.7% of WestCo's equity at the low end (2,900 / 4,861) and 67.1% of WestCo's equity at the high end (4,000 / 5,961). Adding the low-end figure for the conversion of the 2015 EastCo Loan to the 961 shares from the 2012 EastCo Loan resulted in Bamford having beneficial ownership of 79.4% of WestCo's equity (3,861 / 4,861). FF ¶¶ 17-18.

November 2019, SEPTA II was fully subscribed and closed to new investors. There were 479 investors in SEPTA II who contributed a total of $263.45 million, with $239.5 million for qualifying investments and $23.95 million for syndication fees. SEPTA II loaned the $239.5 million to SEPTA at an interest rate of 2% per annum. SEPTA used the funds to improve its public transportation systems. *See id.* ¶¶ 60-61, 64, 66.

DVRC followed SEPTA II with DVRC Pennsylvania Turnpike II LP ("PTC II"). As of January 2021, PTI II was partially subscribed and remained open to new investors. At the time, there were 367 investors in PTC II who had contributed a total of $201.85 million, with $183.5 million for qualifying investments and $18.35 million for **[*31]** syndication fees. To date, PTC II has loaned $183.5 million to the PTC at a rate of 2% per annum. The PTC has used the funds for highway construction projects. *See id.* ¶¶ 60-61, 65-66.

DVRC serves as the general partner of each fund. All fund expenses are born by the investors in the funds. *See* Ban Tr. 271-72. Under the agreements governing the funds, DVRC has a profit interest that entitles it to receive 75% of the profits that each fund generates. FF ¶ 16. Each fund's expenses include a management fee for DVRC equal to 0.25% of AUM. *Id.*

L. The Reorganization

With the prospect of fee-generating investments on the horizon, Manheim, Ban, and Bamford began discussing the Reorganization in fall 2015. At that time, DVRC remained a wholly owned subsidiary of WestCo. The economic returns from DVRC, however, were divvied up through a complex series of arrangements that included (i) Manheim, Ban, and Mandle's status as record owners of stock in WestCo, (ii) Bamford's beneficial interest in WestCo through the 2012 and 2015 EastCo Loans, and (iii) the Ban Profit-Sharing Agreement. FF ¶¶ 23-25.

After DVRC received approval to make investments in February 2016, discussions about the Reorganization **[*32]** intensified. Bamford was interested in holding his interest through an entity rather than personally, which he believed would help minimize his taxes in the United Kingdom. *See, e.g.*, JX 168; JX 174. A major consideration was proposed federal legislation that would have prohibited foreign control or ownership of an EB-5 regional center. *See* JX 126. The parties believed that they could avoid any risk posed by Bamford's ownership in DVRC by creating a structure in which Bamford would hold a passive stake through a holding company. FF ¶ 26.

On March 18, 2016, Manheim formed Penfold, L.P., a Delaware limited partnership, with the expectation that it would serve as the new holding company for DVRC. When Manheim formed Penfold, he identified ReathCo as its general partner on the certificate of formation. It was a logical entity for Manheim to use, but Bamford and Ban had not agreed on ReathCo serving in that role. Manheim, Ban, and Bamford also had not agreed on the terms of Penfold's limited partnership agreement. *Id.* ¶ 27.

To carry out the Reorganization, Manheim and Ban drafted two agreements. The first agreement admitted Manheim, Ban, and Bamford as members of DVRC. *See* JX 452 (the "Admission **[*33]** Agreement"). The second agreement effectuated a contribution of their member interests in DVRC to Penfold. JX 252 (the "Contribution Agreement").

Manheim and Ban prepared both agreements in June 2016. FF ¶¶ 28, 42. For tax purposes, Manheim and Ban tried to backdate the agreements as if they had been executed on June 1, 2015. *Id.* ¶¶ 28, 43. They did that for the Admission Agreement, which was made effective among the parties as of June 1, 2015. *Id.* ¶ 48. They were not able to do that for the Contribution Agreement, because Manheim had not formed Penfold until March 2016. *Id.* ¶ 43. The Contribution Agreement therefore remained dated as of June 10, 2016. Manheim Tr. 556-57.

1. The Admission Agreement

The Admission Agreement contained a series of significant provisions. Three are straightforward:

- In paragraph 1, DVRC and WestCo admitted Manheim, Bamford, and Ban as "Non Managing Member[s]" of DVRC. JX 452 ¶ 1.

- In paragraph 2, the parties agreed that "the Managing Member and Non Managing Members shall have and own the membership interests, and capital accounts set forth in Exhibit B." *Id.* ¶ 2.

- In paragraph 3, the parties agreed that the DVRC LLC Agreement would constitute the operating **[*34]** agreement of DVRC. *Id.* ¶ 3.[8]

---

[8] Technically, the Admission Agreement adopted an agreement that appeared in the form attached as Exhibit C as

In addition to these provisions, the parties agreed in paragraph 4 of the Admission Agreement to amend the DVRC LLC Agreement to add a new Article XIII, addressing "Profits, Losses, and Distributions." *Id.* ¶ 4. The new article contained two provisions: Sections 13.01 and 13.02.

Section 13.01, titled "Allocation," stated: "For financial accounting and tax purposes the Cash Flow shall be determined on an annual basis and shall be allocated to the Members in proportion to each Member's relative interest in the Company as set forth in Exhibit 1 and after allocating for appropriate Officer Compensation." *Id.* ¶ 4(b) (the "Allocation Provision").

The phrase "appropriate Officer Compensation" referred to the compensation that Manheim and Ban were receiving for running the business. Under the Ban-Profit Sharing Agreement, Manheim and Ban were receiving a salary of $300,000 per year plus benefits and the reimbursement of legitimate expenditures. Bamford understood that this was the level of compensation and benefits that Manheim and Ban were receiving and would continue to receive. The Allocation Provision did not cap the amount of officer compensation that DVRC could **[*35]** pay. It rather sought to confirm that the salary and benefits that Manheim and Ban received would be treated as compensation and not as a distribution of cash flow. The provision demonstrates that the parties discussed the topic of the cash flows that each individual was receiving and could be expected to receive going forward.

Section 13.02, titled "Distributions," stated: "The Managing Member shall determine and distribute available Cash Flow. Available Cash Flow, as referred to herein, shall mean the cash of the Company available after appropriate provision for expenses and liabilities, as determined by the Managing Member." *Id.* (the "Distribution Provision"). The Distribution Provision thus authorized WestCo, as the Managing Member, to determine the "appropriate provision for expenses and liabilities." *Id.* Once WestCo had made that determination, the Distribution Provision required that WestCo distribute the available cash flow to the members. Like the Allocation Provision, the Distribution Provision did not cap the amount of expenses or liabilities that the Company could incur, and it granted WestCo the authority to exercise judgment when determining what reserves were necessary. **[*36]** The provision demonstrates that the parties discussed the topic of distributions and established an expectation that available cash flow would be distributed to the members.

Manheim and Ban separately agreed that "[u]pon the signing" of the Admission Agreement, the Ban Profit-Sharing Agreement terminated. JX 89. Because they backdated the Admission Agreement, the reference to "[u]pon the signing" is ambiguous. They logically intended to refer to June 1, 2015, consistent with their desire to make the new equity-ownership arrangement effective as of that date. FF ¶¶ 41, 48.

After the execution of the Admission Agreement, (i) WestCo owned a 10% interest in DVRC as its managing member, and (ii) Manheim, Ban, and Bamford each owned a 30% interest in DVRC as non-managing members. The Admission Agreement did not elaborate on the distinction between managing and non-managing members or define the rights of each. The DVRC LLC Agreement did not shed light on those subjects either, because it continued to contemplate a single-member, member-managed LLC.

2. The Contribution Agreement

The second agreement that Manheim and Ban prepared was the Contribution Agreement. The recitals to the Contribution **[*37]** Agreement stated:

> WHEREAS, Parties [sic] currently hold interest in Delaware Valley Regional Center, LLC ("DVRC") Delaware [sic] limited liability company;
> WHEREAS, each of Parties [sic] is the record and beneficial owners [sic] of 1/3 of all of the share capital, securities, shares or other equity interests of any kind (collectively, Parties own 100% of Penfold) of Penfold [sic]; and
> WHEREAS, Parties [sic] desires [sic] to make a contribution of their membership interests held collectively by the Parties in DVRC to Penfold, subject to the terms and conditions herein below.

JX 252 at 1. The only parties to the Contribution Agreement were Manheim, Bamford, Ban, and Penfold itself.

The only substantive provision of the Contribution Agreement provided as follows: "Effective upon the execution of this Agreement, Parties [sic] hereby will contribute to Penfold, [sic] their membership interests held in DVRC." *Id.* ¶ 1.

DVRC's operating agreement. The record does not contain a version of the Admission Agreement that attaches an Exhibit C, but the circumstantial evidence indicates that this was a reference to the DVRC LLC Agreement that Duane Morris prepared in March 2016.

Through the Contribution Agreement, the parties agreed that the limited partners owned 100% of the equity interest in Penfold. As a consequence of this agreement, the general partner interest did not carry any economic rights. Manheim Tr. 684-85.

3. The Signing Of The Agreements

Manheim **[*38]** traveled to the United Kingdom in early June 2016. During the trip, Manheim visited Bamford, and they signed both agreements. FF ¶¶ 45-46.

Bamford and Manheim also amended the 2012 and 2015 EastCo Loans to eliminate their convertibility features. PTO ¶ 74. That step was necessary to avoid the risk posed by pending federal legislation addressing foreign ownership of EB-5 businesses, because the two loans gave EastCo, a foreign entity, beneficial ownership of at least 79.4% of WestCo's equity (subject to WestCo's ability to repay the 2012 EastCo Loan). If WestCo remained the managing member of DVRC, as contemplated by the Admission Agreement, then a foreign entity could be deemed to control DVRC. FF ¶ 49.

Bamford made major economic concessions by executing those agreements. Before the restructuring, Bamford beneficially owned a fully diluted equity stake in WestCo of at least 79.4%. Because WestCo owned 100% of DVRC, Bamford beneficially owned a similar percentage in DVRC. But those figures exaggerate matters to some degree, because WestCo had the ability to repay the 2012 EastCo Loan and eliminate the right to convert shares comprising 49% of WestCo's equity. With the USCIS approving **[*39]** DVRC's ability to make qualifying investments, the value of DVRC and WestCo might well have made it rational for WestCo to repay the 2012 EastCo Loan. Without the 2012 EastCo Loan, Bamford beneficially owned a 59.6% interest in DVRC ((79.4 - 49) / 51). Through the Reorganization, he accepted a 30% interest in DVRC, which he held through Penfold. Although that exchange might seem economically detrimental, it also negated the threat of potential federal legislation addressing the ownership of an EB-5 business by a foreign national and facilitated Bamford's goal of tax minimization. *See id.*

Ban benefited from the Reorganization. Before executing the agreements, he owned rights to 8.8% of the fully diluted returns from WestCo and DVRC. After executing the agreements, Ban owned rights to 31.5% of the returns from WestCo and DVRC. He beneficially owned a 30% equity stake in DVRC through Penfold, and with Bamford having waived the convertibility feature on the 2012 and 2015 EastCo Loans, Ban's 150 shares in WestCo again represented 15% of its equity, giving him beneficial ownership of an additional 1.5% stake in DVRC. Relative to Manheim, Ban lost ground, because Ban gave up his rights under **[*40]** the Ban Profit-Sharing Agreement. What Ban gained was clear documentation of his economic interests, which is something he craved. *See id.* ¶ 50.

What the Reorganization did not contemplate was the DVRC Management Agreement. By giving ReathCo a right to a management fee equal to 0.25% of AUM, the DVRC Management Agreement affected the allocation of the returns from the EB-5 Business that Manheim, Ban, and Bamford sought to allocate through the Admission Agreement and the Contribution Agreement.

There is no evidence that the parties took into account the DVRC Management Agreement when negotiating the Reorganization. Bamford understood that Manheim and Ban were receiving salaries of $300,000 per year, plus reimbursement of legitimate business expenses. No one suggested that through ReathCo, Manheim would receive additional amounts because of the DVRC Management Agreement. Whether that agreement remained in effect had particular significance for Ban, because as long as the Ban Profit-Sharing Agreement remained in effect, he received half of the economic benefits it generated. Once Ban agreed to terminate the Ban Profit-Sharing Agreement, all of the economic benefit from the DVRC Management **[*41]** Agreement went to Manheim.

The DVRC Management Agreement would obligate DVRC to pay a material percentage of its revenue to ReathCo. Under the agreements governing its funds, DVRC is entitled to a profit interest equal to 75% of the profits that the funds generate. The funds invested 100% of their AUM in loans that paid interest of 2% per year, so DVRC's maximum profit interest would equal 1.5% of AUM. DVRC also was entitled to a management fee from the funds equal to 0.25% of AUM. Together, DVRC's maximum revenue was 1.75% of AUM. The DVRC Management Agreement would have committed DVRC to pay 1/7 of that amount, or approximately 14%, to Manheim.[9]

---

[9] The actual percentage that Manheim received would be higher, because the funds must bear their expenses, and the profit interests is net of expenses. Including expenses reduces the denominator (the 1.75%) and increases the percentage represented by the numerator (the 0.25%). The calculation

In terms of the allocation of the cash flows of the business, the existence of the DVRC Management Agreement was a material fact. Manheim, Ban, and Bamford were seeking to allocate the returns from the EB-5 Business in a fair and transparent manner. In the context of those discussions, Manheim had an obligation to raise the DVRC Management Agreement if it remained in effect.

In the Factual Findings, the court made the following finding:

> Bamford and Ban executed the agreements knowingly and voluntarily. The evidence does not support a finding of **[*42]** any misrepresentations by Manheim in connection with the restructuring of DVRC, the DVRC Admission Agreement, or the Contribution Agreement.

FF ¶ 51. It is only possible to make that finding if the DVRC Management Agreement terminated in June 2015 such that it was no longer in effect and Manheim had no obligation to raise it.

M. A Time Of Coexistence

After the Reorganization, Manheim, Ban, and Bamford co-existed for a time. Money began to flow. Ban handled the day-to-day operations. Manheim provided big-picture oversight and maintained relationships with key stakeholders.

Bamford was optimistic about the prospects for the EB-5 Business. He expected DVRC to make distributions, and he anticipated using them to make investments with Manheim. *See* Bamford Tr. 35.

During 2016, Manheim's brother, Frank, relocated to Philadelphia with his family. Frank Tr. 756. Frank had worked in investment banking for twelve years and was looking to do something entrepreneurial. *See* Manheim Tr. 566; Frank Tr. 755, 757. Frank joined ReathCo, where he spent the bulk of his time analyzing potential investments for Bamford. Frank Tr. 756-57.

In December 2016, Bamford moved to the United States. DVRC provided him with **[*43]** an apartment in Philadelphia. JX 331. He participated in meetings of the WestCo Board, engaged in efforts to market DVRC to investors, and traveled to China with Manheim. *See, e.g.*, JX 330; JX 338; JX 441.

---

above the line thus understates the significance of the DVRC Management Agreement.

N. The SEC Inquiry

In February 2017, the Securities and Exchange Commission ("SEC") sent a letter of inquiry to DVRC asking for twenty-three categories of documents. JX 385. That spelled trouble. Manheim and Ban had spent years operating in start-up mode, had not adhered to corporate formalities, and had not kept diligent records. They needed help getting their house in order. Manheim also did not want any negative repercussions with the PTC or SEPTA.

Manheim reached out to Mezzaroba for help. Manheim Tr. 564-65; Mezzaroba Tr. 780. Mezzaroba was an experienced lawyer and a known quantity. He was a longtime friend of Manheim, and he was one of the first people with whom Manheim discussed the EB-5 Program. He had been involved with DVRC from time to time, and he had helped arrange for DVRC to receive the $500,000 loan in 2013 from the Delaware Valley Regional Economic Development Fund, where he served as a trustee. *See* Mezzaroba Dep. 80-85, 107; PTO ¶ 72. Mezzaroba also had connections **[*44]** at the PTC and SEPTA that gave him credibility with those institutions. Manheim Tr. 564-65.

On March 15, 2017, the WestCo Board met. Manheim and Bamford attended in person. Ban attended by phone. During the meeting, the Board resolved to hire Mezzaroba as general counsel. JX 399.

When he agreed to help, Mezzaroba viewed Manheim and Ban as "the two dogs that caught the fire truck." Mezzaroba Tr. 781. He thought the rapid expansion of the business had gotten away from them, and he needed to help them catch up. But after digging into DVRC's documentation, he realized that he had a mess on his hands:

> So as we were putting together documents to respond to the SEC, we found that there was no rhyme or reason to the files. Each individual investor at that point had [invested $500,000 for a total of] $200 million, which means there were 400 investors. They didn't have individual files. There was no way to really track them. They had immigration files that had to be attached, as well as there was -- the books and records were a mess.
>
> So pretty much in the very beginning, I realized it was going to be a lot of work. And on top of that, we had the time clock of the SEC beating down on us.

Id. at 782. **[*45]**

Mezzaroba recommended hiring Frank to assist in responding to the SEC. Manheim Tr. 566. Frank was another known quantity, and he had experience conducting FINRA investigations from his days in investment banking. *Id.*; Frank Tr. 755, 763. He had the skills to do the heavy lifting necessary to prepare and assemble documentation for the SEC. *See* Frank Tr. 755-56, 766-67.

On May 22, 2017, the WestCo Board held an in-person meeting to address a list of items that were part of the effort to clean up the affairs of WestCo and DVRC. Manheim and Bamford attended. JX 465. The actions they took included appointing Frank and Mezzaroba as vice presidents of WestCo, each with a salary of $150,000 annually. JX 466.

O. The June 2017 Board Meeting

As part of the process of responding to the SEC, DVRC "had to go through a review and kind of figure out what were the agreements that were outstanding that had potential disclosure, should be disclosed at this stage, or would be disclosable kind of thing." Manheim Tr. 569. The Management Agreements surfaced during that process.

The rediscovery of the Management Agreements raised the question of whether to simplify DVRC's financial statements by (i) having DVRC **[*46]** pay a management fee to an entity and (ii) shifting all of DVRC's payroll and other expenses to that entity (the "Management Company Structure"). Mezzaroba liked the Management Company Structure. He believed that it would be easier to present DVRC's financial statements to regulators like the SEC and the USCIS. Mezzaroba Tr. 784-86; *see* Manheim Tr. 570.

As the court has found, Manheim had terminated both Management Agreements on June 30, 2015. There was, however, no formal documentation of that event. Manheim, Ban, and Bamford had created and backdated other documents, such as the DVRC LLC Agreement and the Admission Agreement. If everyone had been on board with saying that the Management Agreements had never actually been terminated, then it would be easy to act as if that were true.

No one saw any need to reactivate the relationship between WestCo and ReathCo. Manheim had anticipated that once DVRC was generating income, the WestCo Management Agreement would become superfluous. *See* Manheim Tr. 515. DVRC had reached that point.

The real question was whether to use the ReathCo Management Agreement as the basis for implementing the Management Company Structure, or whether to establish **[*47]** a new entity and create a new agreement. Conversations about what to do started in March 2017 and went on as the SEC process unfolded. *See id.* at 570 ("[T]hat conversation started in March after we started going through the review folders and started looking at everything."); Mezzaroba Tr. 784-85 (testifying that there were discussions "after or in the middle of this SEC [inquiry]" about "whether it was cleaner to move all of management off of DVRC's payroll").

The WestCo Board considered the issue during an in-person meeting on June 7, 2017 (the "June 2017 Meeting"). The items of business for the meeting included (i) expanding the WestCo Board and filling the newly created vacancies with Frank and Mezzaroba, (ii) "Review and discuss current 17-week cash flow budget," and (iii) "Discussion of role of Reath & Company as manager of DVRC." JX 479 at 1. The 17-week cash flow budget contemplated payments to ReathCo. Before the June 2017 Meeting, DVRC had not made payments to ReathCo. Manheim Tr. 569-70.

The minutes for the June 2017 Meeting are skeletal. They state only that "[d]uring today's meeting the Board tabled and approved the following motions," followed by a list of eight items. **[*48]** JX 480. The list includes "[a]ppointment of [Frank] and [Mezzaroba] as Board members" and "[a]ccept form & function of the 17-week cashflow." *Id.* The 17-week cashflow budget showed a series of weekly payments to ReathCo that varied in amount. JX 1740.

On the ReathCo issue, the minutes state:

> Move all executives off of DVRC payroll to Reath & Company or new entity and payroll is created for Chloe Deon and Kareem Rosser. Compensation will be transferred for [Frank] and [Mezzaroba]. Further, Board will evaluate Reath & Company vs. new entity as appropriate vehicle for executives and executive operations going forward.

JX 480. This is a reference to the Management Company Structure.

The minutes state that the WestCo Board approved moving "all executives . . . and payroll" to "Reath & Company or new entity." *Id.* In other words, the WestCo Board generally approved moving to the Management Company Structure. The minutes do not reflect a decision between ReathCo or a new entity. Instead, the minutes reflect that the Board determined to "evaluate" using ReathCo or a new entity. The minutes do not reflect any consideration of a management fee beyond the approval of the 17-week cashflow budget, which **[*49]** provided for payments to ReathCo. *See* JX 1740.

A particularly sharp dispute of fact exists as to what action, if any, the WestCo Board took during the June 2017 Meeting about DVRC paying a management fee to ReathCo. After the June 2017 Meeting, substantial sums of money began flowing from DVRC to ReathCo. In this litigation, Ban and Bamford challenged those transfers. Manheim responded by relying on the DVRC Management Agreement to validate the transfers. *See* JX 1104 at 10-11 (Interrog. 10); JX 1141 at 4-5 (same); Dkt. 320 at 8, 25-26; PTO ¶¶ 8, 16.

The June 2017 Meeting was the only time that the WestCo Board considered the relationship between DVRC and ReathCo. *See* Frank Tr. 761-62. The witnesses agree for the most part about what took place. Frank, Mezzaroba, and Manheim testified that the discussion focused on whether ReathCo should take on the responsibility of handling DVRC's payroll and expenses. Manheim Tr. 569-70; Frank Tr. 761-62; Mezzaroba Tr. 784-86. Mezzaroba recalled that Ban vehemently opposed using ReathCo as the management company, which led to a "blowup" with Manheim. Mezzaroba Tr. 785. Frank agreed that Ban expressed "concern around the expansion of the [ReathCo] role." **[*50]** Frank. Tr. 762.

Ban similarly recalled that the proposal was to shift the payroll and expenses out of DVRC and to place them in ReathCo or a different entity. Ban testified that he did not object to the idea of moving the payroll and other expenses to a management company, but that he was adamantly opposed to the entity being ReathCo. Ban Tr. 227-28. He insisted on a new entity, and he recalled a "big spat" about that issue. *Id.* at 412. Ban testified that no agreement was reached during the June 2017 Meeting, and that Manheim said that he would look into the possibility of creating a new entity. *Id.* at 228.

The witnesses generally agree that the WestCo Board did not engage in a meaningful discussion about the DVRC Management Agreement. Manheim, Mezzaroba, and Frank maintained that everyone understood that the DVRC Management Agreement remained in place. *See* Manheim Tr. 569-70; Frank Tr. 761-62; Mezzaroba Tr. 785-86. Frank testified that the existence of the DVRC Management Agreement was "taken as given." Frank Tr. 762. The agreement was not circulated in advance of the meeting. *See* JX 478; Mezzaroba Tr. 806. Only Mezzaroba testified that printed copies of the agreement were available **[*51]** during the meeting, and his testimony to that effect at trial went beyond his deposition, where he only recalled a discussion of the agreement. *Compare* Mezzaroba Tr. 786, *with* Mezzaroba Dep. 86-87.

Ban did not recall any discussion of the DVRC Management Agreement, and he insisted that there also was no understanding that the agreement remained in place. Ban Tr. 299, 383-85. On cross-examination, Ban maintained resolutely that Manheim wanted to have either ReathCo or the new entity receive a management fee, but that Manheim was proposing a new arrangement, not the activation of an existing arrangement. *See id.* at 389, 412. Ban said he was "adamantly against" a management fee going to ReathCo. *Id.* at 389. Bamford did not recall any discussion of the DVRC Management Agreement during the June 2017 Meeting. Bamford Dep. 532-33. Bamford testified that "there wasn't any discussion [during the June 2017 Meeting] about [ReathCo] being paid a management fee." Bamford Dep. 462.

The trial testimony supports a finding that the WestCo Board did not approve a management fee for ReathCo during the June 2017 Meeting. The limited contemporaneous documentation points to the same conclusion. There was **[*52]** no formal resolution approving a management fee or referencing the DVRC Management Agreement. By contrast, when considering other significant matters during 2017, the WestCo Board approved formal resolutions. *See* JXs 563-64; JX 581; JX 612; *see also* JX 603; JX 624.

Three weeks after the meeting, Ban asked about the plan to shift the payroll to a new entity or ReathCo. Manheim responded:

> The new entity is ongoing as discussed, but that is irrelevant really to the question of this as regardless what entity it is the policy as we have been discussing it will continue. The policy is namely the movement up and out of DVRC all executives and related compensation and the implementation of a management fee & expenses going forward from DVRC to Reath & Company whether it is vs 1.0 or vs 2.0. . . . As far as how the structure is concerned — regardless of vs 1.0 or vs 2.0 — it will be a multi-member llc with profits interests in the same vein as a private equity management entity (a la' KKR). As

> the AUM grows the management fees will grow and this flow will be taxable income which we will use to grow the overall businesses.

JX 497 (formatting altered). Manheim's email acknowledged the contemplation **[*53]** of a "new entity." He acknowledged that the version of the fee ("1.0 vs. 2.0") was still under discussion. And he asserted that regardless of whether ReathCo or a new entity served in the management company role, it would be a "multi-member llc with profits interests in the same vein as a private equity management entity." *Id.* ReathCo was not a multi-member LLC, and the DVRC Management Agreement did not give ReathCo a profit interest. It gave ReathCo a fee calculated as a percentage of AUM.

During post-trial briefing, the defendants contended that the court already determined in its Factual Findings that the WestCo Board approved paying a management fee to ReathCo during the June 2017 Meeting. They rely on the following language:

> In response to Ban's concerns and as a condition of the 2015 EastCo Loan, Manheim terminated the WestCo Management Agreement. Manheim's email did not expressly address the DVRC Management Agreement, but a preponderance of the evidence demonstrates that it was terminated as well. When the board of directors of WestCo approved a management fee to ReathCo in June 2017, that was a new agreement with ReathCo, not a continuation of the DVRC Management Agreement.

FF **[*54]** ¶ 21 (cleaned up). That finding was directed primarily at the termination of the DVRC Management Agreement. That finding was not intended as a determination that the WestCo Board approved a management fee to ReathCo in June 2017. In hindsight, the court should have drafted the factual finding to read, "To the extent the board of directors of WestCo approved a management fee to ReathCo in June 2017, that was a new agreement with ReathCo, not a continuation of the DVRC Management Agreement." The intent was to make clear that to the extent that occurred, then the arrangement was a new one, not a continuation of the DVRC Management Agreement. The Factual Findings did not attempt to determine what took place at the June 2017 Meeting with any degree of specificity.

Having considered the evidence and weighed the parties' testimony, I do not believe that the WestCo Board focused meaningfully on the DVRC Management Agreement during the June 2017 Meeting. The WestCo Board discussed whether to move to the Management Company Structure. When introducing the concept, Manheim may have referred to the DVRC Management Agreement and the fact that Manheim and Ban had contemplated something similar, but **[*55]** that was it. There was no board-level determination that going forward, DVRC would comply with the DVRC Management Agreement. There was a consensus that DVRC would move towards the Management Company Structure, but no consensus as to the entity or the details. Ban strongly opposed using ReathCo as the management company, but he was not against the Management Company Structure as a concept.

P. The Transfers After The June 2017 Meeting

After the June 2017 Meeting, money started flowing from DVRC to ReathCo. Manheim Tr. 570. The transfers do not appear to match up with the 17-week cash flow budget. They also do not self-evidently match up with the terms of the DVRC Management Agreement. That agreement called for ReathCo to receive an annual management fee equal to 0.25% of AUM, paid in monthly installments on the first of the month. It should have resulted in ReathCo receiving a designated amount on the first of the month.[10] Instead, wires went out to ReathCo at varying times and in varying amounts.[11] Rather than paying an AUM-based

---

[10] For example, assume that DVRC had approximately $414 million in AUM in 2017, consisting of the assets in PTC I, PTC II, and SEPTA II. *See* JX 1060 at 10. The DVRC Management Agreement would have resulted in ReathCo receiving an annual management fee of $1,035,000, payable in monthly installments of $86,250, with each installment due on the first of the month.

[11] *See, e.g.*, JX 494 at '003 (June 27, 2017 email from Manheim to Ban identifying wire transfer of $85,000 to ReathCo for management fee and expenses); JX 506 (June 28, 2017 email from Ban to Manheim, Frank, and Mezzaroba listing transfers to ReathCo); JX 520 (July 24, 2017 email from Frank to Ban stating, "We are moving money today to cover end of July and August expenses at [ReathCo]"); JX 532 (August 9, 2017 email from Frank to Ban stating, "To pay for outstanding payables at [ReathCo] for IT and the Union League, we have transferred $45,000 from the DVRC account"); JX 700 (April 30, 2018 email instructing bank to wire $128,915.63 from DVRC to ReathCo and copying Ban); JX 2052 (Frank emailing Ban about the details of various transfers that DVRC planned to make, including a transfer of $221,065.55 from DVRC to ReathCo).

management fee to ReathCo, it looks like ReathCo was receiving funds to cover Manheim's salary and benefits, plus reimbursement of expenses, plus variable and inconsistent **[*56]** additional amounts to which Ban objected. *See, e.g.*, JX 486; JX 495; JX 506; *see also* JX 674 (Manheim noting that "a bunch of the transfers to Reath and West [during 2017] were reimbursement for expenses").

Frank or another DVRC employee generally initiated the transfers, but Ban knew about them. Ban Tr. 391-92. Ban did not object to every transfer. He had made his objections to the management fee known during the June 2017 Meeting, and he questioned the transfers that took place during the month after the June 2017 Meeting. He recognized that some transfers were proper, such as for reimbursement of expenses. He believed there would be an overall true up at some point once the terms of the management agreement were established. *See id.* at 390, 394; JX 506 ("I assumed . . . that there would be true up at some point soon where money would be coming back to DVRC").

Q. The Recharacterization Of The Transfers As Management Fees

The transfers to ReathCo became management fees when DVRC prepared its audited financial statements for 2017. During that effort, a DVRC employee named Derek Chen calculated the amount of the monthly management fee that would have been due to ReathCo under **[*57]** the DVRC Management Agreement, then added those amounts as liabilities on DVRC's financial statements. For monthly amounts that were past due, he calculated and included the amount of interest due. Chen Tr. 744-45.

To determine how much of the management fee had been paid to ReathCo, Chen and a colleague reviewed all of the transfers from DVRC's bank account to ReathCo. *Id.* at 746. They designated all of the transfers as "management fees." *Id.* at 746-50. There was no investigation into whether the transfers actually were management fees.

Based on these calculations, DVRC's audited financial statements for the year ending December 31, 2017, disclosed that DVRC had incurred $945,434 for management fees in 2017. Those fees were in addition to $940,031 for officer compensation and $235,547 for salaries and wages during that same year. JX 1060 at '005. The notes to the financial statements stated:

> The Company has a management service agreement with Reath & Co. which is wholly-owned by one of the Company's directors . . . . For the year ending December 31, 2017, the Company incurred $945,434 of management fees and $81,240 of interest, of which $670,754 is due to Reath & Co. at December 31, **[*58]** 2017, and is included in due to related party on the balance sheet.

Id. at '011. The notes also disclosed that ReathCo "has paid for certain operating costs for the Company with no formal repayment terms" and that the balance owed to ReathCo as of December 31, 2017, was $338,760. *Id.*

R. Bamford Checks Out, Then Becomes Suspicious.

In late 2017, Bamford struggled with health problems. Bamford Tr. 173. Bamford also found himself strapped for cash following disagreements with his father. *See id.* at 156-57, 161. He became frustrated that DVRC was not generating the magnitude of distributions that he expected, and he questioned the level of expenses that DVRC was incurring. *See id.* at 162. But rather than fight with Manheim over these issues, he "decided not to get involved and clip a coupon," by which he meant to accept the distributions he received. JX 719 at '007.

In early 2018, Bamford returned to the United Kingdom. *See* Bamford Tr. 48, 109, 157. He delegated the task of supervising his investments to his advisors. But then a series of incidents caused him to grow concerned about how Manheim was operating DVRC.

From conversations with Manheim, Bamford understood that DVRC would make distributions **[*59]** twice a year, once in January and a second time in June. In January 2018, Bamford received a distribution of $1 million. Bamford asked Manheim about his expectations for June, and Manheim indicated that the distribution would be around the same amount. In April 2018, Manheim told Bamford the same thing. Six weeks later, Manheim told Bamford there were problems with the business and that DVRC would not be making a distribution in June. *Id.* at 39-40.

The sudden change of fortune did not make sense to Bamford, so he reached out to Ban. *Id.* at 41. Bamford did not have a personal relationship with Ban. To the contrary, Bamford had always trusted Manheim and been skeptical of Ban. *See* JXs 566-69; JX 571; JX 811; Bamford Tr. 78-80. Now, however, Bamford had become suspicious of Manheim, and he wanted to understand what was happening with DVRC. Bamford Tr. 41.

In a series of LinkedIn messages, Ban told Bamford that Manheim wanted Ban to leave DVRC. *See* JX 719. He also said that Manheim was taking lots of money out of the business. Bamford was surprised and wanted to learn more. Bamford also expressed his personal frustration with Manheim "running his life through the business." *Id.* at '003. **[*60]** They soon began discussing whether they could take control of DVRC. *Id.* at '009-10. They decided that Ban would contact a lawyer for advice. *Id.* at '016-17; *see* Ban Tr. 253.

In reality, Ban had been suspended from DVRC. During Frank's efforts to organize DVRC's records, he migrated DVRC's electronic documents to a new system. As part of that process, on May 14, 2018, Frank came across email exchanges between Ban and one of DVRC's representatives in China. The emails discussed threats that certain investors in DVRC's funds would file lawsuits if their investments were not redeemed after they received their green cards. JX 826 at '002, '006-07; Frank Tr. 763-64. In the e-mail chain, Ban proposed potential ways to resolve the lawsuits. *See* JX 826 at '003-14. Ban had not discussed the threatened lawsuits with anyone else at DVRC.

Frank brought the situation to Manheim. Ban and Manheim had endured a contentious relationship for years, and Ban and Frank had never gotten along. For Manheim, the discovery of the email exchanges was the final straw, because the emails raised concerns about compliance with the law and whether DVRC's disclosures to the SEC were correct. Manheim Tr. 572-73. Manheim **[*61]** immediately placed Ban on suspension pending the outcome of an investigation. *Id.* at 581-82; JX 709.

S. The Two Factions

After being suspended and connecting with Bamford, Ban began assembling the documents he possessed and considering ways that he and Bamford could take control of DVRC. *See* JX 722. He also began contacting lawyers about potential lawsuits. *See, e.g.*, JX 725; JX 795; JX 1905. At the same time, Bamford and his advisors began asking for information from DVRC. They asked about the change in the projected level of distributions. They also asked for accounting records for DVRC. *See, e.g.*, JX 791; JX 797; JXs 803-04; JXs 806-07; JX 1906. Like Ban, Bamford contacted a lawyer about potential litigation. *See* JX 788.

Ban traveled to London to meet with Bamford in person. Through their access to Ban's work computer, Manheim, Frank, and Mezzaroba discovered that Ban was meeting with Bamford. They concluded that Ban and Bamford were conspiring against them. *See* Manheim Tr. 585-86, 592.

T. The June 2018 Meeting

In one of his requests for information, Bamford asked when the next meeting of the WestCo Board would be. *See* JX 824. On June 25, 2018, Frank sent Bamford a notice of a meeting **[*62]** on June 28. JX 826. As the sole item of business, it identified "[t]he removal of Young Min Ban as an officer of [WestCo] and DVRC and as a (nominal) director of DVRC, for the reasons set forth in the annexed Statement of [WestCo's] President and Chief Executive Officer." *Id* at '001. The agenda did not list any of the issues that Bamford had been asking about. Bamford Tr. 43.

In his statement to the WestCo Board, Manheim reported that Ban had sent letters to investors that violated USCIS regulations. He also reported that Ban had entered into a finder's fee agreement with an agent that was prohibited by securities laws. JX 826 at '002-03.

On June 27, 2018, Bamford asked for more information about Ban's proposed termination. He also stated that he would be sending a formal demand for books and records. JX 840.

The WestCo Board convened on June 28, 2018. Bamford attended by phone and recorded the meeting, so there is a transcript of what occurred. JX 1923. Manheim had caused ReathCo to hire special counsel who led the meeting. *Id.* at 1-3. The discussions quickly became contentious. When the WestCo Board voted to terminate Ban, Bamford abstained. *Id.* at 33.

During the meeting, Bamford sought **[*63]** to have Manheim confirm that the officers' agreed-upon salaries were $300,000 per year. *Id.* at 50-58. Manheim was evasive, but generally indicated that the officers were receiving $300,000 per year plus benefits. *Id.*

After Ban's termination, Frank took over Ban's responsibilities. He later took on the title of Chief Operating Officer.

U. Manheim Removes Bamford From The WestCo

Board.

Immediately after the June 2018 meeting, Bamford instructed his assistant to "start a litigation file." JX 853; *see, e.g.*, JXs 855-57. On July 9, 2018, Bamford sent a books and records demand to Manheim that asked for thirty-six categories of documents. JX 880. On August 9, 2018, two of Bamford's agents performed an on-site records inspection at DVRC's office. JX 932.

Manheim, Frank, and Mezzaroba viewed Bamford as allied with Ban and a threat to DVRC. *See* Manheim Tr. 578. The day after Bamford's agents conducted their inspection, Manheim caused DVRC to transfer funds to WestCo so that WestCo could repay the loans from EastCo. *See* Mezzaroba Tr. 810-12. A loan agreement dated August 10, 2018, documented a loan in the amount of $1,798,332.17, bearing interest at 6.5% annually, with a single balloon payment due **[*64]** on December 31, 2023. PTO ¶ 76.

On August 13, 2018, Manheim informed Bamford that he had caused WestCo to repay the loans from EastCo. JX 941. Manheim told Bamford that his role as a director derived from the existence of the loans. With WestCo having repaid them, Manheim removed Bamford from the WestCo Board. *Id.* Manheim took that action by written consent in his capacity as the majority stockholder of WestCo. *Id.*

V. Manheim Adds Mandle To The Board.

Having removed Ban and Bamford from the WestCo Board, Manheim filled one of the resulting vacancies with Mandle on September 28, 2018. JX 998. Mandle was given the role of Chief Compliance Officer with a salary of $150,000. *Id.* In November 2018, Mandle was made a vice president. JX 1048.

In addition to her salary, Mandle received a bonus of $75,000 in 2020. *See* JX 1309; Mandle Tr. 735; Mezzaroba Tr. 802. She receives a travel stipend of up to $18,000 per year. Mandle Tr. 736-38.

On November 11, 2018, the Board increased Frank's and Mezzaroba's salaries from $150,000 to $300,000 per year. JX 1018. Frank and Mezzaroba recused themselves from the vote. Manheim and Mandle approved the increase. *Id.*

W. This Litigation

On November 30, 2018, Bamford **[*65]** filed a lawsuit in this court in which he asserted derivative claims on behalf of Penfold and DVRC against Manheim, ReathCo, and WestCo. *See Bamford v. Penfold L.P.*, C.A. No. 2018-0867-JTL (Del. Ch.). Bamford dismissed the complaint voluntarily and without prejudice in December 2018.

On January 4, 2019, Bamford filed this action. He again asserted derivative claims on behalf of Penfold and DVRC against Manheim, ReathCo, and WestCo.

In April 2019, Ban intervened. Bamford and Ban then filed a consolidated complaint. After additional pleading-stage maneuvering, Bamford and Ban settled on an operative complaint. Dkt. 73 (the "Complaint"). The Complaint contained thirteen counts:

- In Count I, the plaintiffs asserted a derivative claim on behalf of Penfold for breach of fiduciary duty against Manheim and ReathCo as general partners. *Id.* ¶¶ 126-31.
- In Count II, the plaintiffs asserted a derivative claim on behalf of DVRC for breach of fiduciary duty against Manheim and WestCo. *Id.* ¶¶ 132-37.
- In Count III, the plaintiffs asserted a derivative claim on behalf of Penfold for fraud against Manheim and ReathCo. *Id.* ¶¶ 138-43.
- In Count IV, the plaintiffs asserted a derivative claim on behalf of **[*66]** Penfold for breach of contract against Manheim and ReathCo. *Id.* ¶¶ 144-47.
- In Count V, the plaintiffs asserted a derivative claim on behalf of DVRC for fraud against Manheim, WestCo, and ReathCo. *Id.* ¶¶ 148-57.
- In Count VI, the plaintiffs asserted personal claims for conversion against Manheim. *Id.* ¶¶ 158-61.
- In Count VII, Bamford asserted a personal claim for breach of fiduciary duty against Manheim. *Id.* ¶¶ 162-68.
- In Count VIII, Bamford asserted a personal claim for common law fraud against Manheim. *Id.* ¶¶ 169-76.
- In Count IX, Ban asserted a personal claim for common law fraud against Manheim. *Id.* ¶¶ 177-86.
- In Count X, the plaintiffs asserted direct claims on their own behalf and a derivative claim on Penfold's behalf for unjust enrichment against Manheim. *Id.* ¶¶ 187-92.
- In Count XI, Bamford asserted a personal claim for

negligent misrepresentation against Manheim. *Id.* ¶¶ 193-200.

• In Count XII, Ban asserted a personal claim for negligent misrepresentation against Manheim. *Id.* ¶¶ 201-09.

• In Count XIII, the plaintiffs sought a declaration that Penfold's limited partnership agreement is void. *Id.* ¶¶ 210-20.

The defendants answered Counts I and XIII and moved to dismiss the **[*67]** other counts. *See* Dkt. 76.

The court issued an opinion on the motion to dismiss. *See* *Bamford v. Penfold, L.P. (Dismissal Decision), 2020 Del. Ch. LEXIS 79, 2020 WL 967942, at *1 (Del. Ch. Feb. 28, 2020)*. The court dismissed Counts III, V, and X in their entirety. *2020 Del. Ch. LEXIS 79, [WL] at *33*. The court dismissed Count XII with respect to Ban's claim for negligent misrepresentation based on his compensation. *Id.*

The plaintiffs then amended the Complaint to add a claim against ReathCo for aiding and abetting Manheim's breaches of fiduciary duty. Dkt. 217 ¶¶ 221-25. Manheim, ReathCo, and DVRC answered and asserted three counterclaims against Ban for violations of the *federal Computer Fraud and Abuse Act*, the *Pennsylvania Uniform Trade Secrets Act*, and conversion. Dkt. 225.

A four-day trial was held in June 2021. At the end of trial, the court found that there was no general fiduciary relationship between Manheim and Bamford and therefore ruled in Manheim's favor on Count VII. Separately, the court found that Ban's loans were retroactive recharacterizations of his 2015 and 2016 compensation and entered judgment in Ban's favor on DVRC's counterclaim against him to recover the loans.

On July 21, 2021, the court issued the Factual Findings, which had the effect of resolving several other claims. First, the court found that Ban never hacked **[*68]** into a DropBox account belonging to DVRC or anyone associated with DVRC. FF ¶¶ 62-64. That finding resulted in Ban prevailing on the remaining counterclaims against him.

Next, the court found that Penfold does not have a written partnership agreement. *Id.* ¶ 59. That finding resulted in the defendants prevailing on Count IV and Count XIII.

Finally, as noted, the court determined that the trial evidence did not support "a finding of any misrepresentations by Manheim" in connection with the Reorganization or the execution of the Admission Agreement and the Contribution Agreement. *Id.* ¶ 51. That finding resolved the plaintiffs' claims of fraud (Counts VI, VIII, and IX) and negligent misrepresentation (Counts XI and XIII).

II. LEGAL ANALYSIS

What remains for decision are derivative claims against Manheim, ReathCo, and WestCo for causing DVRC to make transfers that were unfair to DVRC and its noncontrolling investors. The plaintiffs challenge transfers that went to Manheim and ReathCo. The plaintiffs also challenge transfers that DVRC made to Frank, Mezzaroba, and Mandle. The transfers consist of compensation, benefits like car and travel allowances, and reimbursement of expenses.

As framed in **[*69]** the Complaint, the remaining claims fall under three counts.

• In Count I, the plaintiffs asserted a derivative claim on behalf of Penfold against Manheim and ReathCo for breach of fiduciary duty as general partners of Penfold.

• In Count II, the plaintiffs asserted a double-derivative claim on behalf of DVRC against Manheim and WestCo for breach of fiduciary duty as officers and controlling members of DVRC.

• In Count XIV, the plaintiffs asserted a claim against ReathCo for aiding and abetting Manheim's and WestCo's breaches of fiduciary duties.

Those formulations are legally precise, but analytically cumbersome.

The court is not bound to analyze the case solely through the counts presented in the pleadings. The notion that a complaint must plead the specific legal theories on which the plaintiff can proceed is a throwback to the "theory of the pleadings." *See* 5 Charles Alan Wright & Arthur R. Miller, *Federal Practice and Procedure* § 1219 (4th ed.), Westlaw (database updated Apr. 2022). Under that doctrine, which was a feature of pleading at common law and of code pleading in some jurisdictions, a complaint had to "proceed upon some definite theory, and on that theory the plaintiff must **[*70]** succeed, or not succeed at all." *Mescall v. Tully, 91 Ind. 96, 99 (1883)*. Put differently, a plaintiff had to pick a legal theory at the outset of the case and stick with it to the end. *See* Fleming James, Jr., *The Objective and Function of the Complaint: Common Law—Codes—Federal Rules*, 14 Vand. L. Rev. 899, 910-11 (1961). If the facts did not support the theory that the plaintiff had picked, then the court would not grant relief, even if the plaintiff was entitled to relief until a different theory. *See id.*

Through a combination of rules, the Federal Rules of Civil Procedure "effectively abolished the restrictive theory of the pleadings doctrine, making it clear that it is unnecessary to set out a legal theory for the plaintiff's claim for relief." 5 Wright & Miller, *supra*, § 1219 (footnote omitted).

> Federal Rule of Civil Procedure 8(a) eliminates the concept of "cause of action"; Rule 8(d) provides that a party may set forth two or more statements of claim alternatively or hypothetically; Federal Rule of Civil Procedure 15(b) deals a heavy blow to the doctrine by permitting amendments as late as the trial and treating issues as if they had been raised in the pleadings when they are tried by the express or implied consent of the parties; and Federal Rule of Civil Procedure 54(c) provides that, except in the case of a default judgment, the "final judgment should grant the relief **[*71]** to which each party is entitled, even if the party has not demanded that relief in its pleadings."

Id. (footnotes omitted). Under the Federal Rules of Civil Procedure, "particular legal theories of counsel yield to the court's duty to grant the relief to which the prevailing party is entitled, whether demanded or not." Gins v. Mauser Plumbing Supply Co., 148 F.2d 974, 976 (2d Cir. 1945) (Clark, J.). "The federal rules—and the decisions construing them—evince a belief that when a party has a valid claim, he should recover on it regardless of his counsel's failure to perceive the true basis of the claim at the pleading stage, provided always that a late shift in the thrust of the case will not prejudice the other party in maintaining a defense upon the merits." 5 Wright & Miller, *supra*, § 1219 (footnotes omitted); *see* Johnson v. City of Shelby, 574 U.S. 10, 11, 135 S. Ct. 346, 190 L. Ed. 2d 309 (2014) (per curiam) (reversing dismissal of complaint for failure to articulate a claim under 42 U.S.C. § 1983; explaining that the Federal Rules of Civil Procedure rejected the "theory of the pleadings" and "do not countenance dismissal of a complaint for imperfect statement of the legal theory supporting the claim asserted").

Court of Chancery Rule 15(b) is designed to address this type of situation. It states:

> When issues not raised by the pleadings are tried by express or implied consent **[*72]** of the parties, they shall be treated in all respects as if they had been raised in the pleadings. Such amendment of the pleadings as may be necessary to cause them to conform to the evidence and to raise these issues may be made upon motion of any party at any time, even after judgment; but failure so to amend does not affect the result of the trial of these issues.

Ct. Ch. R. 15(b). The federal counterpart to this rule was part of the drafters' effort to leave behind the earlier system in which "the pleadings completely controlled the subsequent phases of the litigation," under which "[e]vidence offered at trial that was at variance with allegations in the pleadings could not be admitted, or, if admitted, would not be allowed to provide the basis for the final disposition of the action." 6A Wright & Miller, *supra*, § 1491. By adopting Rule 15(b), the drafters sought "to promote the objective of deciding cases on their merits rather than in terms of the relative pleading skills of counsel or on the basis of a statement of the claim or defense that was made at a preliminary point in the action." *Id.* (footnote omitted).

The disputes in this case boil down to whether Manheim breached his fiduciary duties. Delaware **[*73]** law imposes fiduciary duties on those who control an entity.[12] Manheim controlled DVRC through his control over WestCo. He also controlled ReathCo. As the individual who controlled DVRC, Manheim owed fiduciary duties that obligated him to act in the best interests of DVRC and its residual claimants, including Penfold.[13] To the extent Manheim breached his

---

[12] In re Pattern Energy Gp. Inc. S'holders Litig., 2021 Del. Ch. LEXIS 90, 2021 WL 1812674, at *36 (Del. Ch. May 6, 2021); Voigt v. Metcalf, 2020 Del. Ch. LEXIS 55, 2020 WL 614999, at *11 (Del. Ch. Feb. 10, 2020); Quadrant Structured Prods. Co. Ltd. v. Vertin, 102 A.3d 155, 183-84 (Del. Ch. 2014).

[13] Feeley v. NHAOCG, LLC, 62 A.3d 649, 670-71 (Del. Ch. 2012); *see* In re USACafes, L.P. Litig., 600 A.2d 43, 48 (Del. Ch. 1991); *see also* Paige Cap. Mgmt. LLC v. Lerner Master Fund, LLC, 2011 Del. Ch. LEXIS 116, 2011 WL 3505355, at *30 (Del. Ch. Aug. 8, 2011) (applying USACafes to impose fiduciary liability on individual who was the managing member of the LLC that acted as general partner for limited partnership); Gelfman v. Weedon Invs., L.P., 792 A.2d 977,

fiduciary duties by engaging in disloyal conduct, he can be held liable.

It does not matter that Manheim may have acted through an agent or instrumentality like ReathCo or WestCo.[14] Manheim owed fiduciary duties as the ultimate controller of DVRC and remains subject to liability in that capacity.

The additional involvement of an entity as the agent or instrumentality means only that the entity can be held jointly and severally liable with Manheim.[15] There are two routes for the entity to be held jointly and severally liable. To the extent that the entity was itself a fiduciary, then the entity can be held liable in that capacity. WestCo was a fiduciary in its capacity as the managing member of DVRC. ReathCo was a fiduciary in its capacity as general partner of Penfold and in its capacity as the managing agent **[*74]** through which WestCo managed DVRC. To the extent that either entity was not itself a fiduciary or did not act in a fiduciary capacity, then that entity can be held jointly liable with Manheim under a theory of aiding and abetting. Manheim controlled WestCo and ReathCo, and his knowledge is attributed to those entities, making them knowing participants in Manheim's breaches of fiduciary duty.[16]

This decision therefore does not organize its legal analysis by parsing through Counts I, II, and XIV. This decision focuses on the central issue in dispute: Whether Manheim breached his fiduciary duties by engaging in disloyal conduct that took the form of (i) self-dealing transfers and (ii) transfers to his alleged cronies. Because Manheim is the pivotal actor, this decision focuses on Manheim as the key defendant.

Before addressing the central issue in dispute, this decision considers a series of defenses. Those defenses marginally reduce the scope of the transfers that the plaintiffs can challenge. After addressing the central claim, this decision turns to the remedy.

A. The Defenses

Manheim leads with a series of defenses through which he seeks to eliminate or, at a minimum, reduce the

---

992 n.24 (Del. Ch. 2001) (applying USACafes to directors and officers of corporate general partner); Gotham P'rs, L.P. v. Hallwood Realty P'rs, L.P., 795 A.2d 1, 34 (Del. Ch. 2001) (applying USACafes to individuals and entities who controlled corporate general partner), *aff'd in part*, 817 A.2d 160 (Del. 2002); Bigelow/Diversified Secondary P'ship Fund 1990 v. Damson/Birtcher P'rs, 2001 Del. Ch. LEXIS 152, 2001 WL 1641239, at *8 (Del. Ch. Dec. 4, 2001) (explaining that "affiliates of a general partner who exercise control over the partnership's property may find themselves owing fiduciary duties to both the partnership and its limited partners"); Wallace ex rel. Cencom Cable Income P'rs II, L.P. v. Wood, 752 A.2d 1175, 1180 (Del. Ch. 1999) (applying USACafes and stating that "unquestionably, the general partner of a limited partnership owes direct fiduciary duties to the partnership and to its limited partners").

[14] In re EZCORP Inc. Consulting Agreement Deriv. Litig., 2016 Del. Ch. LEXIS 14, 2016 WL 301245, at *8-10 (Del. Ch. Jan. 25, 2016) (holding that fiduciary duties extended to individual defendant who was the "ultimate controller" of the entity even though the defendant exercised control indirectly and did not himself own stock); *see* S. Pac. Co. v. Bogert, 250 U.S. 483, 492, 39 S. Ct. 533, 63 L. Ed. 1099 (1919) ("[T]he doctrine by which the holders of a majority of the stock of a corporation who dominate its affairs are held to act as trustee for the minority does not rest upon such technical distinctions. It is the fact of control of the common property held and exercised, not the particular means by which or manner in which the control is exercised, that creates the fiduciary obligation."); Eshleman v. Keenan, 21 Del. Ch. 259, 187 A. 25, 28-29 (Del. Ch. 1936) (imposing personal liability on individual owners of a corporation that received a management fee from another entity that they controlled), *aff'd*, 23 Del. Ch. 234, 2 A.2d 904, 908 (Del. 1938) ("The conception of corporate entity is not a thing so opaque that it cannot be seen through; and, viewing the transaction as one between corporations, casual scrutiny reveals that the appellants, in fact, dealt with themselves to their own advantage and enrichment. The employment of Consolidated by Sanitary was merely the employment by the appellants of themselves to do what it was their plain duty to do as officers of Sanitary.").

[15] EZCORP, 2016 Del. Ch. LEXIS 14, 2016 WL 301245, at *10 (holding that complaint stated a claim against both Cohen, the ultimate controller, and the entity through which he exercised control); Eshleman, 187 A. at 28-29 (imposing personal liability jointly and severally on corporation that received a self-interested management fee and on its individual owners who were the ultimate controllers of the entity).

[16] In re Dole Food Co., Inc. S'holder Litig., 2015 Del. Ch. LEXIS 223, 2015 WL 5052214, at *39 (Del. Ch. Aug. 27, 2015) (holding entity, through which controller acted, liable jointly and severally with controller as an aider and abettor of the controller's breach of duty); In re Emerging Commc'ns, Inc. S'holders Litig., 2004 Del. Ch. LEXIS 70, 2004 WL 1305745, at *38 (Del. Ch. May 3, 2004) (same).

scope of **[*75]** the plaintiffs' claim. Those defenses largely fail.

1. Standing

Manheim advances two defenses based on the concept of standing. The first is temporal and asserts that the plaintiffs cannot challenge any transfers that took place before they became members of DVRC. The second focuses on the entity that made the transfers and asserts that the plaintiffs only can challenge transfers made by DVRC.

a. The Contemporaneous Ownership Requirement

Manheim's first argument asserts that Ban and Bamford cannot challenge any transfers by DVRC that preceded the execution of the Admission Agreement. Through that agreement, Ban and Bamford formally became members of DVRC. Invoking an alternative-entity version of the contemporaneous ownership requirement, Manheim argues that because Ban and Bamford were not members of DVRC until the Admission Agreement was executed, they lacked standing to assert any claims on behalf of DVRC before that event took place.

There is a threshold question about when the contemporaneous ownership requirement would have been satisfied. Manheim suggests that because the Admission Agreement was executed in early June 2016, that is when the plaintiffs gained standing to sue. But **[*76]** Manheim agreed with his counterparties that the Admission Agreement became effective as of June 1, 2015. FF ¶ 28(b). Although that agreement would not bind a third party, it does bind Manheim. Equity will not permit Manheim or the entities that he controls to disavow that commitment and contend that Bamford and Ban did not gain standing to sue until one year later.

Regardless, Manheim's attempt to invoke the contemporaneous ownership requirement does not succeed. Relying on Lambrecht v. O'Neal, 3 A.3d 277 (Del. 2010), this court previously rejected the defendants' argument that the plaintiffs could not assert claims based on events that preceded the Reorganization. *See* Dismissal Decision, 2020 Del. Ch. LEXIS 79, 2020 WL 967942, at *24-25.

> The Delaware Supreme Court has held that when an investor in a parent entity seeks to litigate derivative claims on behalf of its subsidiary, and when an intervening transaction and the strict operation of the contemporaneous ownership requirement would cut off the ability of parent investors to sue, then the wrong for purposes of analyzing the contemporaneous ownership requirement at the parent-entity level is the failure of the parent to cause the subsidiary to assert its claims. In that setting, the analysis does not require comparing when the investor in **[*77]** the parent entity acquired its interest with when the subsidiary's claim arose.

2020 Del. Ch. LEXIS 79, [WL] at *25 (citation omitted).

As framed in Lambrecht, neither the contemporaneous ownership requirement nor the continuous ownership requirement forecloses an entity's ability to bring its own claims:

> A post-merger double derivative action is not a de facto continuation of the pre-merger derivative action. It is a new, distinct action in which standing to sue double derivatively rests on a different temporal and factual basis—namely, the failure of the [parent entity], post-merger, to enforce the premerger claim of its wholly-owned subsidiary.

3 A.3d at 290; *see* Lewis v. Anderson, 477 A.2d 1040, 1050 (Del. 1984) (holding that there was no impediment to New Conoco, the post-transaction entity, pursuing its own claims). The stockholders in Lambrecht could assert that new claim derivatively if they could establish demand futility as to the new board of directors and the new claim. 3 A.3d at 290

In the Dismissal Decision, the court explained that the facts of this case fall within the Lambrecht rule. 2020 Del. Ch. LEXIS 79, 2020 WL 967942, at *26-27. As limited partners in Penfold, the plaintiffs can assert claims on behalf of Penfold's subsidiary, DVRC, in a double derivative action, including claims based on events pre-dating the Reorganization, as long as demand would be excused. 2020 Del. Ch. LEXIS 79, [WL] at *27. Manheim **[*78]** has never argued that demand would be required as to a claim against him for breach of fiduciary duty. Manheim controls both Penfold's general partner and DVRC's managing member, so demand is doubly futile. 2020 Del. Ch. LEXIS 79, [WL] at *26.

The plaintiffs also satisfy the more general test for equitable standing, viz., the threat of a "complete failure of justice." Schoon v. Smith, 953 A.2d 196, 208 (Del.

2008).

> Bamford, Ban, and Manheim are the only human beings with equity interests in Penfold. Manheim will not sue himself, nor will he cause ReathCo (which he controls) to bring suit. As a result, if Bamford and Ban lack standing to sue, then there will be "no procedural vehicle to remedy the claimed wrongdoing."

Dismissal Decision, 2020 Del. Ch. LEXIS 79, 2020 WL 967942, at *26 (quoting Lambrecht, 3 A.3d at 283).

Bamford and Ban therefore have standing to pursue double-derivative claims based on matters that took place before the effective date of the Reorganization. But even if they did not, they could still challenge the transfers from DVRC to ReathCo that began after the June 2017 Meeting. Manheim claims that those transfers complied with the DVRC Management Agreement, which Manheim and Ban executed in December 2014. But as the court has found, Manheim terminated the DVRC Management Agreement on June 30, 2015. The transfers that began after the **[*79]** June 2017 Meeting were new transactions, and the plaintiffs have standing to challenge them.

b. The Entity That Made The Transfers

Manheim's second defense focuses on the entity that made the transfers. The plaintiffs have not limited themselves to transfers from DVRC. They also have challenged the following transfers from WestCo:

• In 2014, WestCo incurred various hay-related expenses totaling $31,115.35 as part of its hay trading business. JX 1517 at '062.

• In 2016, WestCo made a cash transfer to ReathCo of $5,767. JX 914.

• Between 2014 and 2017, WestCo paid a total of $44,495.57 in expenses for the Union League. In 2014 and 2015, the expenses were labeled "Marketing Fee." In 2015 and 2016, the expenses were labeled "Meals & Entertainment." JX 1517 at '066-67.

• Between 2014 and 2019, WestCo extended loans to ReathCo in the amount of $1,614,670. JX 1796 (citing JX 914; JX 915; JX 1065; JX 1164).

As Manheim correctly argues, any claim based on these transfers belongs to WestCo. Those claims do not belong to DVRC. No one has asserted any claims on behalf of WestCo. The plaintiffs named WestCo as a defendant. They did not name WestCo as a nominal defendant on whose behalf they were asserting **[*80]** claims.

Bamford and Ban could have challenged the unsecured loan in the amount of $1,798,332.17 that Manheim caused DVRC to make to WestCo on August 10, 2018. The transaction between two Manheim-controlled entities plainly conferred a personal benefit on Manheim. Bamford and Ban refer to this transaction in their briefing, but they do not challenge it.

2. Laches

The second defense that Manheim raises is laches. "Laches is an affirmative defense that the plaintiff unreasonably delayed in bringing suit after the plaintiff knew of an infringement of his rights, thereby resulting in material prejudice to the defendant." *U.S. Cellular Inv. Co. of Allentown v. Bell Atl. Mobile Sys., Inc., 677 A.2d 497, 502 (Del. 1996)*. "Absent some unusual circumstances, a court of equity will deny a plaintiff relief when suit is brought after the analogous statutory period." *Id.* "[T]he general law in Delaware is that the statute of limitations begins to run, *i.e.*, the cause of action accrues, at the time of the alleged wrongful act, even if the plaintiff is ignorant of the cause of action." *In re Dean Witter P'ship Litig., 1998 Del. Ch. LEXIS 133, 1998 WL 442456, at *4 (Del. Ch. July 17, 1998)*, *aff'd*, *725 A.2d 441 (Del. 1999)*.

Here, the operative statutory period is three years. *See* *10 Del. C. § 8106(a)*. Bamford filed this lawsuit on January 4, 2019. By default, challenges to payments made before January 4, 2016, are untimely.[17]

A plaintiff can avoid **[*81]** a timeliness bar through tolling doctrines. One is fraudulent concealment, which applies when a defendant acted affirmatively to prevent the plaintiff from gaining knowledge of the facts giving rise to the claim. Another is equitable tolling, which applies when the plaintiff reasonably relied on the competence and good faith of a fiduciary. *See* *Stone &*

---

[17] Without explanation, Manheim accepts November 30, 2018, as the relevant date for the laches analysis. Bamford initially filed suit on that date, then dismissed the case less than a month later. The plaintiffs do not appear to challenge any payments made between November 30, 2015, and January 4, 2016. As a result, it does not matter which date the court uses for the laches determination.

Paper Invs., LLC v. Blanch, 2021 Del. Ch. LEXIS 167, 2021 WL 3240373, at *33 (Del. Ch. July 30, 2021); Weiss v. Swanson, 948 A.2d 433, 451 (Del. Ch. 2008). The limitations period is only tolled until a plaintiff is on inquiry notice. Once a plaintiff discovers the injury—or should have discovered the injury by exercising reasonable diligence—the limitations period will begin to run. *See* Weiss, 948 A.2d at 451. "[N]o theory will toll the statute beyond the point where the plaintiff was objectively aware, or should have been aware, of facts giving rise to the wrong." In re Tyson Foods, Inc., 919 A.2d 563, 585 (Del. Ch. 2007).

Ban has no basis for avoiding the timeliness bar. Until his suspension in May 2018 and subsequent removal in June 2018, Ban ran the day-to-day operations of the business. He knew what was going on.

Bamford is in a different position and presents a closer question. He argues that his time for filing suit should not begin to run "until Ban disclosed [Manheim's] defalcations to Bamford in mid-2018." Dkt. 365 at 13 n.3.

Although Bamford was not involved with **[*82]** the EB-5 Business to as great a degree as Ban, he was sufficiently involved that he should have made more timely efforts to pursue a lawsuit against Manheim. Bamford testified that by late 2017, he was frustrated that DVRC was not generating the magnitude of distributions that he expected, and he questioned the level of expenses that DVRC was incurring. *See* Bamford Tr. 162. Bamford made a conscious decision not to pursue his concerns. He "decided not to get involved and clip a coupon." JX 719 at '007. Having decided not to pursue his claims, Bamford cannot claim that he was not on inquiry notice.

Any challenges to payments made before January 4, 2016, are barred by laches. The effect of this ruling is relatively minimal. It prevents some challenges to expenses, but nothing more.

3. Ratification And Acquiescence

Manheim contends that the doctrines of ratification and acquiescence preclude any challenge to a range of transfers, most notably any management fees ostensibly paid under the DVRC Management Agreement. Manheim blends the two doctrines together. Neither applies.

"Ratification is an equitable defense that precludes a party who has accepted the benefits of a transaction from thereafter **[*83]** attacking it." Genger v. TR Invs., Inc., 26 A.3d 180, 195 (Del. 2011) (cleaned up). Ratification may be express or implied based on a party's conduct. "Implied ratification occurs where the conduct of a complainant, subsequent to the transaction objected to, is such as reasonably to warrant the conclusion that he has accepted or adopted it." *Id.* (cleaned up).

Acquiescence is similar. Acquiescence can bar a claim as a matter of equity when a plaintiff

> has full knowledge of his rights and the material facts and (1) remains inactive for a considerable period of time; or (2) freely does what amounts to recognition of the complained of act; or (3) acts in a manner inconsistent with the subsequent repudiation, which leads the other party to believe the act has been approved.

Klaassen v. Allegro Dev. Corp., 106 A.3d 1035, 1047 (Del. 2014) (cleaned up). "The doctrine of acquiescence effectively works an estoppel: where a plaintiff has remained silent with knowledge of her rights, and the defendant has knowledge of the plaintiff's silence and relies on that silence to the defendant's detriment, the plaintiff will be estopped from seeking protection of those rights." Lehman Bros. Hldgs. Inc. v. Spanish Broad. Sys., Inc., 2014 Del. Ch. LEXIS 28, 2014 WL 718430, at *9 (Del. Ch. Feb. 25, 2014), *aff'd*, *105 A.3d 989 (Del. 2014)*.

The facts do not support either ratification or acquiescence. For starters, Ban did not acquiesce to the DVRC Management Agreement by **[*84]** participating in drafting it. When Manheim and Ban prepared the DVRC Management Agreement, Ban was working for Manheim and beholden to him. He had no real ability to object to it.

Ban also did not ratify or acquiesce in the DVRC Management Agreement through his subsequent conduct. The agreement only remained in place until June 30, 2015, when Manheim terminated it along with the WestCo Management Agreement. After that point, there was no reason for Ban to object to a terminated agreement.

The only event that might contribute to a defense of ratification or acquiescence is the June 2017 Meeting, when Manheim proposed shifting DVRC to the Management Company Structure. Ban did not acquiesce to that initiative. During the June 2017 Meeting, Ban supported the Management Company

Structure, but he objected vigorously to using ReathCo as the management company. Because of Ban's objection, the WestCo Board resolved to investigate the alternatives further. After the June 2017 Meeting, Ban followed up on his objections.

After the June 2017 Meeting, DVRC transferred funds to ReathCo. Manheim has pointed out that Ban was aware of the transfers, but he is incorrect that Ban did not object to them. **[*85]** Ban made his position clear during the June 2017 Meeting. He also objected to transfers to ReathCo after the June 2017 Meeting. He did not object to each and every transfer, which would have been tiresome and unnecessary. He also recognized that some of the transfers to ReathCo were for legitimate expenses. Ban understood that once the WestCo Board decided upon a management company and a fee structure, there would be a true up.

Because of how events unfolded, Ban did not acquiesce to the transfers to ReathCo. Nor did he ratify those transfers. Whether viewed through the lens of acquiescence or ratification, Ban could challenge the transfers to ReathCo.

The defenses have even less purchase on Bamford. Manheim argues that Bamford ratified the DVRC Management Agreement and acquiesced in the transfers to ReathCo based on what occurred during the June 2017 Meeting, but those events were not sufficient. During the June 2017 Meeting, there was a consensus that DVRC would move to the Management Company Structure. Beyond that, the WestCo Board did not make specific determinations about the management company, the amount of the management fee, or what expenses it would cover. In light of Ban's **[*86]** objection, the WestCo Board committed to investigate the options further. Just as those events are not sufficient to foreclose Ban's challenge, they do not prevent Bamford's challenge.

Manheim also observes that in August 2018, Bamford requested information about the management fees paid to ReathCo and was provided with the DVRC Management Agreement. *See* JX 931. Instead of objecting to the agreement, Bamford filed this lawsuit three months later, in which he challenged the transfers from DVRC to ReathCo. Bamford acted promptly; he did not acquiesce.

In a related line of argument, Manheim contends that Ban and Bamford understood that the WestCo Board approved a management fee for ReathCo during the June 2017 Meeting, then decided to contend otherwise as a litigation invention. They cite a litigation memorandum that Ban prepared which referred to the payment of management fees. *See* JX 991. They also cite an email exchange in which Ban sent the minutes of the June 2017 Meeting to Bamford where they discussed whether the WestCo Board had approved a management fee. *See* JXs 894-95.

Zooming out from these specific documents, it is apparent that after Ban and Bamford began sharing their concerns **[*87]** about DVRC, they attempted to figure out how Manheim was extracting cash from the EB-5 Business without sharing it with them. *See* JX 734; JX 757. They decided that it had to be through a combination of a management fee and reimbursement of expenditures. Their next step was to attempt to figure out how the management fee was put in place. That exercise led them to the minutes of the June 2017 Meeting, which was the only documented time that the WestCo Board discussed the relationship between ReathCo and DVRC. It is understandable that Manheim would view their efforts skeptically as an attempt to manufacture a theory, just as Ban and Bamford have viewed skeptically Manheim's efforts to recharacterize transactions and put backdated agreements into place as attempts to manufacture defenses. Human memory is inherently fallible and subject to natural evolution over time. It is neither surprising nor problematic that Bamford and Ban investigated the origins of the management fee and attempted to reconstruct what took place at the June 2017 Meeting. They were trying to figure out what happened.

In a related argument, Manheim observes that the plaintiffs did not challenge the validity of the **[*88]** DVRC Management Agreement in their complaints. That makes sense. They challenged the transfers that Manheim caused DVRC to make. The DVRC Management Agreement was Manheim's defense. The plaintiffs could have anticipated Manheim's defense and targeted it preemptively, but their decision to let Manheim raise his defense does not mean that they thought the DVRC Management Agreement remained valid.

Neither ratification nor acquiescence helps Manheim. At best for Manheim, the defenses might operate against Ban, but because the claims in this case are derivative, Bamford can maintain them.

4. Exculpation

Finally, Manheim argues that the plaintiffs cannot recover any damages whatsoever because he sought to insert an impressively broad exculpatory provision (the "Exculpatory Provision") in a version of the DVRC LLC Agreement that he adopted unilaterally in February 2018 (the "Fourth LLC Agreement"). The adoption of the Exculpatory Provision was itself a self-interested act, and it is invalid because Manheim failed to prove that the implementation of the Exculpatory Provision was entirely fair.

The Exculpation Provision provides, in relevant part:

> No Indemnified Representative of the Company, or **[*89]** any of their respective Affiliates, representatives or agents (each, a "Covered Person") shall be liable to the Company or any other Covered Person for any loss, damage or claim incurred by reason or any act or omission (including for any breach of contract or breach of fiduciary or other duties) performed or omitted by such Covered Person; provided, however, that this sentence shall not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.
> To the maximum extent permitted by applicable law, each Member hereby waives any claim or cause of action against the Indemnified Representatives or any of their respective Affiliates, employees, agents and representatives for any breach of any fiduciary duty to the Company or the Members, including as may result from a conflict of interest between the Company or any of its subsidiaries and such Person in his or her capacity as a Member.

JX 2012 § 11.3 (formatting added). An "Indemnified Representative" is defined as a current or former manager or executive officer of DVRC. *Id.* § 11.2.

Through this provision, Manheim sought to insulate himself **[*90]** from liability for "any loss, damage or claim," including "for any breach of contract or breach of fiduciary or other duties." *See id.* § 11.3. The only liability that Manheim would have would be for conduct that "constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing." *Id.* The implied covenant is a means of implying terms that do not expressly exist in an agreement. Manheim thus sought to eliminate liability for any breach of fiduciary duty or any breach of an express term of the contract, while only preserving liability for a *bad faith* (i.e., knowing) violation of an implied term. Since an implied provision will, by definition, not be express, that residual category of potential provides little comfort.[18]

---

[18] As extreme as that degree of exculpation might seem, it adheres to the statutory floor that the Delaware Limited Liability Company Act (the "LLC Act") imposes. *See* 6 Del. C. § 18-1101(e) ("A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; *provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing*." (emphasis added)). When the General Assembly adopted that provision, Delaware decisions had not yet distinguished cleanly between the concept of bad faith under tort law and the role that the implied covenant of good faith and fair dealing plays as a source of implied contractual terms. *See, e.g.,* *Gerber v. Enter. Prods. Hldgs., LLC, 67 A.3d 400, 418-19 (Del. 2013)*, *overruled on other grounds by* *Winshall v. Viacom Int'l, Inc., 76 A.3d 808 (Del. 2013)*; *Renco Gp., Inc. v. MacAndrews AMG Hldgs. LLC, 2015 Del. Ch. LEXIS 25, 2015 WL 394011, at *7 n.74 (Del. Ch. Jan. 29, 2015)*. It seems possible that by preventing exculpation for bad faith violations of the implied covenant, the drafters of the LLC Act were seeking preserve accountability for intentional misconduct that ran contrary to the best interests of the entity. But in its role as a doctrine for implying contract terms, the implied covenant cannot fulfill that mission. The implied covenant does not operate as a fiduciary substitute. *Wood v. Baum, 953 A.2d 136, 143 (Del. 2008)* ("[T]he Complaint does not purport to allege a 'bad faith violation of the implied contractual covenant of good faith and fair dealing.' The implied covenant of good faith and fair dealing is a creature of contract, distinct from the fiduciary duties that the plaintiff asserts here." (cleaned up)). Establishing a breach of the implied covenant is notoriously difficult. *See* ***Oxbow Carbon & Mins. Hldgs. v. Crestview-Oxbow Acq. LLC, 202 A.3d 482, 502-08 (Del. 2019)***. And express terms displace it, enabling alternative entity agreements to authorize a decision maker to consider and act based on its own interests, irrespective of the entity's interests. *See, e.g.*, Paul M. Altman & Srinivas M. Raju, *Delaware Alternative Entities and the Implied Contractual Covenant of Good Faith and Fair Dealing Under Delaware Law*, 60 Bus. Law. 1469, 1484 (2005) (recommending that alternative entity agreements provide that the decision maker be granted discretion to "consider only such interests and factors as it desires, including its own interests," and eliminate any "duty or obligation to give any consideration to any interest of or factors affecting the" entity or its investors). Rather than preserving a measure of accountability by imposing a meaningful floor, the statutory limit on exculpation sets the bar at the band sill.

Not content with this capacious elimination of liability, **[*91]** Manheim went further and provided that each member of DVRC "hereby waives any claim or cause of action . . . for any breach of any fiduciary duty." JX 2012 § 11.3. Through this language, Manheim sought to make the Exculpatory Provision not just prospective, but retrospective as well.

Accepting for purposes of analysis that Manheim had the legal authority to adopt the Fourth LLC Agreement, including the Exculpatory Provision, it remains a self-interested decision that can be reviewed in equity.[19] It was not equitable for Manheim to implement the Fourth LLC Agreement unilaterally in an effort to eliminate all liability, prospectively and retrospectively, for any fiduciary breach.

Fiduciaries who control an entity can adopt prospective protective provisions, including exculpatory provisions, particularly if the provisions do not implicate the duty of loyalty. For example, in *Orloff v. Shulman*, the fiduciaries who controlled a corporation adopted an exculpatory provision under *Section 102(b)(7)* at a time when minority stockholders had filed a books-and-records action. *2005 Del. Ch. LEXIS 184, 2005 WL 3272355, at *6 (Del. Ch. Nov. 23, 2005)*. The plaintiffs alleged that the defendants approved the provision "under the threat of imminent litigation, and breached **[*92]** their fiduciary duties by self-interestedly protecting themselves against litigation that they knew would soon name them as defendants." *Id.* This court dismissed the claim, finding that the plaintiffs failed to adequately allege "facts creating a reasonable doubt that the directors were disinterested or independent when they made their decision to approve the certificate amendment." *2005 Del. Ch. LEXIS 184, [WL] at *13*. By definition, a provision under *Section 102(b)(7)* cannot protect directors from claims that implicate the duty of loyalty. Nor can it eliminate liability retrospectively. *See* *8 Del. C. § 102(b)(7)* ("No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective.").

Manheim sought to eliminate any liability for breaches of the duty of loyalty. He attempted to adopt a provision that not only limited liability prospectively, but also retrospectively.

Manheim points out that the Exculpatory Provision also covered Bamford and Ban. Nominally equal treatment is generally desirable, and it is equitable when the recipients are similarly situated and benefit to a similar extent. But if the recipients of nominally equal treatment are differently situated, **[*93]** then nominally equal treatment can manifest as differential (even discriminatory) treatment. Delaware law recognizes this reality, but our precedents have applied it cautiously because it represents a departure from the generally desirable principle of equal treatment. For example, our law recognizes that if a merger has the additional effect of extinguishing the standing of minority stockholders to bring derivative claims against the fiduciaries who approved the merger, then those fiduciaries receive a non-ratable benefit from the merger, even if the fiduciaries nominally receive the same *pro rata* consideration as all other stockholders. *See* *In re Primedia, Inc. S'holders Litig., 67 A.3d 455, 487 (Del. Ch. 2013)*. And this court has recognized that when a fiduciary has a pressing need for liquidity, a liquidity-generating transaction can confer a non-ratable benefit on the fiduciary—even if the fiduciary nominally receives the same *pro rata* consideration as all other stockholders. *See* *In re Mindbody, Inc., 2020 Del. Ch. LEXIS 307, 2020 WL 5870084, at *15 (Del. Ch. Oct. 2, 2020)* (collecting cases).

The same logic applies here. Manheim faced claims for breach of the duty of loyalty based on his past conduct. Manheim sought to cut off that threat and benefit himself through the adoption of the Exculpatory Provision. Superficially, the Exculpatory **[*94]** Provision treated all Covered Persons equally. But because Manheim had engaged in misconduct and faced litigation risk, it was really Manheim who benefitted.

Manheim did not attempt to prove that the Exculpatory

---

[19] *Sample v. Morgan, 914 A.2d 647, 672 (Del. Ch. 2007)* ("Corporate acts thus must be 'twice-tested'—once by the law and again by equity."); *accord* *Quadrant Structured Prods. Co. v. Vertin, 2014 Del. Ch. LEXIS 214, 2014 WL 5465535, at *3 (Del. Ch. Oct. 28, 2014)* ("Delaware law adheres to the twice-testing principle."), *aff'd*, ***151 A.3d 447 (Del. 2016)*** (TABLE); *see* *In re Pure Res., Inc. S'holders Litig., 808 A.2d 421, 434 (Del. Ch. 2002)* ("Nothing about [the doctrine of independent legal significance] alters the fundamental rule that inequitable actions in technical conformity with statutory law can be restrained by equity."); *see also* *Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971)* ("[I]nequitable action does not become permissible simply because it is legally possible."); ***Marino v. Patriot Rail Co., 131 A.3d 325, 336 (Del. Ch. 2016)*** ("Post-1967 decisions by the Delaware Supreme Court . . . rendered untenable the strong-form contention that a statutory grant of authority necessarily foreclosed fiduciary review.").

Provision was entirely fair. Manheim therefore cannot rely on the Exculpatory Provision to protect him.[20]

B. The Standard Of Review

The plaintiffs sought to prove that Manheim breached his fiduciary duties by causing DVRC to make the challenged transfers. The core fiduciary principle at issue is the obligation of loyalty, "the equitable requirement that, with respect to the property subject to the duty, a fiduciary always must act in a good faith effort to advance the interests of his beneficiary." *U.S. West, Inc. v. Time Warner Inc., 1996 Del. Ch. LEXIS 55, 1996 WL 307445, at *21 (Del. Ch. June 6, 1996)* (Allen, C.). "Most basically, the duty of loyalty proscribes a fiduciary from any means of misappropriation of assets entrusted to his management and supervision." *Id.*

Entity law distinguishes between the standard of conduct that governs a fiduciary's behavior and the standard of review that a court applies to determine whether the standard of conduct was breached.[21] Entity law generally uses three standards of review: a default standard of review that is highly deferential and known **[*95]** as the business judgment rule; an intermediate standard of review known as enhanced scrutiny; and an onerous standard of review known as the entire fairness test. *Reis v. Hazelett Strip-Casting Corp., 28 A.3d 442, 457-59 (Del. Ch. 2011)*. "In each manifestation, the standard of review is more forgiving of [defendant fiduciaries] and more onerous for [the] plaintiffs than the standard of conduct." *Chen, 87 A.3d at 667*.

When a fiduciary who controls an entity engages in self-dealing, then equity requires that the fiduciary prove that the self-dealing transaction was entirely fair to the entity and its minority investors. *See Ams. Mining Corp. v. Theriault, 51 A.3d 1213, 1239 (Del. 2012)*. The controller may seek to avoid the full measure of this standard of review by implementing protections for the entity and its minority investors. One protective measure involves the controller establishing a committee composed of independent and disinterested individuals and empowering the committee with the authority to **[*96]** negotiate the terms of the transaction and determine whether it takes place. Another protective device is to condition the transaction on the approval of the independent investors, such as by conditioning the transaction on the affirmative vote of a majority of the shares owned by stockholders who are not affiliated with the controller.

If the controller agrees on both protections up front, then the deferential business judgment rule applies to the transaction. *Flood v. Synutra Int'l, Inc., 195 A.3d 754, 761-62 (Del. 2018)*. If a controller agrees to only one of the protections, or does not agree to both protections up front, then the most that the controller can achieve is a shift in the burden of proof such that the plaintiff challenging the transaction must prove unfairness. *Ams. Mining, 51 A.3d at 1240*.

Manheim controlled DVRC through his control over WestCo, DVRC's managing member. Manheim controlled WestCo through his ownership of 70% of WestCo's common stock. Manheim never implemented any procedural protections to limit or disable his control for purposes of any of the transfers at issue in the case. Manheim therefore bore the burden of proving that the transfers at issue were entirely fair.[22]

[20] As a fallback, Manheim argues that the DVRC LLC Agreement already contained an exculpatory provision, which protects him in any event. Section 11.2 of the DVRC LLC Agreement only covers "the Member" and "every officer of the Company." JX 27 § 11.02(a). It does not extend to controllers. It also only applies if the covered party's conduct "did not constitute gross negligence, gross misconduct or fraud." *Id.* Manheim was not entitled to exculpation in his capacity as DVRC's controller. *See In re Atlas Energy Res., LLC, 2010 Del. Ch. LEXIS 216, 2010 WL 4273122, at *8-9 (Del. Ch. Oct. 28, 2010)* (holding that provision in LLC agreement that eliminated fiduciary duties but did not mention LLC's controller did not apply to controller). Regardless, his self-dealing qualified as gross misconduct.

[21] *Chen v. Howard-Anderson, 87 A.3d 648, 666 (Del. Ch. 2014)*; *In re Trados Inc. S'holder Litig., 73 A.3d 17, 35-36 (Del. Ch. 2013)*. *See generally* William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and its Progeny as a Standard of Review Problem*, *96 Nw. U. L. Rev. 449, 451-52 (2002)*; William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of the Standards of Review in Delaware Corporation Law*, *56 Bus. Law. 1287, 1295-99 (2001)*; Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, *62 Fordham L. Rev. 437, 461-67 (1993)*.

[22] As an alternative basis for shifting the burden of proof on the management fees to ReathCo, Manheim argues that the burden to show unfairness shifts because the plaintiffs voted as members of the WestCo Board during the June 2017 Meeting to approve a management fee for ReathCo equal to

"The concept of fairness has two basic aspects: fair dealing and fair **[*97]** price." *Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983)*. Fair dealing "embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained." *Id.* Fair price "relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock." *Id.* Although the two aspects may be examined separately, "the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness." *Id.* That said, "perfection is not possible, or expected." *Id. at 709 n.7*.

Because the entire fairness test is not bifurcated, "the two aspects of the entire fairness standard interact." *Dole, 2015 Del. Ch. LEXIS 223, 2015 WL 5052214, at *34*. "A strong record of fair dealing can influence the fair price inquiry, reinforcing the unitary nature of the entire fairness test. The converse is equally true: process can infect price." *Reis, 28 A.3d at 467* (collecting authorities).

"Fair price can be the predominant consideration in the unitary entire fairness inquiry." **[*98]** *Dole, 2015 Del. Ch. LEXIS 223, 2015 WL 5052214, at *34*. The fair price analysis "is part of the entire fairness standard of review; it is not itself a remedial calculation." *Reis, 28 A.3d at 465*. "For purposes of determining fairness, as opposed to crafting a remedy, the court's task is not to pick a single number, but to determine whether the transaction price falls within a range of fairness." *Dole, 2015 Del. Ch. LEXIS 223, 2015 WL 5052214, at *33*.

"[A] demonstrably fair price is inconsistent with the notion that a fiduciary disloyally attempted to channel value to himself or third parties at the expense of the beneficiaries of his duties." *In re Tesla Motors, Inc. S'holder Litig., 2022 Del. Ch. LEXIS 94, 2022 WL 1237185, at *32 (Del Ch. Apr. 27, 2022)*. But establishing a price that falls within the range of fairness may not be dispositive if a fiduciary has engaged in acts of fraud, misrepresentation, self-dealing, or gross and palpable overreaching. *See* *Weinberger, 457 A.2d at 714*. In those settings, the defendant fiduciary "does not meet the entire fairness standard simply by showing that the price fell within a reasonable range that would be considered fair." *William Penn P'ship v. Saliba, 13 A.3d 749, 756-57 (Del. 2011)*. Depending on the facts and the nature of the loyalty breach, the beneficiaries may be entitled to "a 'fairer' price." *Reis, 28 A.3d at 467*.

C. The ReathCo Management Fees

The plaintiffs sought to prove at trial that Manheim breached his fiduciary duties by causing DVRC to pay management fees to ReathCo. **[*99]** It is undisputed that Manheim received the full benefit of the management fees. It is also undisputed that the management fees and his employment benefits represented Manheim's only source of compensation from DVRC.[23]

Between 2017 and 2020, ReathCo received $5,652,406 in management fees, ostensibly for amounts due for the years 2014-2020. The transfers for management fees did not begin until after the June 2017 Meeting. The transfers were recharacterized as management fees during the preparation of DVRC's audited financial statements for 2017. As part of that process, two DVRC employees calculated the amounts that were due for management fees under the DVRC Management Agreement and included interest on pastdue amounts from prior years. They then treated any transfers from DVRC to ReathCo as the payment of a management fee.

The plaintiffs do not challenge the full amount of the management fees. They agree Manheim was entitled to

0.25% of AUM. Dkt. 364 at 32-33. This decision has found that the WestCo Board did not approve a management fee for ReathCo during the June 2017 Meeting. *See, supra*, Part I.O. Manheim also does not offer any legal support for the proposition that Ban and Bamford's actions as directors would shift the burden of proof in an investor-level challenge to the fairness of the management fees. Manheim cites *Kahn v. Lynch Communications System, Inc., 638 A.2d 1110, 1116-17 (Del. 1994)*, but that decision addressed (i) the effect of a special committee on the burden of proving fairness and (ii) the effect of a majority of the minority vote on the burden of proving fairness. It did not address what would happen if a director voted in favor of a transaction and then subsequently pursued a derivative action in his capacity as a stockholder.

[23] The plaintiffs identified $58,540.14 in transfers that DVRC made to lease luxury automobiles for Manheim between December 2017 and December 2019. That amount works out to an average of $2,439.17 per month, which is a hefty car payment. Beyond referring to the luxury cars in passing, the plaintiffs did not devote attention to the car-related transfers. This decision therefore does not consider them.

receive compensation of $300,000 per year. Accordingly, the plaintiffs do not challenge the first $2,100,000 in management fees ($300,000 * 7 = $2,100,000). Deducting that amount leaves excess management fees of $3,552,406.

1. The Management Fees: Fair Dealing

The **[*100]** evidence pertinent to the dimension of fair dealing weighs decidedly in favor of the plaintiffs. That is true whether the court examines the original entry into the DVRC Management Agreement, the decision made during the June 2017 Meeting, or the transfers made after the June 2017 Meeting.

a. The Original Entry Into The DVRC Management Agreement

The circumstances surrounding the original entry into the DVRC Management Agreement did not bear any of the hallmarks of fair dealing. It was an interested transaction that Manheim and Ban entered into unilaterally under circumstances where they both benefited from the agreement.

The fair dealing inquiry examines how the transaction was negotiated. There was no negotiation over the DVRC Management Agreement. Manheim and Ban drafted it. Manheim decided on a fee equal to 0.25% of AUM. Ban was not in a position to negotiate with Manheim because he was neither independent nor disinterested. Ban worked for Manheim, so he was not independent. Ban also benefitted from the DVRC Management Agreement through the Ban Profit-Sharing Agreement. To the extent that DVRC paid a fee to ReathCo, Manheim and Ban each would receive half.

The fair dealing inquiry also **[*101]** embraces questions of who approved the transaction. There was never any formal approval of the DVRC Management Agreement, whether by the WestCo Board or by anyone else. Manheim and Ban executed it. When they acted, they comprised the only directors of WestCo, which was the sole member of DVRC, but they never took action as directors. The stockholders of WestCo never approved the DVRC Management Agreement.

b. The June 2017 Meeting

The decision made by the WestCo Board during the June 2017 Meeting did not bear the hallmarks of fair dealing. The WestCo Board did not have a disinterested and independent majority. It did not have full information about the decision that Manheim asked the directors to make. Most important, the WestCo Board did not make a decision to pay ReathCo a management fee in accordance with the DVRC Management Agreement.

When the WestCo Board convened for the June 2017 Meeting, the WestCo Board did not have a disinterested and independent majority for purposes of determining whether to pay a management fee to ReathCo:

• Manheim was interested in the management fee as the controller of ReathCo.

• Ban was not independent because he was subject to Manheim's control as an employee **[*102]** of DVRC and an officer of WestCo.

• Frank was not independent because he was subject to Manheim's control as an employee of DVRC, and he was Manheim's brother.

• Mezzaroba was not independent because he was subject to Manheim's control as an employee of DVRC. He also was a personal friend of Manheim's.[24]

Only Bamford was nominally independent, yet he had been Manheim's close friend since childhood, and at that point, he still trusted Manheim completely. Since that meeting, Ban and Bamford have become adverse to Manheim. During the June 2017 Meeting, neither was independent of him.

During the June 2017 Meeting, the WestCo Board did not have full information about the DVRC Management Agreement or the decisions that Manheim was asking the directors to make. Manheim did not make clear that the DVRC Management Agreement had terminated in June 2015. There is no indication that Manheim discussed the significant differences between the circumstances that prevailed when he and Ban originally executed the DVRC Management Agreement and the circumstances that prevailed in June 2017. To reiterate, when Manheim and Ban originally created the DVRC Management Agreement, they were operating under the Ban **[*103]** Profit-Sharing Agreement, so they each

---

[24] Mezzaroba's friendship with Manheim would not be enough, standing alone, to call Mezzaroba's independence into question. But when viewed holistically in the context of Mezzaroba's employment relationship and Manheim's status as a controller, the friendship contributes to a finding that Mezzaroba was not independent of Manheim.

would receive half of the benefits of the DVRC Management Agreement. The fee they contemplated would have provided compensation for both Manheim and Ban, not just Manheim. By June 2017, Manheim and Ban terminated the Ban Profit-Sharing Agreement, so any revival of the DVRC Management Agreement only would benefit Manheim.

In addition, the capital structure of DVRC had changed significantly. When Manheim and Ban entered into the DVRC Management Agreement, DVRC was a wholly owned subsidiary of WestCo, and the rights to the cashflows from the EB-5 Business were divided through a complex set of relationships that included the Ban Profit-Sharing Agreement, the ownership stakes that Manheim, Ban, and Mandle held in WestCo, and the beneficial interest that Bamford held through the 2012 and 2015 EastCo Loans. In connection with the Reorganization, Manheim, Ban, and Bamford agreed to a more transparent and straightforward allocation of cash flows by giving Manheim, Ban, and Bamford an equity participation in DVRC through Penfold's 90% non-voting member interest. No one mentioned the DVRC Management Agreement during the negotiations over the Reorganization, **[*104]** and reviving the management fee to ReathCo was inconsistent with the agreements that Manheim, Ban, and Bamford had reached.

The WestCo Board did not consider these important issues during the June 2017 Meeting. All of the witnesses agree that there was relatively little discussion of the DVRC Management Agreement. Manheim, Frank, and Mezzaroba asserted that the discussion was minimal because everyone took the DVRC Management Agreement as a given. Ban asserted that the discussion was minimal because the DVRC Management Agreement had terminated and Manheim was proposing a new arrangement. Bamford did not recall any discussion of the DVRC Management Agreement.

To my mind, it seems likely that there was minimal discussion of the DVRC Management Agreement because the specific terms of the agreement did not matter to the issue before the WestCo Board. That issue was the policy question of whether DVRC should shift to the Management Company Structure. For purposes of that question, the specific details and history of the DVRC Management Agreement were of secondary importance. The effort to respond to the SEC inquiry had uncovered the DVRC Management Agreement, and the re-discovery of that agreement **[*105]** prompted Manheim and Mezzaroba to think that it would be easier to present DVRC to regulators, like the USCIS and SEC, if DVRC simply paid a management fee to a management company, but they did not have to use the DVRC Management Agreement to implement a Management Company Structure. The DVRC Management Agreement was a cursory, one-sentence agreement, and Manheim had terminated it two years earlier. The more logical course was to put in place a new and more detailed agreement with a different management company.

The WestCo Board therefore did not delve into the details of the DVRC Management Agreement. As a consequence, the WestCo Board did not have full information about that agreement, its termination, or the significant differences between the circumstances when it was executed and the circumstances that prevailed in June 2017.

During the June 2017 Meeting, the WestCo Board did not make specific decisions about what entity would serve as the management company, what the management fee would be, or what services the fee would cover. The WestCo Board reached a consensus that DVRC should shift to the Management Company Structure. The WestCo Board also discussed whether ReathCo should **[*106]** serve as the management company, what services the fee relationship should cover, and whether to move salaries and other expenses from DVRC to ReathCo. But the WestCo Board did not make any decisions on those more specific topics. Ban strongly opposed having ReathCo serve as the management company. To the extent there was a shift to the Management Company Structure, which Ban generally supported, Ban wanted a new entity to serve in that role.

Because of Ban's opposition, the WestCo Board did not make any specific determinations. The WestCo Board reached a consensus that DVRC would move to a Management Company Structure, but it resolved to analyze the details further.

The minutes for the June 2017 Meeting reflect these determinations. On the ReathCo issue, the minutes state:

> Move all executives off of DVRC payroll to Reath & Company or new entity and payroll is created for Chloe Deon and Kareem Rosser. Compensation will be transferred for [Frank] and [Mezzaroba]. Further, Board will evaluate Reath & Company vs. new entity as appropriate vehicle for executives and

executive operations going forward.

JX 482. The WestCo Board thus approved the Management Company Structure, but it did not make **[*107]** final determinations about what entity would serve as the management company or the services that it would provide. Instead, the Board resolved to "evaluate" using ReathCo or a new entity. The minutes do not reflect any consideration of a management fee beyond the approval of a 17-week cashflow budget that provided for specific payments to ReathCo. *See* JX 1740. The post-meeting communications also evidence that no decision was made. *See* JX 497; JX 506.

The decisions that the WestCo Board made during the June 2017 Meeting thus do not bear indicia of fairness. The WestCo Board lacked a disinterested and independent majority, and the directors did not have full information about the DVRC Management Agreement. Most significantly, the WestCo Board did not make a decision to pay ReathCo a management fee in accordance with the DVRC Management Agreement.

c. The Payment Of Management Fees After The June 2017 Meeting

Finally, the payment of management fees after the June 2017 Meeting did not bear the hallmarks of fair dealing. The court has found that (i) Manheim terminated the DVRC Management Agreement in June 2015, and (ii) the WestCo Board reached a consensus during the June 2017 Meeting about **[*108]** moving to a Management Company Structure, but did not determine any of the details. Under the circumstances, DVRC did not have authority to pay management fees to ReathCo. There should have been further deliberation by the WestCo Board and specific decisions on the open issues.

Instead, the transfers began. As discussed in the Factual Background, the transfers did not resemble a regular management fee, and there was no clear designation of a payment that constituted a management fee. Transfers went to ReathCo at varying times and in varying amounts. Ban questioned some of those transfers, and he expected there would be a true up once the WestCo Board decided on the details of the Management Fee Structure. *See* Ban Tr. 390, 394; JX 506.

Rather than resulting from a decision by the WestCo Board, the reactivation of the DVRC Management Agreement and the recharacterization of transfers to ReathCo as management fees happened when DVRC prepared its audited financial statements for 2017. During that process, two DVRC employees calculated the amounts that DVRC would have owed to ReathCo under the DVRC Management Agreement, including interest on past due amounts. They booked those amounts as liabilities **[*109]** in DVRC's financial statements. Then they recharacterized any transfers from DVRC to ReathCo as management fees. Those decisions did not result from a fair process. They were administrative exercises by DVRC employees.

2. The Management Fees: Fair Price

The more difficult aspect of the entire fairness analysis is financial fairness. The evidence is mixed, with Manheim presenting expert testimony indicating that to the extent that the management fees were viewed as his compensation, then the level of compensation that he received fell within a broad range of financial fairness when compared to the compensation received by executives at private equity firms and by fund managers. The plaintiffs called into question the persuasiveness of those comparisons, and they attacked the level of Manheim's compensation in light of the agreements reached in connection with the Reorganization.

a. The Expert Testimony

To establish the fairness of the management fees, Manheim relied on expert testimony from Irv Becker, Vice Chairman of the Executive Pay & Governance Practice of Korn Ferry.[25] Becker is an experienced

---

[25] Manheim also cited his own employment history. He explained that he had worked in highly compensated positions, including as a bond trader at Salomon Brothers in London, as an investment banker at ING, as a fund manager for a New York hedge fund, and as the Chief Investment Officer at the Swarthmore Group. *See* Manheim Tr. 451-53. Manheim did not, however, provide any information about his compensation in these positions, except his testimony that during his first two years at the Swarthmore Group, he was paid $400,000 per year. *Id.* at 456-57. Manheim also testified that he received bonuses, but he did not identify the amount. *Id.* at 457. And ReathCo was paid $500,000 annually for acting as a family office for Manheim's wealthy friend. Ban Tr. 209; *see* Manheim Tr. 516.

Manheim's compensation history might have provided some compensation consultant who works with boards of directors and senior management in the design **[*110]** and development of compensation programs. *See* JX 1418 ¶¶ 1-5.

Becker testified that an AUM-based methodology is a reasonable and common form of executive compensation for asset management firms. Becker Tr. 1040. Becker opined that it creates a pay-for-performance structure that aligns DVRC's and Manheim's interests to grow DVRC's asset base and profitability. *Id.* That opinion addresses the structure of the management fee; it does not speak to the amount of the fee. Becker did not do any benchmarking to determine whether a management fee of 0.25% of AUM was reasonable. Becker Tr. 1056-57.[26]

Becker testified that Manheim's compensation fell within a range of fairness. To develop a range, Becker conducted his own competitive market assessment by examining the pay of executives that he regarded as performing roles similar to Manheim. JX 1418 ¶ 6; Becker Tr. 1039-40. No public information about EB-5 regional centers is available, so Becker looked at compensation levels for executives at private equity firms, investment management firms, and investment advisory firms. He used information from three different sources. JX 1418 ¶¶ 15-33.

The first source was a database created **[*111]** by Economic Research Institute ("ERI"), which collects data through salary surveys and from public company filings. *Id.* ¶¶ 15-19. Using a proprietary regression, ERI created a formula that calculates an implied level of compensation for a particular position based on the level of AUM. Becker only had access to the formula for 2019. Becker Tr. 1043. To generate a compensation figure for 2019, Becker keyed in DVRC's AUM and selected the CEO position, then the ERI interface generated an implied level of compensation. *Id.* To generate compensation figures for the years 2015-2018, Becker discounted the 2019 figures by 5% per year. To generate data for 2020, he increased the 2019 figures by 5%. *Id.* Becker did not have access to ERI's underlying data or to the regression. *Id.* at 1044.

Becker's second source was Heidrick & Struggles, which conducts an annual survey of private equity compensation and aggregates the data to evaluate trends. Becker used the surveys from 2016 to 2019 to determine the compensation of the person in the managing partner position (the highest position) at a private equity firm with AUM similar to DVRC. Becker excluded carried interest compensation from the calculation. **[*112]** JX 1418 ¶¶ 27-33; Becker Tr. 1046-47. Becker again did not have access to data for 2020, so he used the figures for 2019 and increased them by 5%. Becker Tr. 1046.

Becker's third source consisted of surveys of compensation at financial services companies prepared by McLagan Data & Analytics ("McLagan"). Becker used the surveys for private equity firms, asset management companies, and banks. JX 1418 ¶¶ 20-26. From the private equity survey, Becker generated a benchmark based on the compensation of a managing director of direct investments. The only available data was for funds with up to $5 billion in AUM, many times DVRC's size. From the asset management surveys, Becker developed a benchmark for the compensation of a senior portfolio manager in fixed-income investments. The only available data was for funds with up to $15 billion in AUM, many more times DVRC's size. Becker also used the asset management surveys to develop a benchmark for the compensation of a senior portfolio manager in municipal fixed-income investments, which included funds of all sizes. From the banking survey, Becker developed a benchmark for a managing director of municipal finance, where he again drew data from **[*113]** companies of all sizes. To attempt to account for the fact that the surveys included compensation data from much larger entities, Becker used data for the second highest executive position, rather than the highest position. Becker Tr. 1048-49.

Becker opined that a reasonable range of compensation would fall between the 10th percentile and the 90th percentile of peer companies. Using his data sources, Becker developed the following ranges of reasonable compensation:

support for the level of management fees that ReathCo received, but Manheim would have needed to provide additional details, including more specific compensation figures. He also would have needed to provide additional insight into the advisory fees that ReathCo received from Manheim's wealthy friend and how they were calculated. As presented, Manheim's description of his compensation history is unpersuasive.

[26] The plaintiffs' industry expert, Sam Silverman, agreed that officer compensation for an EB-5 business could be tied to AUM. Silverman Tr. 898. That statement was not the strong endorsement that Manheim claims. Silverman agreed that it was possible to tie compensation to AUM, and he noted that executive compensation could be tied to other metrics as well. *See id.*

Go to table1

JX 1418 ¶¶ 35-39; Becker Tr. 1049-52. Based on these ranges, Becker opined that reasonable compensation for the period from 2015 to 2020 for a role comparable to Manheim's would range from $2,940,000 to $10,369,000. *See* JX 1418 ¶ 40. Becker opined that Manheim's compensation of $5,652,406 fell within a reasonable range. Becker Tr. 1052-55.

The plaintiffs' rebuttal expert, David Denis, critiqued Becker's analysis. Denis explained that Becker simply looked at pay for comparable positions at comparable firms. Denis Tr. 1082. As with any analysis of this type, its persuasiveness **[*114]** depends on the strength of the comparisons.[27] Becker failed to establish persuasively that the positions were comparable, that the firms were comparable, or that the resulting range was informative.

In terms of firms, Becker failed to explain persuasively that private equity, investment management, and investment advisory firms were sufficiently comparable to the EB-5 Business. The compensation received by fund executives correlates with the fund's investment strategy, investment risk, and rate of return. *See* Becker Tr. 1073-75; Denis Tr. 1084-85, 1088. DVRC, however, is not a traditional investment manager that seeks to generate above-market rates of return by following a particular investment strategy. DVRC's investors do not expect to receive even at-market returns, because they are motivated by the prospect of receiving green cards. *See* Denis Tr. 1084-85. DVRC's investments and fee structure demonstrate how distinctive it is. DVRC invests all of its capital by making loans to the PTC or SEPTA that bear interest at a rate of 2% per annum. DVRC retains 75% of the income that the funds generate. In addition, DVRC takes 0.25% of AUM as a management fee. DVRC thus receives around 87.5% **[*115]** of the returns from the funds' investments, with the fund investors receiving only 12.5%. Moreover, to receive that return, the funds' investors must pay a subscription fee equal to 10% of their principal. Denis calculated that the combination results in a rate of return of negative 1.41%. *Id.* at 1086. Becker did not consider the distinctions between the funds he examined and the EB-5 Business. *See* Becker Tr. 1070, 1073-74.

In terms of positions, Becker did not persuasively establish a comparable relationship between what Manheim does and what fund executives do. A fund manager in an actively managed fund engages in the process of buying and selling securities in an effort to deploy an investment strategy designed to generate an attractive rate of return. That effort requires complex due diligence and a series of investment decisions. In the case of private equity funds, the fund managers become actively involved in their portfolio companies. In the EB-5 Business, each fund makes a single loan to a government agency which it holds to term. The differences between the EB-5 Business and other types of fund management businesses means that there are necessarily significant differences **[*116]** between the executive positions. *See* Denis Tr. 1088-90. Becker did not know if Manheim performed activities similar to fund managers and admitted that he was not qualified to make that determination. Becker Tr. 1069.

In terms of his ultimate range, Becker opined that a range of fairness ran from the 10th percentile to the 90th percentile. That range was expansively wide, and it did not take into account differences among firms that would be correlated with relevant criteria. *See* Denis Tr. 1091. The compensation range used to justify Manheim's total compensation also included 2015, before DVRC had AUM.

Denis and the plaintiffs offered still more critiques. Denis noted that because ERI uses an undisclosed, proprietary regression analysis, Becker could not confirm if the regression was reliable. Becker Tr. 1076. Denis pointed out that the benchmarks generated from the McLagan data either did not have any limitations on a firm's AUM or included firms with AUM much greater than DVRC, resulting in the inclusion of companies that

---

[27] *In re Cellular Tel. P'ship Litig., 2022 Del. Ch. LEXIS 56, 2022 WL 698112, at *30 (Del. Ch. Mar. 9, 2022)* ("The reliability of the comparable companies method thus depends in the first instance on having companies that are sufficiently comparable that their valuation ratios provide insight into the value of the subject company."); *In re Appraisal of Orchard Enters., Inc., 2012 Del. Ch. LEXIS 165, 2012 WL 2923305, at *9 (Del. Ch. July 18, 2012)* ("Reliance on a comparable companies or comparable transactions approach is improper where the purported 'comparables' involve significantly different products or services than the company whose appraisal is at issue, or vastly different multiples. At some point, the differences become so large that the use of the comparable company method becomes meaningless for valuation purposes." (cleaned up)); *In re Radiology Assocs., Inc. Litig., 611 A.2d 485, 490 (Del. Ch. 1991)* ("The utility of the comparable company approach depends on the similarity between the company the court is valuing and the companies used for comparison.").

were not comparable to DVRC. JX 1519 ¶ 66. Denis also observed that Becker did not take into account regional variations in compensation. The Heidrick & Struggles **[*117]** data showed that in 2018, managing partners in the mid-Atlantic region, where DVRC is located, earned 71% of what their counterparts in the Northeast earned. In 2019, that figure was 52%. *Id.* ¶ 69.

On balance, Denis called into question the persuasiveness of Becker's work. The persuasiveness of a study based on comparisons depends on how similar the comparisons are. Becker failed to establish that his comparisons were sufficiently persuasive, and Denis undermined them further.

b. The Case-Specific Evidence

Rather than looking to survey evidence on third-party compensation, Denis opined that the fairness analysis must consider the understandings that Manheim, Ban, and Bamford reached in connection with the Reorganization. *See* Denis Tr. 1083-84. This court recently looked to parties' original agreement to evaluate the fairness of management fees that a fund manager subsequently charged. *See* *HOMF II Inv. Corp. v. Altenberg, 2020 Del. Ch. LEXIS 190, 2020 WL 2529806, at *45-48 (Del. Ch. May 19, 2020)*, *aff'd*, *263 A.3d 1013 (Del. 2021)* (TABLE).

When the Reorganization took place, Manheim and Ban were receiving compensation of $300,000 in salary plus benefits. The Admission Agreement contemplated that after DVRC paid or made provision for its liabilities and expenses, including the compensation due to its officers, WestCo would **[*118]** distribute the available cash flow to the members of DVRC. Through that mechanism, Penfold would receive 90% of the distribution, and Manheim, Ban, and Bamford would receive equal shares of the 90%. No one said anything about the existence of a commitment by DVRC to pay a management fee to ReathCo equal to 0.25% of AUM.

The Admission Agreement memorialized those agreements through the Allocation Provision and the Distribution Provision. Through the Allocation Provision, Manheim, Ban, and Bamford agreed that the officer compensation Manheim and Ban received would be treated as an expense of DVRC and not as a distribution of cash flow. JX 452 ¶ 4(b). In the Distribution Provision, Manheim, Ban, and Bamford agreed that WestCo "shall . . . distribute Available Cash Flow," defined as "the cash of the Company available after appropriate provision for expenses and liabilities, as determined by the Managing Member." *Id.*

These provisions did not prevent the WestCo Board from increasing the compensation paid to Manheim and Ban. The WestCo Board had the power to increase officer compensation. These provisions did not even prevent the WestCo Board from approving a management fee. The WestCo Board **[*119]** could cause DVRC to incur liabilities and expenses, including a management fee to a related party. For this reason, the plaintiffs do not possess a claim for breach of the Admission Agreement based on the payment of management fees to ReathCo.

The Admission Agreement did reflect an expectation that the WestCo Board would act openly through a formal increase in officer compensation, rather than through other means. As this decision has discussed, Manheim, Ban, and Bamford agreed to the Reorganization in an effort to allocate cash flows transparently and fairly. They did not contemplate a management agreement under which DVRC committed to pay approximately 14% of its revenue to Manheim, above the level of compensation that the WestCo Board approved for him to receive.

This evidence supports a finding that the full amount of the management fees paid to ReathCo was not entirely fair. At the same time, the evidence does not suggest that any amount paid in management fees over $300,000 was unfair. Ban himself acknowledged that some of the transfers to DVRC were proper and he did not object to their payment. *See, e.g.*, Ban Tr. 390, 394; JX 506.

3. The Finding Regarding Fairness

Viewing the evidence **[*120]** holistically, Manheim failed to carry his burden of showing that the management fees paid to ReathCo were entirely fair. The evidence on fair dealing favors the plaintiffs. The evidence on fair price is mixed. Manheim offered an expert opinion from a compensation expert, but the plaintiffs successfully undermined his testimony. The case-specific evidence indicates that the full amount of the management fee that Manheim extracted was not entirely fair.

Manheim therefore failed to prove that it was entirely fair for ReathCo to receive excess management fees in the amount of $3,552,406. As discussed below, however, the court will not award the full amount as a remedy.

D. Transfers To Frank, Mezzaroba, And Mandle

The plaintiffs also challenge $3,047,651.69 in transfers from DVRC to Frank, Mezzaroba, and Mandle between 2018 and 2020. These transfers consist of compensation and benefits paid to Frank, Mezzaroba, and Mandle.

a. Frank's Compensation

The plaintiffs challenge Frank's compensation of $1,415,918.48. That total consists of:

• Salary of $150,000 per year from May 2017 until November 2018. JX 466.

• Salary of $300,000 per year from November 2018 through the end of 2020. JXs 1017-18.

• A **[*121]** bonus of $150,000 in 2020. *See* JX 1309; Mezzaroba Tr. 802.

• Car reimbursement in 2018 and 2019 in the amount of $38,594.98. JX 1517 at '076.

• Gym expenses in 2019 in the amount of $9,087.50. *Id.* at '077.

At post-trial argument, the plaintiffs conceded that Frank was entitled to compensation of $150,000 per year. Given that concession, Frank was entitled to at least $600,000 in compensation. The debate is over the remaining $815,918.48.

"Self-interested compensation decisions made without independent protections are subject to the same entire fairness review as any other interested transaction." *Valeant Pharms. Int'l v. Jerney, 921 A.2d 732, 745 (Del. Ch. 2007)*. When a compensation decision is not plainly self-interested, however, a plaintiff must make a *prima facie* showing that the person making the compensation decision faced a conflict of interest. *Avande, Inc. v. Evans, 2019 Del. Ch. LEXIS 305, 2019 WL 3800168, at *14 (Del. Ch. Aug. 13, 2019)*. For purposes of Frank's compensation, the plaintiffs made the necessary showing. Family ties raise doubts about a fiduciary's independence. *In re J.P. Morgan Chase & Co. S'holder Litig., 906 A.2d 808, 823 (Del. Ch. 2005)*, *aff'd*, *906 A.2d 766 (Del. 2006)*. As Frank's brother, Manheim could not make an independent decision regarding Frank's compensation. He therefore had the burden of proving that Frank's compensation was entirely fair. *See* *CanCan Dev., LLC v. Manno, 2015 Del. Ch. LEXIS 144, 2015 WL 3400789, at *17 (Del. Ch. May 27, 2015)* ("The amounts Manno paid Joey and Patty are subject to entire fairness **[*122]** review."), *aff'd*, *132 A.3d 750 (Del. 2016)*.

Manheim carried his burden of demonstrating that Frank's compensation was entirely fair, notwithstanding defects from the standpoint of fair process. In November 2018, when the Board increased Frank's salary to $300,000, the only two directors who voted were Manheim and Mandle. JX 1018. Regardless of how one views Mandle, the WestCo Board that approved Frank's compensation lacked an independent and disinterested majority of directors.

The Board's process for approving a $150,000 bonus for Frank in 2020 was worse. Manheim, Frank, Mezzaroba, and Mandle voted to approve "discretionary bonuses in the aggregate amount of $375,000.000 for Board members Paula Mandle, Albert Mezzaroba, and Frank Manheim for their work in 2019." JX 1309. The resolution authorized Manheim to allocate the bonus pool. *Id.* Frank, Mezzaroba, and Mandle thus voted in favor of their own compensation in what was an obviously self-interested transaction.

Nevertheless, the fair price dimension of the entire fairness analysis carries the day. Frank's compensation increased from $150,000 to $300,000 because Frank took over Ban's duties after Ban left DVRC. Ban was paid $300,000 per year. It makes sense **[*123]** that Frank would receive similar compensation for similar work.

Manheim also proved that reimbursing Frank for his car and gym expenses was fair. DVRC had similarly covered Ban's car and gym expenses during his employment. JX 1517 at '078-80; Ban Tr. 262, 282, 400-04. The amounts paid to Frank do not seem excessive.

A compensation study that the Board commissioned in 2020 provides some additional evidence that Frank's compensation was fair. The Board retained HResults, Inc., a compensation consultant, to perform the study. HResults used two data sets to benchmark the compensation paid for the COO role at comparable firms. JX 1544. In one data set, HResults drew on published compensation surveys to obtain compensation information for firms with $500-$650 million AUM that were involved in "investing/harvesting assets" and "mezzanine/institutional/fund of funds." *Id.* at 2. HResults determined that $605,000 was the mean for the total cash compensation for a COO in 2020. *Id.* at 5. In the other data set, HResults drew on proprietary surveys and determined that at the 50th percentile, comparable firms paid $672,000 in salary and bonus for a COO. *Id.* at 13.

The HResults study is vulnerable to **[*124]** many of the same criticisms that undermined Becker's testimony in this case. Nevertheless, it provides an indication, and Frank's compensation is well below the figures in the study. That was even true in 2019 when Frank's total compensation reached its height of $478,286.77, consisting of a salary of $300,000, a bonus of $150,000, car reimbursements of $19,199.27, and gym expenses of $9,087.50. *See* Mezzaroba Tr. 802; JX 1517 at '076-77.

Manheim proved Frank's total compensation was fair.

b. Mezzaroba's Compensation

The plaintiffs challenge Mezzaroba's compensation of $1,189,527.39. That total consists of:

• Salary of $150,000 per year from May 2017 until November 2018. JX 466.

• Salary of $300,000 per year from November 2018 through the end of 2020. JXs 1017-18.

• A bonus of $150,000 in 2020. *See* JX 1309; Mezzaroba Tr. 802. 101

• Car reimbursement in 2018 and 2019 in the amount of $14,527.39. JX 1517 at '075.

Like Frank, Mezzaroba was entitled to at least $150,000 per year, which is the amount that Ban and Bamford approved in May 2017. JX 466. Mezzaroba was therefore entitled to at least $600,000 in compensation.

The plaintiffs did not make a *prima facie* showing that Mezzaroba's compensation **[*125]** was an interested transaction that would necessitate Manheim proving its fairness. *See* *Avande, 2019 Del. Ch. LEXIS 305, 2019 WL 3800168, at *14*. Unlike Frank, Mezzaroba did not have a family relationship with Manheim. Manheim and Mezzaroba are longtime friends, but the plaintiffs did not show that the relationship was sufficiently close to compromise Manheim's independence. The Manheim-Mezzaroba relationship was asymmetrical. Mezzaroba was not able to make independent decisions regarding transfers to Manheim because of the combination of his employment relationship, their friendship, and Manheim's status as a controller. The compromising connections do not run the other way.

The plaintiffs argue that Manheim paid Mezzaroba an excessive amount so that Mezzaroba would bless Manheim's self-interested transfers. Mezzaroba's compensation is not so excessive as to support an inference to that effect. Mezzaroba's compensation rather appears reasonable given his skills and qualifications. Mezzaroba is an experienced lawyer and executive who is well connected in state government and has important relationships with SEPTA and the PTC. He clearly provides considerable value to DVRC.

Because Mezzaroba's compensation was not an interested transaction, **[*126]** Manheim did not have to prove that Mezzaroba's compensation was entirely fair. Assuming for purposes of analysis that Manheim bore that burden, Manheim proved that Mezzaroba's total compensation was fair.

c. Mandle's Compensation

Finally, the plaintiffs challenge Mandle's compensation of $442,205.82. That total consists of:

• Salary of $150,000 per year from September 2018 until December 2020. JX 998.

• A bonus of $75,000 in 2020. *See* JX 1309; Mandle Tr. 735.

• A travel stipend of up to $18,000 per year from 2018-2020. Mandle Tr. 736-38

Given Mandle's astounding testimony at trial, the plaintiffs proved that Manheim breached his fiduciary duties by providing Mandle with this level of compensation, which Manheim failed to prove was entirely fair.

Once again, to invoke entire fairness review, the plaintiffs had the burden to make a *prima facie* showing that Manheim faced a conflict of interest when determining Mandle's compensation. *See* *Avande, 2019 Del. Ch. LEXIS 305, 2019 WL 3800168, at *14*. Mandle is an outside director. She has known Manheim since his days at the Swarthmore Group, she was one of the original directors and officers of WestCo, and she received shares when WestCo was created that she still owns today. Mandle then left the WestCo **[*127]** Board in 2012 after Ban acquired half of her shares. *See* JX 28; JX 49. Manheim reappointed her to the WestCo Board in September 2018, after the disputes arose with Bamford and Ban. *See* JX 998. Those ties are not sufficient to raise meaningful questions about

Manheim's independence from Mandle or his ability to set her compensation, so the business judgment rule applies as the default standard of review.

When the business judgment rule applies, the court will not second guess the decision unless it is so extreme that it constitutes waste. The plaintiffs disavowed making a claim for waste. They instead argued that Mandle's compensation was so extreme as to support an inference that Manheim paid Mandle as a *quid pro quo* for her to support his self-dealing.

At first blush, it is difficult to find conceptual daylight between these theories. Contemporary Delaware decisions have brought waste within the fiduciary framework of the business judgment rule by re-conceiving waste as a means of pleading that a fiduciary acted in bad faith.[28] A court may find that a fiduciary acted in bad faith "where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of **[*128]** the [entity]."[29] "The waste test is one way of establishing irrational, bad faith conduct." CanCan, 2015 Del. Ch. LEXIS 144, 2015 WL 3400789, at *21. A wasteful transaction is so extreme "as to create an inference that no person acting in a good faith pursuit of the corporation's interests could have approved the terms." Sample v. Morgan, 914 A.2d 647, 670 (Del. Ch. 2007).

The plaintiffs perceive a distinction between challenging a transaction solely on the basis of waste (i.e., because its terms are so extreme and nothing more) versus challenging a transaction as part of a larger breach of duty (i.e., because it is both extreme and inferably part of an illicit and symbiotic *quid pro quo*). They maintain that they have disavowed the former claim and asserted the latter claim.

The big picture always matters whenever this court considers a claim of fiduciary misconduct. A scenario in which one fiduciary appears to be facilitating breaches of duty by another fiduciary is qualitatively different than a scenario in which the plaintiff claims only that the terms of the transaction are egregiously or irrationally unfair. By disavowing a waste claim, the plaintiffs did not forsake their ability to argue that Mandle's compensation is sufficiently extreme, taking into account **[*129]** her responsibilities and knowledge, to support a finding that it constitutes an illicit and symbiotic *quid pro quo*.

Through her testimony at trial, Mandle portrayed herself as an individual so devoid of knowledge about DVRC and the EB-5 Business that her compensation would qualify as corporate waste. Mandle's testimony bordered on the farcical, to the point where the court must infer that Manheim pays her for reasons unrelated to her ability to act as a member of the WestCo Board and an officer of DVRC. Given Mandle's testimony, Manheim must be paying her to act as a rubber stamp for the self-interested decisions that he makes.

Mandle claimed to have an astounding lack of knowledge about WestCo, DVRC, and her roles. She was able to testify that she and Manheim are friends and that she rejoined the WestCo Board at Manheim's request. Mandle Tr. 722, 733. Other than that, Mandle claimed to know nothing:

- She did not know how much of the member interest in

[28] *See, e.g.,* White v. Panic, 783 A.2d 543, 554 n.36 (Del. 2001) ("To prevail on a waste claim or a bad faith claim, the plaintiff must overcome the general presumption of good faith by showing that the board's decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation's best interests."); In re Books-A-Million, Inc. S'holders Litig., 2016 Del. Ch. LEXIS 154, 2016 WL 5874974, at *8 (Del. Ch. Oct. 10, 2016) ("When the business judgment rule provides the operative standard of review, then a court will not consider the substance of the transaction unless its terms are so extreme as to constitute waste and thereby support an inference of subjective bad faith."), *aff'd*, ***164 A.3d 56 (Del. 2017)*** (TABLE); CanCan, 2015 Del. Ch. LEXIS 144, 2015 WL 3400789, at *20 (explaining that waste is "best understood as one means of establishing a breach of the duty of loyalty's subsidiary element of good faith"); Se. Penn. Transp. Auth. v. AbbVie Inc., 2015 Del. Ch. LEXIS 110, 2015 WL 1753033, at *14 n.144 (Del. Ch. Apr. 15, 2015) ("This Court has found that, doctrinally, waste is a subset of good faith under the umbrella of the duty of loyalty."), *aff'd*, ***132 A.3d 1 (Del. 2016)*** (TABLE).

[29] In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 67 (Del. 2006); *accord* Stone ex rel. AmSouth Bancorp. v. Ritter, 911 A.2d 362, 369 (Del. 2006); *see* Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1051 n.2 (Del. Ch. 1996) (defining a "bad faith" transaction as one "that is authorized for some purpose other than a genuine attempt to advance corporate welfare or is known to constitute a violation of applicable positive law"); In re RJR Nabisco, Inc. S'holders Litig., 1989 Del. Ch. LEXIS 9, 1989 WL 7036, at *15 (Del. Ch. Jan. 31, 1989) (explaining that the business judgment rule would not protect "a fiduciary who could be shown to have caused a transaction to be effectuated (even one in which he had no financial interest) for a reason unrelated to a pursuit of the corporation's best interests").

DVRC was owned by WestCo. Mandle Tr. 727-29.[30]

• Besides WestCo, she did not know who DVRC's other owners were. *Id.*[31]

• She had "heard of" Penfold but had "no understanding" of what it was. *Id.* at 729.[32]

• She knew there was a general manager for **[*130]** DVRC, but she had no specific knowledge of the general manager and believed it was Manheim. *Id.* at 728.[33]

• She had "no specific knowledge" of the business ReathCo was in. *Id.* at 730.[34]

• The only knowledge she had of ReathCo was of "its existence." *Id.*[35]

• She did not know if ReathCo provides any services to DVRC. *Id.* at 730-31.[36]

• When asked if she was aware of any management fee paid by DVRC to ReathCo, she said she was "aware that there is a management fee," but she did not know how much it is. *Id.* at 731.[37]

• She was not familiar with any loans between DVRC and WestCo. *Id.* at 733.[38]

• When asked if she was an officer of DVRC, she said, "I do not believe so, no." Mandle Tr. 728.[39]

• After being shown a document that identified her as DVRC's Chief Compliance Officer, she acknowledged that the document said that, but she was not sure that she held that title and could not describe any work she did in that capacity. *Id.* at 734. During her deposition, she stated that the Chief Compliance Officer role did not need to be active. Mandle Dep. 137.

• She agreed that she approves the wire transfers that DVRC uses to pay its expenses. Mandle Tr. 731-32. She could not recall approving wire transfers to ReathCo **[*131]** in the amount of $115,000 per month during 2019. *Id.* at 732.

• She had never done anything to determine whether any wire transfers sent to ReathCo were correct. *Id.*

• When asked about spending time at DVRC's offices, she testified that she went there "socially" at a frequency of "most likely every other week." *Id.* at 734-35.

She did know that she received a salary of $150,000 and a bonus of $75,000 in 2020. Mandle Tr. 734-35.

Mandle's testimony paints a stunning picture. She showed up at DVRC about once "every other week," where she has no recollection of doing much of anything. She approved transfers, but she did not know what they were for or why. She thought of her appearances as social visits. Based on her salary of $150,000 per year, she was paid about $5,769 per visit in 2018 and 2019. Adding in her bonus in 2020, she received about $8,654 for each visit in that year. She has no meaningful knowledge of DVRC, its governance structure, or its significant obligations.

It is hard to believe that Mandle actually knows so little about DVRC. Mandle seems to have had a successful career as one of the principals of the Swarthmore

---

[30] WestCo owns 10% of DVRC.

[31] DVRC has only one other owner—Penfold.

[32] Penfold is the only other owner of DVRC. It holds 90% of DVRC's member interests.

[33] WestCo is the managing member of DVRC. ReathCo is paid a management fee to act as the managing agent for DVRC.

[34] ReathCo is in the business of managing DVRC. ReathCo receives a management fee to fulfill that role.

[35] Between 2017 and 2020, ReathCo received $5,652,406 in management fees from DVRC. According to the defendants, ReathCo was and remains entitled to an on-going management fee equal to 0.25% of DVRC's AUM. Mandle claimed not to know anything about the recipient of those fees.

[36] To reiterate, between 2017 and 2020, ReathCo received $5,652,406 in management fees from DVRC, and the defendants claim that ReathCo was and remains entitled to an on-going management fee equal to 0.25% of DVRC's AUM. Mandle claimed not to know of any services that ReathCo provided in return for those fees.

[37] For a third time, between 2017 and 2020, ReathCo received $5,652,406 in management fees from DVRC. According to the defendants, ReathCo was and remains entitled to an on-going management fee equal to 0.25% of DVRC's AUM. As this decision has discussed, the management fee equates to 14% of DVRC's topline revenue. It is one of DVRC's largest expenses.

[38] Between 2014 and 2019, WestCo extended informal loans to ReathCo in the amount of $1,614,670. A loan agreement dated August 10, 2018, documented an additional loan from DVRC to WestCo in the amount of $1,798,332.17. JX 930.

[39] Mandle is both Chief Compliance Officer and a vice president.

Group, where she served as its CEO. Having considered her testimony **[*132]** and demeanor, it seems likely that she played dumb and pretended not to know anything about DVRC because she thought that would be helpful to the defendants and to herself for purposes this litigation. But that behavior itself provides powerful evidence of an illicit and symbiotic relationship between Mandle and Manheim. He pays her to serve his interests in the boardroom, and she continued to play that role on the witness stand. In return, she cashes her checks and ignores her duties.

The plaintiffs proved that Manheim paid Mandle to be his stooge. The payments to Mandle therefore constituted a breach of duty, and Manheim had the burden to prove that they were entirely fair to DVRC. Given Mandle's testimony, that was an impossible task. Manheim is liable for those payments.

E. Miscellaneous Expenses

The plaintiffs have challenged a long list of other expenditures. The plaintiffs bore the burden of establishing a *prima facie* case that the expenditures were self-interested. They failed for many of the expenditures. This decision only addresses the expenditures where they succeeded in making a *prima facie* case. As to those expenditures, Manheim failed to establish a proper business purpose **[*133]** for the expenses or to prove that it was entirely fair for DVRC to bear them.

The first two expenses involve transfers to Work to Ride, a charity co-founded by Manheim. In 2014, DVRC donated a horse trailer to Work to Ride that was valued at $1,000. JX 1517 at '062. Any challenge to that expense is barred by laches. *See, supra*, Part II.A.2. In 2018, DVRC made a contribution of $50,000 to Work to Ride. JX 1517 at '070. Manheim made no effort to demonstrate that the donation had a legitimate business purpose. Nor did he show that the donation was entirely fair to DVRC.

In July 2016, Manheim submitted an expense report to DVRC on behalf of WestCo seeking reimbursement of $66,186.89 in expenses. *See id.* at '069. The report identified the following amounts, each of which was marked "personal" or "ReathCo."

• A political donation in the amount of $10,000.

• Stays at the Connaught Hotel totaling $24,991.20.

• Airfare totaling $16,936.22.

• A charge at the George Club for $796.79.

• Office furniture and expenses totaling $13,462.68.

Id.; JX 282. Manheim failed to prove that these expenses had a legitimate business purpose or were entirely fair to DVRC.

Over multiple years, charges totaling $3,928 were **[*134]** incurred at Delilah's Gentleman's Club. Of this amount, challenges to charges totaling $3,195 are barred by laches. *See* JX 1517 at '064. The remaining $733 was charged on a card in Manheim's name. *See id.* at '064-65. Manheim failed to prove that these expenses had a legitimate business purpose or were entirely fair to DVRC.

In 2019, DVRC paid $30,480.51 in medical expenses for Manheim after a skiing accident. *Id.* at '071. Manheim testified that he thought that DVRC had submitted these expenses to the health insurer for reimbursement but did not provide documentation showing that the insurer had reimbursed the expenses. *See* Manheim Dep. 384. There may have been a business purpose in having DVRC advance the expenses necessary to protect the health of its CEO in the immediate aftermath of his accident, but Manheim accepted the medical expenses were amounts that he, and not DVRC, should bear. Manheim did not prove that DVRC had been reimbursed for the expenses. Manheim is therefore liable for those amounts.

F. The Remedy

In light of the foregoing findings and rulings, Manheim failed to establish that the following amounts were entirely fair:

Go to table2

The presumptively proper remedy is to award damages to DVRC in the amount of $4,142,012.22. Ban endorses that form of relief, but he also seeks other remedies. Bamford wants an investor-level damages award in addition to other remedies.

This court has broad authority to craft relief suited to the specific facts and equities of the case.[40] The "protean

---

[40] *See* Gotham P'rs, 817 A.2d at 176 ("[T]he Court of

power of equity" allows a court to "fashion appropriate relief," and a court "will, in shaping appropriate relief, not be limited by the relief requested by plaintiff." *Tex. Instruments Inc. v. Tandy Corp., 1992 Del. Ch. LEXIS 101, 1992 WL 103772, at *6 (Del. Ch. May 12, 1992)* (Allen, C.). "When equity takes jurisdiction of a cause and decides that relief shall be granted, the relief, including damages, if any, will be tailored to suit the situation as it exists on the date the relief is granted and the choice of relief is largely a matter of discretion with the trial judge." *Guarantee Bank v. Magness Constr. Co., 462 A.2d 405, 409 (Del. 1983)* (holding that the Court of Chancery did not err in awarding a remedy that diverged from the parties' stipulated facts).

> Fundamentally, once a right to relief in Chancery has been determined to exist, the powers of the Court are broad and the means flexible to shape and adjust the precise relief **[*136]** to be granted so as to enforce particular rights and liabilities legitimately connected with the subject matter of the action. It is necessary for the Court to adapt the relief granted to the requirements of the case so as to give to the parties that to which they are entitled.

Wilmont Homes, Inc. v. Weiler, 42 Del. Ch. 8, 202 A.2d 576, 580 (Del. 1964) (citation omitted). "The choice of relief to be accorded a prevailing plaintiff in equity is largely a matter of discretion with the Chancellor, and Delaware, with its long history of common law equity jurisprudence, has followed that tradition." *Lynch v. Vickers Energy Corp., 429 A.2d 497, 500 (Del. 1981)* (citation omitted), *overruled on other grounds*, *Weinberger, 457 A.2d 701*.

> Unlike its extinct English ancestor, the High Court of Chancery of Great Britain, Delaware's Court of Chancery has never become so bound by procedural technicalities and restrictive legal doctrines that it has failed the fundamental purpose of an equity court—to provide relief suited to the circumstances when no other remedy is available at law.

William T. Quillen & Michael Hanrahan, *A Short History of the Delaware Court of Chancery: 1792-1992, in* Court of Chancery of the State of Delaware: 1792-1992, at 21, 22 (1992).

Chancery's powers are complete to fashion any form of equitable and monetary relief as may be appropriate." (cleaned up)); *Hanby v. Wereschak, 42 Del. Ch. 206, 207 A.2d 369, 370 (Del. 1965)* ("[T]he Court of Chancery [has] . . . the inherent powers of equity to adapt its relief to the particular rights and liabilities of each party . . . .").

In one respect, the court departs from the presumptively proper remedy. Manheim failed to prove that **[*137]** the $3,522,406 in excess management fees was entirely fair. At the same time, Manheim's evidence demonstrated that $300,000 in salary was a low level of compensation for his position. Manheim had been receiving $300,000 per year in salary since his original agreement with Ban in 2014. The WestCo Board certainly could have increased Manheim's compensation openly by some amount and demonstrated that the increased compensation was entirely fair.

The parties have taken diametrically opposing positions about what the court should do in this situation. The plaintiffs want Manheim to be liable for the full amount of the management fees. Manheim contends that the plaintiffs were obligated to prove what a fair amount of compensation would have been, with Manheim only liable for the excess. Manheim contends that because the plaintiffs did not seek to prove a fair amount of compensation, he gets to keep the whole amount.

Each side has valid conceptual reasons for its position. By making the fiduciary disgorge the full measure of the unfair payment, the plaintiffs' approach discourages self-dealing and promotes good governance. The plaintiffs' approach also recognizes that Manheim bore the burden **[*138]** of proof on the issue of fairness. Manheim responds that a remedy of full disgorgement is unfair to him, precisely because his services were worth more to DVRC. A full disgorgement remedy therefore would confer a windfall on DVRC. Manheim contends that the plaintiffs must prove their damages, rather than simply receiving disgorgement.

Delaware law generally supports the plaintiffs' positions. *See* *Metro Storage Int'l LLC v. Harron, ___ A.3d ___, 2022 Del. Ch. LEXIS 101, 2022 WL 1404359, at *35-36 (Del. Ch. May 4, 2022)* (collecting authorities). That said, the court is not obligated to award full disgorgement. The court can award what it regards as a fair remedy. *See* *In re Happy Child World, Inc., 2020 Del. Ch. LEXIS 302, 2020 WL 5793156, at *13 (Del. Ch. Sept. 29, 2020)*.

The court is convinced that it would be unfair on the facts of this case to require Manheim to disgorge of all of the management fees in excess of $300,000 per year. As noted, the evidence on fairness was mixed. To resolve the case, the court has had to resolve difficult factual questions, and while the court has made its findings based on what a preponderance of the evidence showed, the court acknowledges the existence of contrary evidence.

This is also not a case where Ban and Bamford acted blamelessly. Ban played a major role in creating the hot mess of the Company's historical records. Bamford should have paid more attention. And when it **[*139]** came time to sue, Ban and Bamford could and should have been more precise in their challenges. Ban and Bamford each advanced wide-ranging arguments and theories, several of which turned out to lack factual support.

The critical question is whether the court has a factual basis to craft a fair remedy that falls in between the parties' all-or-nothing poles. The DVRC Management Agreement provides an evidentiary hook. Although Manheim relied on the DVRC Management Agreement to support the propriety of ReathCo receiving a management fee equal to 0.25% of AUM, the reality is that when that agreement was executed, Manheim had agreed to share the economic returns from the EB-5 Business equally with Ban. What the DVRC Management Agreement actually called for, therefore, was for Manheim to receive compensation equal to 0.125% of AUM.

At that level, Manheim would have received $1,776,203 in management fees, in addition to his salary of $2,100,000 from 2014 to 2020, for total compensation of $3,876,203. DVRC did not have AUM until 2016, so for the five years from 2016 to 2020, Manheim would have received additional compensation averaging $355,241 per year. Added to his salary of $300,000 per year, **[*140]** Manheim would have received total compensation of $655,241 per year. Compensation at that level brings Manheim above the low-end of the (flawed) range of fairness that his compensation expert presented.

In the exercise of the court's remedial discretion, the court only will hold Manheim liable for half of the excess management fees, or $1,776,203. Put conversely, the court finds that it would have been entirely fair for Manheim to receive total compensation of $3,876,203. Manheim is liable to DVRC for the full amounts of the other categories of transfers.

1. Damages Based On DVRC's Overall Level Of Expenses

Going beyond the specific transactions that this decision has addressed, the plaintiffs seek an award of damages on the theory that DVRC's overall expenses were too high. To support this remedy, the plaintiffs' damages expert calculated the difference between DVRC's reported expenses and what the plaintiffs' expert on the EB-5 industry, Silverman, opined was a reasonable level of expense for a comparable firm. Using that calculation, the plaintiffs sought total damages of $13,734,744, which they label "Scenario B Damages." As a practical matter, this approach sought to recover all **[*141]** of DVRC's expenditures to the extent they exceeded the *pro forma* figure that Silverman opined was reasonable.

When seeking Scenario B Damages, the plaintiffs did not attempt to isolate individual instances of self-dealing. They instead argued that Manheim's obligations as a fiduciary required that he justify the firm's expenses. They claimed that Manheim must be held liable for any expenses that he did not justify.

Under Delaware law,

> fiduciaries have a duty to account to their beneficiaries for their disposition of all assets that they manage in a fiduciary capacity. That duty carries with it the burden of proving that the disposition was proper. . . . [I]ncluded within the duty to account is a duty to maintain records that will discharge the fiduciaries' burden, and . . . if that duty is not observed, every presumption will be made against the fiduciaries.

*Technicorp Int'l II, Inc. v. Johnston, 2000 Del. Ch. LEXIS 81, 2000 WL 713750, at *2 (Del. Ch. May 31, 2000)*. "If corporate fiduciaries divert corporate assets to themselves for non-corporate purposes, they are liable for the amounts wrongfully diverted." *2000 Del. Ch. LEXIS 81, [WL] at *45*.

This legal principle, however, does not make a fiduciary strictly liable for every insufficiently documented expense. "[T]he mere fact that an expense is unsubstantiated is not grounds **[*142]** for finding a fiduciary breach." *Happy Child, 2020 Del. Ch. LEXIS 302, 2020 WL 5793156, at *15*. Before a fiduciary must demonstrate the fairness of an expenditure, the plaintiff must make a *prima facie* showing that the expenditures in question constituted a breach of fiduciary duty, typically because it constituted a self-interested transfer. *Avande, 2019 Del. Ch. LEXIS 305, 2019 WL 3800168, at *14*. Alternatively, if there is substantial evidence that a fiduciary engaged in widespread self-dealing through the reimbursement of expenses, then a court may hold the fiduciary to account for a broader range of transactions. *Dweck v. Nasser, 2012 Del. Ch. LEXIS 7,* 2012 WL 161590, at *19 (Del. Ch. Jan. 18, 2012) (holding fiduciary liable for "$171,966 of admittedly personal expenses and the $170,400 of indeterminate expenses" but not for $124,582 in expenses that the fiduciary testified were legitimate).

The plaintiffs did not make a *prima facie* showing that the thousands of individual expenditures covered by the Series B Damages scenario, incurred by DVRC over more than six years, constituted self-interested transfers or otherwise supported a *prima facie* case for breach of fiduciary duty. The plaintiffs did not even demonstrate that all of the expenses can be attributed to Manheim. Before his suspension and subsequent termination, Ban had the authority to incur expenses for DVRC. He had a **[*143]** DVRC credit card, and he charged many expenses to that account. *See, e.g.*, JX 596 (American Express transaction summary where 1,245 transactions of 1,400 were made on a company card in Ban's name). Ban used DVRC funds to pay for things like his apartment, car, bar review course, martial arts classes, and massages. *See* JX 1517 at '078-80; Ban Tr. 262, 282, 400-04. Some of the transactions benefited Bamford. For example, DVRC paid for Bamford to have an apartment in Philadelphia. *See* JX 331; Bamford Tr. 109.

In an attempt to avoid the consequences of failing to make a *prima facie* showing, the plaintiffs argue that their damages expert "didn't feel like he had sufficient information to opine definitively about the business purposes of DVRC's expense reimbursements, lacking underlying supporting documentation." Dkt. 357 at 51-52 (cleaned up). The plaintiffs had the ability to conduct broad discovery, and they obtained documents and testimony from the defendants' auditors and accountants. *See* Dkt. 176; Dkts. 181-82. The plaintiffs did not make a sufficient showing to call into question DVRC's general level of expenses. The court will not award additional damages on that basis.

2. An Accounting [*144] For Expenses Incurred On Or After January 1, 2020

As an additional remedy, the plaintiffs seek an accounting to identify expenses that Manheim incurred after January 1, 2020. The plaintiffs did not show a sufficient need for an accounting.

The plaintiffs' forensic expert received "financial information pertaining to the year ended December 31, 2020 for DVRC, the DVRC EB-5 Funds, and Penfold, including bank statements, payroll journal reports, contractor payment reports, employee expense reports, monthly credit card statements, deposit confirmation reports, and cash card statements." JX 1530 at '004. The only financial records that the plaintiffs claim their expert was missing were DVRC's audited financial statements and its 2020 tax returns. The documentation that the expert received should have been enough to allow the plaintiffs to challenge any supposedly improper expenses in 2020.

The plaintiffs did not receive any information about subsequent time periods, raising the possibility of an accounting for 2021. If the plaintiffs had shown that Manheim engaged in a widespread practice of causing DVRC to pay improper expenses, then an accounting might be warranted. *See, e.g.,* Carlson v. Hallinan, 925 A.2d 506, 537 (Del. Ch. 2006); Technicorp, 2000 Del. Ch. LEXIS 81, 2000 WL 713750, at *2. During **[*145]** DVRC's early days, its bookkeeping was poor, and Manheim and Ban were using DVRC to cover personal expenses to generate tax benefits. Had those practices continued, then an accounting might well be appropriate. Since the SEC inquiry, however, DVRC has cleaned up its act.

The plaintiffs can use their informational rights to obtain financial statements and basic entity-related documents. They also can obtain information about any related-party transfers involving Manheim, the members of the WestCo Board, or DVRC's senior officers. *See Woods Tr. of Avery L. Woods Tr. v. Sahara Enters., Inc., 238 A.3d 879, 900-02 (Del. Ch. 2020)*. If they have a proper purpose that would support further digging, such as a credible basis to explore potential wrongdoing, then they can obtain additional documents. The court will not require an accounting as part of the remedy in this case.

3. An Investor-Level Remedy

Bamford argues that to the extent the court holds Manheim liable for diverting amounts from DVRC, then the court should award an investor-level remedy rather than a corporate-level remedy. A court has the power to award an investor-level remedy in a derivative action, but this case does not warrant it.

"The recovery in a derivative action generally goes to the injured entity, but that rule **[*146]** is not absolute." Goldstein v. Denner, 2022 Del. Ch. LEXIS 125, 2022 WL 1797224, at *15 (Del. Ch. June 2, 2022) (footnote omitted) (collecting authorities). The rule that calls for the investor to sue derivatively in the corporation's name and for the corporation to receive the recovery "must always yield to the requirements of equity, and is cast aside in view of the fact that the stockholders are the real beneficiaries whenever the usual course is not open." *Home Fire Ins. Co. v. Barber, 67 Neb. 644, 93 N.W. 1024, 1033 (Neb. 1903)* (Pound, C.).

Courts have awarded investor-level remedies when the defendants were insiders who misappropriated entity property, such that an entity-level recovery would return the property to the wrongdoers' control. *See* *Goldstein, 2022 Del. Ch. LEXIS 125, 2022 WL 179224, at *17* (collecting authorities). Courts likewise have crafted an investor-level recovery when the entity-level recovery would enable the "guilty" to benefit, but an investor-level recovery could be tailored to benefit only the "innocent" stockholders. *Id.* (collecting authorities). Courts have been most willing to award an investor-level remedy when the entity is no longer an independent going concern, such that channeling the recovery through the entity is no longer feasible or a *pro rata* recovery is more efficient. *Id.* (collecting authorities). Courts are less willing to consider an investor-level remedy **[*147]** if it would prejudice the rights of parties having a higher priority in the capital structure, such as creditors. *Id.* (collecting authorities).

This case exhibits two of the traditional factors that could support an investor-level remedy. Manheim, the self-dealing fiduciary, continues to control DVRC, so an entity-level recovery would return the wrongfully taken funds to Manheim's control. For similar reasons, an entity-level recovery would benefit Manheim, while an investor-level recovery could be tailored specifically for Bamford and Ban.

The traditional factor that does not apply is that DVRC remains a going concern. DVRC has not dissolved or merged into another entity, so channeling the recovery through the entity remains both possible and efficient.

A factor that could point to an investor-level remedy is the Distribution Provision, which requires that DVRC distribute its available free cash flow to its members. By causing DVRC to make the challenged transfers, Manheim demonstrated that the funds were not required to pay creditors or as reserves for potential liabilities. The amounts of those transfers would have been part of DVRC's available cash flow, and WestCo would have been **[*148]** obligated to cause DVRC to make a distribution that included those amounts. This court has regarded similar claims as direct rather than derivative,[41] suggesting that an investor-level recovery could be warranted.

Another factor that could point to an investor-level remedy is the burden on Manheim. To satisfy an entity-level remedy, Manheim must pay $2,365,809.22. In an investor-level remedy, Manheim only would need to pay 30% of that amount to Bamford ($709,742.77), and 30% of that amount to Ban (also $709,742.77) for a total of $1,419,485.53.

A factor weighing against an investor-level remedy is the role of WestCo, which owns 10% of DVRC. WestCo would benefit indirectly from 10% of an entity-level recovery, but Ban does not seek to include WestCo in an investor-level recovery. Bamford and Ban did not pursue this action on a class-wide basis, so it is not as easy as it might be to translate the entity-level remedy into an investor-level remedy. *Cf.* *Baker v. Sadiq, 2016 Del. Ch. LEXIS 126, 2016 WL 4375250, at *1-2 (Del. Ch. Aug. 16, 2016)* (explaining how investor-level and entity-level remedies can act as substitutes and be converted from one to the other). No one has addressed whether the court could realign WestCo as a plaintiff for purposes of receiving its share of **[*149]** the remedy.[42]

Conceptually, enabling WestCo to receive that recovery would stand in tension with this decision's rejection of the plaintiffs' efforts to assert claims that belong to WestCo. Either the court should engage with the real relations among the parties and address the injuries to WestCo, or it should pass and treat this case as a traditional derivative action involving DVRC.

On balance, the court will not take the step of awarding an investor-level remedy. An entity-level remedy in this case is straightforward and efficient. The court need not deviate from the well-trod path.

---

[41] *See* *Sehoy Energy LP v. Haven Real Est. Gp., LLC, 2017 Del. Ch. LEXIS 58, 2017 WL 1380619, at *8 (Del. Ch. Apr. 17, 2017)* (declining to hold that claim for excessive loans was derivative where entity was "a mere pass through entity" such that the benefits "flow directly back to the investors"); *Anglo Am. Sec. Fund, L.P. v. S.R. Global Int'l Fund, L.P., 829 A.2d 143, 152-53 (Del. Ch. 2003)* (same).

[42] Alternatively, the court could decline to address WestCo's rights, recognizing that WestCo could bring a separate action to recover its share of the recovery and invoke principles of issue preclusion against Manheim. Because Manheim owns 70% of WestCo and controls it, a demand to cause him to assert WestCo's claim would be futile, so Ban could cause WestCo to pursue it.

4. The Invalidation Of WestCo's 10% Interest

In addition to a monetary remedy, Bamford and Ban ask the court to find that Manheim, Ban, and Bamford agreed in connection with the Reorganization that each would own one-third of DVRC's equity. To implement that agreement, Ban and Bamford ask the court to invalidate the 10% interest in DVRC that WestCo retained in the Reorganization. At the conclusion of trial, the court flagged this as an open issue. Tr. 1157.

Having considered the parties' arguments, the court finds that WestCo retained a 10% interest in DVRC and that there is no persuasive reason to deprive **[*150]** WestCo of that interest. The Admission Agreement expressly provides for that outcome, and Bamford and Ban each signed the Admission Agreement. They agreed to have WestCo retain a 10% interest.

As noted, Bamford and Ban have argued that Manheim represented that they each would own a one-third interest in DVRC, rather than WestCo owning a 10% interest and Manheim, Bamford, and Ban sharing a 90% interest. *See* Bamford Tr. 24-25; Ban Tr. 213. The Admission Agreement contains an integration clause which provides that it

> constitutes the entire agreement between the parties with respect to its subject matter and supersedes any and all other previous or contemporaneous communications, representations, understandings, agreements, negotiations, and discussions, either oral or written or oral agreements, understandings, or representations, directly or indirectly related to this Agreement, that are not set forth in this Agreement.

JX 452 § 6. In light of the integration clause, Ban and Bamford cannot rely on an unwritten understanding. If Ban and Bamford wanted to cut out WestCo or convert WestCo's interest into a non-economic one, they should have provided for that result in the Admission Agreement. **[*151]**

Regardless, the record does not support the existence of an unwritten understanding. The court has found that Manheim did not make any misrepresentations to Ban or Bamford in connection with the Reorganization. FF ¶ 51. That includes not making a misrepresentation that they each would receive a one-third interest in DVRC.

As among themselves, Manheim, Ban, and Bamford may have referred colloquially to having equal ownership, and perhaps Ban and Bamford understood that to mean that they each would receive a third. If they did, then their understanding was unreasonable. The Admission Agreement clearly provides that WestCo retained a 10% interest as a managing member and that Manheim, Ban, and Bamford each received a 30% non-managing interest.

At trial, Manheim provided a credible explanation for retaining WestCo as DVRC's managing member with a 10% member interest. He pointed out that Mandle continued to own a 15% interest in WestCo. It was one thing to dilute her interest through the Reorganization. It was another to eliminate WestCo's status as a member and cut her out entirely. *See* Manheim Tr. 537. It is possible to discount that explanation as a make-weight excuse. It would have been **[*152]** easy to eliminate WestCo from the structure and preserve Mandle's share by giving her a 1.5% interest in DVRC. The person who benefitted most from retaining WestCo's 10% interest in DVRC was Manheim, because he owned 70% of that entity. But Manheim's explanation is plausible, and it provides another reason for rejecting the plaintiffs' position.

There is no justification for disturbing the Reorganization and eliminating WestCo's interest. WestCo retains a 10% managing member interest in DVRC.

5. An Order Terminating Manheim's Control

In their most aggressive request for relief, the plaintiffs ask the court to terminate Manheim's control over DVRC by removing WestCo as DVRC's managing member, removing ReathCo as Penfold's general partner, and replacing each with a board consisting of Manheim, Bamford, and Ban. The plaintiffs have come nowhere close to proving facts that would support such an extraordinary remedy.

From the outset, Manheim has always had control of the EB-5 Business. He established WestCo as an entity that he controlled, and he made WestCo the sole member of DVRC. Manheim was willing to share the economic returns with Ban through the Ban Profit-Sharing Agreement, but he was **[*153]** not willing to give up control. Manheim accepted financing from Bamford for WestCo in the form of convertible debt, but he ensured that he could repay the debt to prevent Bamford from being able to take control of WestCo. In the Admission Agreement, Manheim provided for WestCo to continue as the managing member of DVRC and for the 90% interest that he shared equally with Ban and Bamford to be a non-managing member interest. Through the

Contribution Agreement, Manheim, Ban, and Bamford placed their interests in Penfold, an entity in which they were limited partners. Manheim thus has always been in control of the EB-5 Business. Ban and Bamford understood that and accepted it.

If Manheim had abused his control pervasively, then the court might consider appointing a receiver or exploring other equitable remedies. The plaintiffs have not shown a level of wrongdoing sufficient to deprive Manheim of control. Manheim is guilty of taking too much money out of the EB-5 Business, which is something he has done since the venture's early days. That shortcoming can be remedied through an award of damages. Further relief is not necessary.

III. CONCLUSION

Manheim breached his fiduciary duty to DVRC. **[*154]** He is liable to DVRC for the following amounts:

Go to table3

Manheim is also liable for pre- and post-judgment interest on these amounts, compounded quarterly at the legal rate.

Within thirty days, the parties will submit a proposed final judgment that has been agreed as to form. If there are issues that need to be addressed before a final judgment can be entered, then the parties will submit a joint letter outlining those issues and proposing a schedule for their resolution.

Table1 (*Return to related document text*)

Year	Low End (10%)	High End (90%)
2015	$486,000	$1,447,000
2016	$498,000	$1,308,000
2017	$444,000	$1,445,000
2018	$491,000	$1,788,000
2019	$524,000	$2,137,000
2020	$550,000	$2,224,000

Table1 (*Return to related document text*)

Table2 (*Return to related document text*)

Category	Amount
Excess Management Fees	$3,552,406.00 **[*135]**
Compensation to Mandle	$442,205.82
Improper Expenses	$147,400.40
Total	$4,142,012.22

Table2 (*Return to related document text*)

Table3 (*Return to related document text*)

Category	Amount
Excess Management Fees	$1,776,203.00
Compensation to Mandle	$442,205.82
Improper Expenses	$147,400.40
Total	$2,365,809.22

Table3 (*Return to related document text*)

End of Document

Bandera Master Fund LP v. Boardwalk Pipeline, LP

Court of Chancery of Delaware

July 14, 2021, Submitted; November 12, 2021, Decided

C.A. No. 2018-0372-JTL

Reporter

2021 Del. Ch. LEXIS 266 *; 2021 WL 5267734

BANDERA MASTER FUND LP, BANDERA VALUE FUND LLC, BANDERA OFFSHORE VALUE FUND LTD., LEE-WAY FINANCIAL SERVICES, INC., and JAMES R. MCBRIDE, on behalf of themselves and similarly situated BOARDWALK PIPELINE PARTNERS, LP UNITHOLDERS, Plaintiffs, v. BOARDWALK PIPELINE PARTNERS, LP, BOARDWALK PIPELINES HOLDING CORP., BOARDWALK GP, LP, BOARDWALK GP, LLC, and LOEWS CORP., Defendants.

Notice: THIS OPINION HAS NOT BEEN RELEASED FOR PUBLICATION. UNTIL RELEASED, IT IS SUBJECT TO REVISION OR WITHDRAWAL.

Prior History: *Bandera Master Fund LP v. Boardwalk Pipeline Partners, LP, 2019 Del. Ch. LEXIS 1296, 2019 WL 4927053 (Del. Ch., Oct. 7, 2019)*

Counsel: **[*1]** A. Thompson Bayliss, J. Peter Shindel, Jr., Daniel G. Paterno, Eric A. Veres, Samuel D. Cordle, ABRAMS & BAYLISS LLP, Wilmington, Delaware; Attorneys for Plaintiffs.

Srinivas M. Raju, Blake Rohrbacher, Matthew D. Perri, John M. O'Toole, RICHARDS, LAYTON & FINGER, P.A., Wilmington, Delaware; Rolin P. Bissell, YOUNG CONAWAY STARGATT & TAYLOR LLP, Wilmington, Delaware; Daniel A. Mason, PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP, Wilmington, Delaware; Stephen P. Lamb, Andrew G. Gordon, Harris Fischman, Robert N. Kravitz, Carter E. Greenbaum, PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP, New York, New York; Lawrence Portnoy, Charles S. Duggan, Gina Cora, DAVIS POLK & WARDWELL LLP, New York, New York; Attorneys for Defendants.

Judges: LASTER, V.C.

Opinion by: LASTER

Opinion

MEMORANDUM OPINION

LASTER, V.C.

In 2005, Loews Corporation formed Boardwalk Pipeline Partners, LP ("Boardwalk" or the "Partnership"). Loews controlled Boardwalk by controlling Boardwalk's general partner. From 2005 until 2018, Boardwalk was a master limited partnership ("MLP"), meaning that the common units representing its limited partner interests traded on an exchange.

Throughout its existence, Boardwalk has served as a holding company for subsidiaries **[*2]** that operate interstate pipeline systems for the transportation and storage of natural gas. The Federal Energy Regulatory Commission ("FERC" or the "Commission") regulates interstate pipelines. Loews took Boardwalk public in 2005 after FERC implemented a regulatory policy that made MLPs a highly attractive investment vehicle for pipeline companies.

As a business matter, Loews wanted to be able to take Boardwalk private again if FERC took regulatory action that would have a material adverse effect on Boardwalk. To address that business issue, the lawyers who drafted Boardwalk's partnership agreement included a provision that gave Boardwalk's general partner the right to acquire the limited partners' interests if certain conditions were met (the "Call Right"). Two conditions are front and center in this case.

The first condition required that the general partner receive "an Opinion of Counsel that the Partnership's status as an association not taxable as a corporation and not otherwise subject to an entity-level tax for federal, state or local income tax purposes has or will reasonably likely in the future have a material adverse effect on the maximum applicable rate that can be charged **[*3]** to customers" (respectively, the "Opinion," and the "Opinion Condition"). The Opinion Condition required counsel to address a mixed question of fact and law: whether an event had or was reasonably likely in the future to have a material adverse effect on the maximum applicable rate that Boardwalk could charge its customers. By focusing on a rate that could be charged to customers, the Opinion Condition meshed imperfectly with Loews' business goal of protecting against future regulatory action that would have a material adverse effect on Boardwalk. And as this decision details, the Opinion Condition used language that presented a host of interpretive difficulties.

The second condition required that the general partner determine that the Opinion was acceptable (the "Acceptability Condition"). Boardwalk's general partner was itself a limited partnership. The general partner of that limited partnership was a limited liability company, and it had both a board of directors and a sole member, each of which had authority to make certain decisions regarding the Partnership. Boardwalk's partnership agreement did not specify which decision-maker in this structure would determine whether the Opinion **[*4]** was acceptable. Other agreements did not clearly answer the question either. Reading the agreements in combination led to at least two possible answers. Under one interpretation, the LLC's board of directors would make the acceptability determination. That made sense from a governance perspective, because the LLC's board of directors included outside directors who could inject a measure of independence into the determination. Under another interpretation, the LLC's sole member would make the determination. The LLC's sole member was a subsidiary of Loews, and all of the decision-makers at that entity were Loews insiders. That interpretation enjoyed more textual support, but it rendered the Acceptability Condition surplusage, because Loews always had the ability to make a *de facto* acceptability determination when deciding whether or not to exercise the Call Right.

In March 2018, FERC proposed a package of regulatory policies that could have made MLPs an unattractive investment vehicle for pipeline companies. Everyone recognized that the proposals were not final, and industry players lobbied vigorously to change them. One of the major questions surrounding the proposals was how FERC would **[*5]** treat a pipeline's outstanding balance for accumulated deferred income taxes ("ADIT"). Boardwalk made clear in its public comments to FERC that it was impossible to determine the effect of FERC's proposals on Boardwalk's rates until FERC made a decision on the treatment of ADIT.

Boardwalk and other industry participants expected FERC to provide further insight at its July 2018 meeting. At that meeting, FERC implemented its proposals in conjunction with a determination that pipelines could eliminate their outstanding ADIT balances. Rather than making MLPs a less attractive investment vehicle for pipeline companies, that regulatory result made MLPs even more attractive.

In the interim, Loews seized on the period of maximum uncertainty that existed after FERC announced the proposed changes but before FERC implemented the actual changes. Loews caused Boardwalk's general partner to exercise the Call Right, and the acquisition closed just one day before FERC announced the final package of regulatory measures.

By acquiring the limited partner interest, Loews generated what its management team described euphemistically as $1.5 billion in "Value Creation"—much of which would be characterized more **[*6]** aptly as value expropriation. And Loews was able to acquire the limited partners' interest at a highly attractive price even though the regulatory changes ultimately did not have any negative effect on Boardwalk.

Loews achieved this remarkable result because its in-house legal team and outside counsel worked hard to generate a contrived Opinion. The Opinion that outside counsel provided did not satisfy the Opinion Condition because outside counsel did not render it in good faith. Outside counsel knowingly made unrealistic and counterfactual assumptions, knowingly relied on an artificial factual predicate, and consistently engaged in goal-directed reasoning to get to the result that Loews wanted. Among other noteworthy decisions detailed in this opinion, outside counsel determined that the regulatory proposals were sufficiently final to trigger the Call Right, even though everyone knew the proposals were not final. And outside counsel determined that the proposals were reasonably likely to have a material adverse effect on Boardwalk's rates, even as Boardwalk stated in its comments to FERC that it was impossible to determine the effect on Boardwalk's rates until FERC made a decision **[*7]** on the treatment of ADIT. To address the issue that management deemed impossible to assess, outside counsel examined hypothetical indicative rates, failed to incorporate the admittedly low chance that Boardwalk's rates actually would change, and derived the magnitude of the assumed change from a simple syllogism. Viewed as a whole, outside counsel's conduct went too far to constitute a good faith effort to render a legal opinion.

Loews locked in its ability to exercise the Call Right by having the sole member of the LLC that served as the general partner of Boardwalk's general partner pronounce the Opinion acceptable. That determination did not satisfy the Acceptability Condition because the partnership agreement is ambiguous. Under the doctrine of *contra proferentem*, the resulting ambiguity must be resolved against the general partner, not in favor of the general partner. In this case, the doctrine requires interpreting the partnership agreement so that only the board of directors of the LLC could pronounce the Opinion acceptable. Four of the eight members of that board of directors were outsiders. Vesting the decision in that decision-maker is more favorable to the limited partners **[*8]** than an interpretation that gives sole authority over the decision to the sole member of the LLC, where all of the decision-makers were Loews insiders.

A bevy of lawyers strived to paper the record so that the Opinion Condition and the Acceptability Condition would appear satisfied. In reality, they were not. The general partner therefore breached the partnership agreement by exercising the Call Right and acquiring the limited partners' interests.

At this point in the analysis, the general partner argues that it is nevertheless insulated against liability by two protective provisions in the partnership agreement. The first provision generally exculpates the general partner against liability, but contains an exception for willful misconduct. Because the general partner acted intentionally and opportunistically, the general partner's contractual breach constituted willful misconduct, and the general partner is not exculpated from liability. The second provision protects the general partner if it relies on opinions, reports, or other statements provided by someone that the general partner reasonably believes to be an expert. Here, the general partner participated knowingly in the efforts **[*9]** to create the contrived Opinion and provided the propulsive force that led the outside lawyers to reach the conclusions that Loews wanted. The general partner therefore cannot claim to have relied on the Opinion, and the defense is unavailable.

The general partner is liable for damages in the amount of $689,827,343.38, plus pre- and post-judgment interest on that amount from July 18, 2018, through the date of payment. The plaintiffs are entitled to an award of costs as the prevailing party.

I. FACTUAL BACKGROUND

Trial took place over four days using the zoom videoconferencing platform. Eight fact witnesses and six experts testified live. The parties introduced 1,978 exhibits, including twenty deposition transcripts.

In the pre-trial order, the parties commendably agreed to nearly 400 stipulations of fact. The court thanks litigation counsel for their efforts as officers of the court in preparing those detailed stipulations. This decision relies on them when applicable.[1] The stipulations do not address all of the factual issues, and they do not determine the inferences to be drawn from the stipulated facts when evaluated in conjunction with the evidence.

The court has evaluated **[*10]** the credibility of the witnesses and carefully weighed the evidence. The court has placed the burden of proof on the plaintiffs for all contested issues. The plaintiffs proved the following factual account by a preponderance of the evidence.

A. The Partnership

Boardwalk is a limited partnership organized under the laws of the State of Delaware. During the period relevant to this litigation, Boardwalk owned three principal subsidiaries, each of which operated an interstate pipeline and storage system for natural gas: Texas Gas Transmission, LLC ("Texas Gas"); Gulf South Pipeline Company, LP ("Gulf South"); and Gulf Crossing Pipeline Company LLC ("Gulf Crossing").

Loews formed Boardwalk in August 2005. At all times since Boardwalk's formation, Loews has controlled

[1] Citations in the form "PTO ¶ _" refer to stipulated facts in the pre-trial order. *See* Dkt. 173. Citations in the form "[Name] Tr." refer to witness testimony from the trial transcript. Citations in the form "[Name] Dep." refer to witness testimony from a deposition transcript. Citations in the form "JX _ at _" refer to a trial exhibit, with the page designated by the internal page number. If a trial exhibit used paragraph numbers or sections, then references are by paragraph or section. Citations in the form "PDX _ at _ " refer to the plaintiffs' demonstrative exhibits that summarized information appearing of record in other sources.

Boardwalk. Loews is a diversified conglomerate whose shares trade on the New York Stock Exchange under the symbol "L." Loews is controlled and managed by members of the Tisch family.

FERC regulates interstate pipeline companies, including the rates that pipelines can charge for cost-based services. PTO ¶ 61. Loews took Boardwalk public as an MLP after FERC implemented a regulatory policy that made MLPs a highly attractive investment **[*11]** vehicle for pipeline companies. Thirteen years later, Loews exercised the Call Right after FERC proposed a package of regulatory policies that could have made MLPs an unattractive investment vehicle for pipeline companies. As it turned out, the package of policies that FERC actually implemented made MLPs an even more attractive investment vehicle for pipeline companies. Because of the importance of the potential and actual regulatory changes to the case, a basic understanding of the regulatory landscape is necessary to make sense of what transpired.

1. The Regulation Of Pipeline Rates

As part of its regulatory mandate, FERC determines the maximum rates—also known as "recourse rates"—that a pipeline can charge the firms who pay the pipeline to transport and store their product—known as "shippers." PTO ¶¶ 61, 80, 111. Under the *Natural Gas Act ("NGA")*, a pipeline's recourse rates must be "just and reasonable." PTO ¶ 88.

FERC establishes a pipeline's recourse rates through a litigated administrative proceeding known as a "rate case." *Id.* ¶ 81; JX 89 at 7-8. If a pipeline believes its recourse rates are too low, then it can file a rate case under *Section 4 of the NGA* to obtain new, higher rates. JX 89 at 7. If FERC or a shipper believes **[*12]** the pipeline's recourse rates are too high, they can file a rate case under Section 5 of the NGA to challenge the rates. *See id.* at 7-8.

Recourse rates remain in effect until FERC approves new rates in a subsequent rate case. PTO ¶ 88. Once approved, a pipeline's recourse rates are listed publicly in a schedule known as a "tariff." As a result, they are sometimes called "tariff rates." *See* JX 1744 (Webb Report) ¶ 89.

Recourse rates are not mandatory rates. FERC generally grants pipelines the authority to contract with shippers to provide services at agreed-upon rates. PTO ¶ 97. The resulting "negotiated rates" are "not bound by the maximum and minimum recourse rates in the pipeline's tariff." *Id.* FERC also allows pipelines "to selectively discount their rates," resulting in what are referred to as, unsurprisingly, "discounted rates." *Id.* Negotiated and discounted rates are alternatives to recourse rates. The term "recourse rate" reflects the fact that a shipper always has *recourse* to the rates specified in the tariff and cannot be forced to pay a different rate. PTO ¶ 97.

A rate case is a complex affair that involves a five-step process, known as "cost-of-service ratemaking." JX 89 at **[*13]** 7, 10. Cost-of-service ratemaking aims to "establish just and reasonable rates" that will provide the pipeline with the opportunity to recover all components of its cost of service and to generate a reasonable rate of return that will adequately compensate its investors. PTO ¶ 93.

What follows is a high-level overview of each of the five steps. Those curious about cost-of-service ratemaking may consult FERC's 106-page Cost-of-Service Rates Manual, which includes much more detail on each of the five steps and an example of the five steps as applied to a fictional pipeline company. *See generally* JX 89.

The first step in the ratemaking process is to determine the pipeline's cost-of-service requirement, which represents the total revenue that the pipeline needs both to cover its expenses and to provide a reasonable rate of return on its invested capital. *Id.* at 12. The total investment in a pipeline is known as its rate base. *Id.* at 14. To arrive at a pipeline's cost-of-service requirement, FERC (1) multiplies a pipeline's rate base by its overall rate of return, then (2) adds a pipeline's operating and maintenance expenses, administrative and general expenses, depreciation expenses, and **[*14]** non-income and income taxes, and (3) subtracts any revenue credits. *Id.* at 12-13. The pipeline's overall rate of return is a function of the pipeline's capitalization ratio, its cost of debt, and an allowed rate of return on equity ("ROE"). *Id.* at 20. In 2018, to calculate a pipeline's allowed ROE, FERC used a discounted cash flow model. Webb Report ¶ 67.

As noted, a pipeline's rate base "represents the total investment of the pipeline," determined using a formula specified by FERC. JX 89 at 14. Among other things, the formula accounts for ADIT, discussed in greater detail below. *Id.* at 14, 17-18.

After determining the pipeline's cost-of-service requirement, the analysis moves to step two. That phase involves computing a "functionalized cost-of-service" by allocating the expenses associated with a pipeline system between its two main functions: transmission and storage. JX 89 at 29-30. There are two main categories of expenses: operation and maintenance expenses, and administrative and general expenses. *Id.* at 30. Assigning operation and maintenance expenses to one function or another is relatively easy because of existing pipeline accounting requirements. *Id.* Assigning administrative **[*15]** and general expenses is less straightforward, and FERC prefers to allocate those expenses using a four-step process known as the Kansas-Nebraska Method. *Id.* at 30-31. FERC then functionalizes any remaining expenses, costs, or credits. *Id.* at 31-32. At the end of step two, the analysis has generated a functionalized cost of service for both the transmission and storage functions.

Step three is itself a two-step process. *Id.* at 34. Each of the functionalized costs is "classified as either fixed or variable." *Id.* A functionalized cost is fixed if it "remain[s] constant regardless of the volume of throughput" and typically is "associated with capital investment in the pipeline system." *Id.* Variable costs, unsurprisingly, are those that "vary with the volume of throughput." *Id.* The fixed and variable costs are then further designated as either reservation (demand) costs or usage (commodity) costs. *Id.* at 35. Whether a cost is classified as a demand or a commodity cost can have an effect on the rate. *Id.* Generally, variable costs are designated as commodity costs. *Id.* There is no similar consensus on fixed costs, which require a case-by-case assessment. *Id.*

Step four splits the functionalized **[*16]** and classified costs derived in steps two and three "between jurisdictional and non-jurisdictional services, among zones and among jurisdictional services." *Id.* at 39. FERC uses volume metrics to allocate costs between jurisdictional and non-jurisdictional services, but the importance of that distinction has waned over time. *Id.* at 42-43. When a pipeline is divided into geographic regions, FERC uses distance metrics to allocate costs among zones. *Id.* at 43.

The final step of rate design "directly translate[s] the costs allocated to the jurisdictional customers into unit charges or rates." *Id.* at 45. The goal of this phase is to design rates that enable the pipeline to "recover the jurisdictional cost-of-service." *Id.* Rate design includes both a "firm service rate," which is made up of a "reservation charge" and a "usage charge," and an "interruptible service rate," which is "charged per unit of gas transported." *Id.* at 45-46. Calculating the "interruptible service rate" requires a separate multi-step analysis. *Id.* at 47-48.

The accuracy of a rate design is determined by running a revenue check. *Id.* at 49. A rate is accurate if the product of the rates for each service and its accompanying **[*17]** billing determinant (for example the volume of gas transported over a given contractual period) equals the cost of service calculated at step one. *Id.* The numbers need not be exactly equal, but they must be within 1/100th of a percent of each other. *Id.*

2. The Income Tax Allowance And ADIT

One component of a pipeline's cost of service is the income taxes that the pipeline pays. In the years before 1995, FERC allowed all pipelines to include an "income tax allowance" in their cost-of-service calculations, regardless of how they were organized as entities. As a general rule, including the income tax allowance increases the total cost of service, which in turn supports a higher rate base and a greater revenue requirement. JX 89 at 12. A higher cost of service generally (but not always) leads to higher recourse rates. That result favors pipelines, who could therefore charge shippers higher rates.

A related component of a pipeline's cost of service is ADIT, which is an accounting concept that arises because various tax provisions authorize pipelines to depreciate their assets on an accelerated basis. PTO ¶ 98. When calculating recourse rates, however, FERC uses straight-line depreciation. **[*18]** Because a pipeline can claim depreciation more quickly for tax purposes than for rate setting, the pipeline pays lower income taxes in the years when accelerated depreciation applies, resulting in greater cash flows than FERC's rate-setting calculations contemplate. *Id.* ¶ 99. Once the period of accelerated depreciation ends, the process reverses, and the pipeline ends up paying higher taxes than FERC's rate-setting calculations contemplate. *Id.* ¶ 100.

By accelerating depreciation and deferring taxes, the pipeline benefits from the time-value of money. To reflect the fact that the taxes ultimately must be paid, the pipeline records the accumulated value of the tax deferral on its balance sheet as ADIT. During the years when the pipeline benefits from accelerated depreciation and pays lower taxes, the ADIT balance builds up. After the period of accelerated depreciation, once the pipeline begins paying higher taxes, the ADIT balance declines. *Id.* ¶¶ 99-100.

In substance, the accelerated depreciation acts as an interest-free loan from the government that the pipeline eventually must repay. The balance on the pipeline's balance sheet is therefore referred to as an "ADIT liability." *Id.* ¶ **[*19]** 99. More importantly for present purposes, FERC historically treated a positive ADIT balance as a cost-free source of capital. *Id.* ¶ 98. FERC therefore subtracted the ADIT balance from the pipeline's rate base for purposes of the cost-of-service calculation.

As a general rule, subtracting ADIT decreases the total cost of service, which in turn supports a lower rate base and a lower revenue requirement. A lower cost of service thus generally (but not always) leads to lower recourse rates. *See id.* ¶¶ 98, 101. That result favors shippers, who have recourse to lower rates.

The foregoing discussion makes explicit an obvious economic reality: pipelines and shippers have opposing interests in setting recourse rates. As a general rule, pipelines want higher recourse rates, and they advocate for regulatory approaches that tend to generate higher rates. Shippers want lower recourse rates, and they advocate for regulatory approaches that tend to generate lower rates.

3. Changes In Cost Of Service Do Not Necessarily Lead To Changes In Recourse Rates.

Although the cost-of-service calculation is a core part of the ultimate determination of recourse rates, a change in a pipeline's cost of service is **[*20]** not the same as a change in its recourse rates. The two ideas reflect "different things." Wagner Tr. 286. A pipeline's cost of service changes over time, but those changes do not automatically trigger changes in recourse rates. *See id.* at 265. As a result, it is improper to equate a change in cost of service with a change in recourse rates. *See* McMahon Tr. 547-48; JX 575 at 2; JX 1139 at 30-31.

Instead, there must be a "vehicle" for a rate change, namely a rate case under *Section 4* or *5 of the NGA*. *See, e.g.*, McMahon Tr. 481; Wagner Tr. 264-66; Webb Tr. 936-37. If there is no rate case, then there cannot be a change in recourse rates. If a rate case is unlikely, then a change in recourse rates is unlikely. Wagner Tr. 266.

If a rate case is filed, and if the evidence shows that one cost-of-service input has changed, then rates still might end up increasing, decreasing, or staying the same. As described above, the complex five-step analysis in a rate case looks to all of the cost-of-service inputs and applies principles of rate design. It does not simply adjust a single cost-of-service variable (such as the income tax allowance) to generate a change in recourse rates. *See* Wagner Tr. 274-75; Webb **[*21]** Tr. 914. That type of approach is called "single-issue ratemaking," and FERC has a general policy against it.[2]

There is also a longstanding legal prohibition against FERC engaging in "retroactive ratemaking." That term refers to any effort to adjust a pipeline's current rates to make up for over- or under-collection in prior periods. *See* Court Tr. 854-55. Put another way, "FERC's regulation of rates has to be prospective only." Johnson Tr. 662. In a decision from 1990, the United States Court of Appeals for the District of Columbia (the "DC Circuit")—the final court of appeal as of right from FERC determinations—applied the prohibition against retroactive ratemaking to an ADIT balance. *Public Utilities Com. v. FERC, 894 F.2d 1372, 282 U.S. App. D.C. 332 (D.C. Cir. 1990)*. The case involved a pipeline changing how it priced its services such that it would no longer draw on an accumulated ADIT balance to fund future tax liability. *See id. at 1375-76*. The pipeline's customers sought a refund of the ADIT balance, but the court rejected that request. Among other reasons, the court stated that refunding ADIT would violate the prohibition on retroactive ratemaking by forcing the pipeline to return a portion of the rates that FERC had approved and the pipeline had collected during prior **[*22]** periods. *Id. at 1383*.

4. FERC's 2005 Policy

Because cost-of-service calculations ultimately affect rates, and because pipelines and shippers have opposing interests when it comes to rates, FERC's regulations and policies regarding cost-of-service calculations are subject to constant challenge. Pipelines

---

[2] *See* JX 1743 (Court Report) ¶ 39 ("[A]lthough one component of the cost-of-service calculation may have increased, others may have declined[,] . . . . and any decreases in an individual component may be offset against increases in other cost components."); McMahon Tr. 548 (same); Johnson Tr. 663 (agreeing that "if you change one variable in a rate calculation, you have to revisit all the other variables as well"); *id.* at 614-16 (same); Sullivan Dep. 102 (agreeing that changing one cost-of-service element does not provide "meaningful information" regarding recourse rates).

and shippers engage relentlessly in litigation and lobbying to advance their competing interests.

One perennial debate concerns the extent to which a pipeline organized as a pass-through entity for tax purposes, and which therefore does not pay taxes at the entity level, can nevertheless claim an income tax allowance for purposes of its cost-of-service calculation. The prevailing pass-through entity in the pipeline industry is the limited partnership, so the debate has been framed in terms of the extent to which a pipeline organized as a limited partnership can claim an income tax allowance.

In 1995, FERC issued a ruling that permitted a pipeline organized as a limited partnership to claim an income tax allowance when calculating its cost of service, but only to the extent that its partnership interests were held by a corporation. FERC announced that ruling in a decision involving the Lakehead Pipeline **[*23]** Company, so the ruling became known as the *Lakehead* policy. *See Lakehead Pipeline Co., Ltd. P'ship*, 71 FERC ¶ 61,338 (1995), *abrogated by* *SFPP, L.P. v. FERC, 967 F.3d 788, 448 U.S. App. D.C. 395 (D.C. Cir. 2020)*.

When adopting the *Lakehead* policy, the Commission focused on the existence of two potential levels of taxation before returns from the pipeline reached investors. The Commission noted that for the partnership interests owned by the corporation, the corporation would have to pay corporate-level tax before distributing any returns to its investors. The Commission reasoned that the pipeline should be able to take into account the corporate-level tax when determining the level of return that those investors would require. By contrast, the Commission noted that for the partnership interests owned by individual investors, there would not be an intervening level of tax; those investors would receive the returns from the pipeline directly. Accordingly, the Commission reasoned that because the individuals would not pay corporate-level tax, the pipeline should not receive a tax allowance for those individuals. Otherwise, the Commission concluded, the pipeline would be able to claim an unrealistically large cost-of-service requirement and provide its investors with a rate of return greater than warranted. *See Lakehead*, 71 FERC ¶ **[*24]** 62,313-15, 62,329.[3]

Nine years later, in 2004, the DC Circuit abrogated the *Lakehead* policy. The case involved challenges to the Commission's determinations in a rate case involving SFPP, L.P., an oil pipeline organized as a limited partnership. *See* *BP West Coast Products, LLC v. FERC, 374 F.3d 1263, 362 U.S. App. D.C. 438 (D.C. Cir. 2004)*. The Commission had applied the *Lakehead* policy to SFPP, ruling that SFPP could claim a tax allowance for the taxes paid by its corporate parent, which owned a 42.7% interest in the partnership. The Commission had determined that SFPP could not claim a tax allowance for any of the interests held by its public investors. The DC Circuit rejected that analysis and the *Lakehead* policy in general, finding that the Commission had not provided any grounds for distinguishing between the tax liability of the corporate partner and the tax liability of other partners. *Id. at 1290*. The DC Circuit explained that the regulated entity was entitled to include its own costs of service in its rate base, including taxes, but not costs incurred by its investors, again including taxes. *Id.* The DC Circuit held squarely that "no such [tax] allowance should be included." *Id. at 1291*.

In 2005, FERC responded to the *BP West* decision by heading in the opposite direction. Rather than concluding that a pipeline organized **[*25]** as a partnership could not claim an income tax allowance, as *BP West* held, FERC announced that it would "return to its pre-*Lakehead* policy" and permit a pipeline organized as a partnership to claim an income tax allowance for all of its partners. PTO ¶ 104; *see* JX 205 (the "2005 Policy"). In reaching this conclusion, the Commission took the view that all partners pay income taxes and that their taxes should be imputed to the pipeline for purposes of determining the pipeline's cost of service. PTO ¶ 104. Because a pipeline organized as a limited partnership does not actually pay entity-level income taxes, the 2005 Policy made pipelines organized as limited partnerships a highly attractive investment vehicle. *See id.* ¶ 106; Rosenwasser Tr. 39-40.

B. Loews Forms Boardwalk.

To take advantage of the 2005 Policy, Loews formed Boardwalk in August 2005. PTO ¶ 106. Loews planned

[3] An example illustrates how the *Lakehead* policy operates. Assume that a pipeline is organized as an MLP, that its corporate general partner owns 50% of the partnership interests, and that public investors own the rest. If the corporation paid taxes at a rate of 35%, then the pipeline could claim a tax allowance of 17.5%, reflecting the taxes paid at the corporate level. Rosenwasser Tr. 42. The pipeline could not, however, claim a tax allowance for taxes paid by the individual investors.

to take Boardwalk public through an initial public offering ("IPO") later that year. *Id.* Loews retained Michael Rosenwasser, then a partner at Vinson & Elkins LLP, to lead the legal team that prepared Boardwalk's organizational documents and supported the IPO. *Id.* ¶ 51.

1. Boardwalk's Structure

Loews organized Boardwalk as a Delaware **[*26]** limited partnership. As a result, its internal affairs were (and are) governed by its partnership agreement. By the time of the events giving rise to this litigation, the operative version was the Third Amended and Restated Agreement of Limited Partnership dated June 17, 2008. JX 352 (the "Partnership Agreement" or "PA").

The Partnership's general partner was another Delaware limited partnership, defendant Boardwalk GP, LP (the "General Partner"). The General Partner held a 2% general partner interest in the Partnership and owned all of its incentive distribution rights. JX 256 at 14. The General Partner did not have a board of directors. *Id.*

The sole general partner of the General Partner was defendant Boardwalk GP, LLC ("the GPGP"). *Id.* The GPGP was a Delaware limited liability company, so its internal affairs were governed by its limited liability company agreement. By the time of the events giving rise to this litigation, the operative version was the First Amended and Restated Limited Liability Company Agreement dated November 15, 2005. JX 235 (the "LLC Agreement" or "LLCA").

The sole member of the GPGP was defendant Boardwalk Pipelines Holding Corp. ("Holdings," or the "Sole Member"). **[*27]** *Id.* § 1.1 at 7. At all relevant times, Holdings was a wholly owned subsidiary of Loews. Through Holdings, Loews controlled the GPGP. Through the GPGP, Loews controlled the General Partner. Through the General Partner, Loews controlled Boardwalk and its subsidiaries.

In addition to having Holdings as its Sole Member, the GPGP had a board of directors (the "GPGP Board"). The LLC Agreement generally assigned authority over the business and affairs of the GPGP and the Partnership to the GPGP Board. PTO ¶ 76. The LLC Agreement granted the Sole Member "exclusive authority over the business and affairs of [the GPGP] that do not relate to management and control of [the Partnership]." LLCA § 5.6.

For the vast majority of the Partnership's existence as an MLP, the GPGP Board had eight members. Four were outside directors whose only affiliation with Boardwalk or Loews was their status as directors on the GPGP Board. The other four members were:

• Kenneth I. Siegel, Senior Vice President of Loews and Chairman of the GPGP Board;

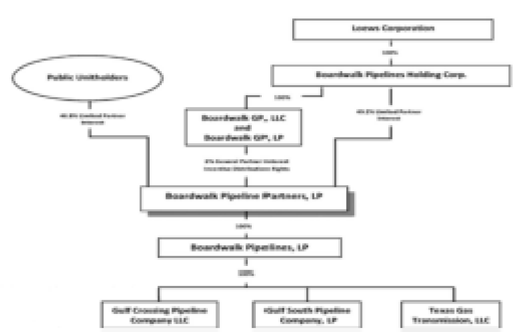
• Andrew H. Tisch, the Co-Chairman of the board of directors of Loews, the Chairman of the Executive Committee of Loews, and member of the Office of the President of Loews. **[*28]**

• Peter W. Keegan, a Senior Advisor to Loews; and

• Stanley C. Horton, the President and Chief Executive Officer of Boardwalk. During the period relevant to this litigation, the Holdings board of directors (the "Holdings Board") consisted of Siegel, Keegan, and Jane Wang, Vice President of Loews.

The different composition of the GPGP Board and the Holdings Board meant that if Holdings made a decision for the GPGP as its Sole Member, then Loews controlled the decision. By contrast, if the GPGP Board made the decision for the GPGP, then the outside directors would participate in the decision. If the four outside directors unanimously opposed the Loews and Boardwalk representatives, then they could prevent the GPGP from taking the action that Loews wanted.

The following diagram depicts Boardwalk's organizational structure and its principal pipeline subsidiaries.



2. The Call Right

The provision at the heart of this case is the Call Right, which granted the General Partner the right to acquire the common units that the General Partner and its affiliates did not already own as long as certain conditions were met. The Call Right came to be included in the Partnership Agreement because the 2005 **[*29]** Policy was contentious. It favored pipelines over shippers, and shippers challenged it immediately. *See, e.g.*, *ExxonMobil Oil Corp. v. FERC, 487 F.3d 945, 376 U.S. App. D.C. 259 (D.C. Cir. 2007)* (addressing shipper challenge to 2005 Policy). Loews was concerned that FERC might change course. McMahon Dep. 62, 160-61.

Loews wanted a mechanism for taking Boardwalk private again if the 2005 Policy changed in a manner that was materially adverse to Boardwalk. *See* Rosenwasser Tr. 41-44; McMahon Tr. 480, 544-45. Rosenwasser recalled these matters vividly. He testified that Loews was not "going to go forward with [Boardwalk's IPO] unless [Rosenwasser and his team] were able to include a provision in [the Partnership Agreement] which would allow them quickly, easily and without dispute, to go private if there was an adverse change in that tax policy or the way it was implemented." Rosenwasser Dep. 34-35; *see id.* at 39 ("Loews . . . wanted a mechanism that would allow them to go private in a simple, clear manner without dispute if, in fact, there was a change in FERC policy that would be adverse to maximum applicable rates."). He testified at trial that Loews told the underwriter for the IPO that it would not take Boardwalk public unless it could guard against the risk of "los[ing] **[*30]** any substantial portion of the tax allowance if there was a reversion to *Lakehead*." Rosenwasser Tr. 42. Early drafts of the Partnership Agreement referred to the call right as a "*Lakehead* call." PTO ¶ 109. Referring to the 2005 Policy, the IPO prospectus and Boardwalk's subsequent annual reports informed investors that "[i]f the FERC policy is reversed . . . our general partner's call right may be triggered." JX 256 at 31; *accord* JX 285 at 11.

Critically, however, no one intended the Call Right to be triggered by a change that "wasn't substantive, wasn't meaningful." Rosenwasser Tr. 46. Loews "wanted an off-ramp if FERC reverse[d] its policy" in a way that materially threatened revenues. McMahon Tr. 480, 545. Rosenwasser and his team attempted to draft the Call Right to achieve that business objective. Rosenwasser Dep. 39. It was a "business point," not a "legal point." *Id.* at 40.

In an effort to implement this business point, Rosenwasser included language stating that the General Partner could exercise the Call Right if three conditions were met. First, the General Partner and its affiliates had to own "more than 50% of the total Limited Partner Interests of all classes then Outstanding." PA § 15.1(b)(i). **[*31]** Second, the General Partner had to satisfy the Opinion Condition by receiving an "Opinion of Counsel" that Boardwalk's status as a pass-through entity for tax purposes "has or will reasonably likely in the future have a material adverse effect on the maximum applicable rate that can be charged to customers." *Id.* § 15.1(b)(ii). Third, the General Partner had to satisfy the Acceptability Condition by determining that the Opinion was "acceptable to the General Partner." *Id.* § 1.1 at 24.

As long as these conditions were met, then the General Partner could decide whether to exercise the Call Right. When making that decision, the General Partner could act in its sole discretion, free of any fiduciary duty or express contractual standard, with the express right to consider its self-interest, and constrained only by its obligation to comply with the non-waivable implied covenant of good faith and fair dealing. *Id.* § 7.1(b)(iii).

The Partnership Agreement did not impose any timeline for obtaining the Opinion, but once the Opinion Condition was satisfied, the General Partner had ninety days to exercise the Call Right. *Id.* §15.1(b). The Partnership Agreement did not require that independent counsel render the **[*32]** Opinion. The term "Opinion of Counsel" was not specific to the Opinion Condition and appeared in multiple provisions in the Partnership Agreement; the agreement defined it as "a written opinion of counsel (who may be regular counsel to the Partnership or the General Partner or any of its Affiliates)." *Id.* § 1.1 at 24.

If the General Partner exercised the Call Right, then the General Partner was obligated to send notice by mail to that effect to the limited partners. *Id.* § 15.1(c). The General Partner was then obligated to purchase all of the outstanding limited partner interests that it did not already own "at a purchase price . . . equal to the average of the daily Closing Prices . . . for the 180 consecutive Trading Days immediately prior to the date three days prior to the date that the notice described in Section 15.1(c) is mailed." *Id.* § 15.1(b) (the "Purchase Price").

3. The IPO

On November 8, 2005, Boardwalk offered common units to the public at a price of $19.50 per unit. JX 260 at 1. Until the General Partner acquired the public units at a price of $12.06 per unit on July 18, 2018, Boardwalk's common units traded on the New York Stock Exchange under the symbol "BWP."

During the **[*33]** intervening years, Loews caused Boardwalk to issue additional units at prices well above $12.06 per unit. Loews also sold units to the public in secondary offerings at values well above $12.06 per unit. The following table summarizes those offerings:

Go to table1

PDX 6 at 1 (footnotes omitted).

When Loews exercised the Call Right, public investors held approximately 49% of Boardwalk's common units. PTO ¶ 48. It is undisputed for purposes of this litigation that the General Partner and its affiliates held a sufficient percentage of the total limited partnership interests to satisfy the first condition for exercising the Call Right.

C. The *United Airlines* Decision

For purposes of the current litigation, the next significant development took place in 2016. The initial **[*34]** efforts by shippers to challenge the 2005 Policy failed when the DC Circuit held in 2007 that the 2005 Policy was "not unreasonable" and hence entitled to deference. *ExxonMobil, 487 F.3d at 953*. Nine years later, however, the shippers prevailed in *United Airlines, Inc. v. FERC, 827 F.3d 122, 423 U.S. App. D.C. 480 (D.C. Cir. 2016)*.

Despite its name, the *United Airlines* case was an appeal from FERC's determinations in a rate case involving SFPP. Advancing a different argument than the theory the DC Circuit had rejected in 2007, the shippers contended that by permitting MLP pipelines to claim an allowance for partner-level taxes, the 2005 Policy "permit[ted] [the] partners in a partnership pipeline to 'double recover' their taxes." *Id.* at 127.

FERC rejected that contention, but the DC Circuit endorsed it. In vacating the Commission's order and ruling in favor of the shippers, the DC Circuit cited the following undisputed facts:

> First, unlike a corporate pipeline, a partnership pipeline incurs no taxes, except those imputed from its partners, at the entity level. Second, the discounted cash flow return on equity determines the pre-tax investor return required to attract investment, irrespective of whether the regulated entity is a partnership or a corporate pipeline. Third, with a tax allowance, a partner in a **[*35]** partnership pipeline will receive a higher after-tax return than a shareholder in a corporate pipeline, at least in the short term before adjustments can occur in the investment market.

Id. at 136 (internal citations omitted). Based on these undisputed facts, the DC Circuit concluded that "granting a tax allowance to partnership pipelines results in inequitable returns for partners in those pipelines as compared to shareholders in corporate pipelines." *Id. at 137*. The DC Circuit remanded the case with instructions for the Commission to determine whether it could eliminate the double-recovery problem, such as by changing the calculation of the ROE. The DC Circuit also noted that "prior to *ExxonMobil*, FERC considered the possibility of eliminating all income tax allowances and setting rates based on pre-tax returns," and that none of the court's precedents "foreclos[ed] that option." *Id.*

In December 2016, FERC responded to the *United Airlines* decision by issuing a notice of inquiry requesting "comment[s] regarding the double-recovery concern." JX 579 ¶ 1. Before FERC announced the results of that inquiry, Congress enacted the Tax Cuts and Jobs Act (the "Tax Act"). Among other things, the Tax Act lowered the federal corporate income **[*36]** tax rate from 35% to 21%, effective January 1, 2018. Pub. L. No. 115-97, 131 Stat. 2054 (2017).

D. The March 15 FERC Actions

At its regularly scheduled meeting on March 15, 2018, FERC took four interrelated actions to address the implications of the *United Airlines* decision and the Tax Act (the "March 15 FERC Actions"). In presenting the March 15 FERC Actions, the Commission explained that it was "addressing these issues concurrently" to "ensure[] administrative efficiencies by reducing the number of filings required of regulated entities." JX 554 at 49.

1. The Revised Policy

The first of the March 15 FERC Actions was the issuance of a revised policy statement on the treatment of income taxes. JX 579 (the "Revised Policy Statement" or "Revised Policy"). In the Revised Policy, FERC stated that it would no longer permit pipelines organized as MLPs to recover both an income tax allowance and a ROE determined by the discounted cash flow methodology in their cost-of-service calculations. *See id.* ¶ 8. FERC stated in a concurrently issued notice of proposed rulemaking that it would promulgate regulations to address the effects of the Revised Policy "on the rates of interstate natural gas pipelines organized as MLPs." *Id.; see* JX 580.

During the March **[*37]** 15 meeting, in response to a question about when "FERC Jurisdictional Rates [would] actually change," FERC staff stated that "the NOPR anticipates that the deadlines for pipeline filings will be late summer or early fall [2018]. We obviously have to go to a final rule first." PTO ¶ 117. The Revised Policy thus had no impact on Boardwalk's rates. Court Report ¶¶ 102-12.

At the same time, FERC signaled that pipelines would have answers on the regulatory issues soon—in "late summer or early fall"—which would allow them to make anticipated regulatory filings. PTO ¶ 117. Boardwalk anticipated that FERC would address the March 15 FERC Actions further in connection with its regularly scheduled meeting on July 19, 2018. *See* JX 1152 at 2.

2. The Notice Of Proposed Rulemaking

The second of the March 15 FERC Actions was the issuance of a notice of proposed rulemaking titled *Interstate and Intrastate Natural Gas Pipelines; Rate Changes Relating to Federal Income Tax Rate* (the "NOPR"). JX 580. The NOPR was not an actual rule and did not have any immediate effect on Boardwalk or other industry participants. It was a notice of a proposed rule that invited comment.

In the NOPR, FERC proposed to require **[*38]** interstate natural gas pipelines to make a one-time informational filing on a proposed Form 501-G so that FERC could evaluate the impact of the Tax Act and the change in income tax policy on pipelines' revenue requirements. JX 580 ¶ 32. FERC explained that the purpose of the Form 501-G was to provide information "regarding the continued justness and reasonableness of the pipeline's rates after the income tax reduction and elimination of MLP income tax allowances." *Id.* ¶ 26. The Form 501-G therefore would call for "an abbreviated cost and revenue study in a format similar to the cost and revenue studies the Commission has attached to its orders initiating NGA section 5 rate investigations in recent years." *Id.* ¶ 32.

FERC proposed that when completing the Form 501-G, a pipeline would use data from its 2017 FERC Form No. 2, which provided information on the major components of its cost of service for that year. *Id.* Using that information, the pipeline would estimate (1) the percentage change in its cost of service resulting from the Tax Act's reduction of the corporate income tax from 35% to 21% and the Revised Policy's reduction of the corporate income tax allowance for MLPs from 35% to 0% and (2) **[*39]** the pipeline's ROE both before and after those developments. *Id.; see also* PTO ¶ 120. To derive the cost-of-service component associated with the return to equity investors, FERC proposed that pipelines use an ROE of 10.55%. JX 580 ¶ 34.

FERC intended for resulting calculations to indicate whether the pipeline's rate base could have decreased as a result of the elimination of the income tax allowance. The resulting calculations also would indicate whether, based on the pipeline's actual historical revenues, the pipeline was over-recovering its rate base in a manner that might warrant a rate case.

The NOPR proposed that a pipeline would have four options to consider in connection with its Form 501-G:

• The pipeline could make a limited filing under Section 4 of the NGA to reduce the pipeline's recourse rates to reflect a decrease in its revenue requirements.

• The pipeline could commit to file a general rate case under Section 4 of the NGA in the near future to establish new recourse rates.

• The pipeline could file a statement explaining why a rate adjustment was not needed.

• The pipeline could take no action other than filing the Form 501-G.

PTO ¶ 121; JX 580 ¶¶ 41-51. If a pipeline chose the third or fourth option, the Commission **[*40]** anticipated that it would consider, based on information in the Form 501-G, whether to issue an order to show cause to the pipeline requiring a reduction in its rates. PTO ¶ 121.

FERC recognized that even with a lower tax rate and the elimination of the income tax allowance, "a rate reduction may not be justified for a significant number of pipelines." JX 580 ¶ 48. As an example, FERC noted that "a number of pipelines may currently have rates that do not fully recover their overall cost of service," such that a reduction in tax costs "may not cause their rates to be excessive." *Id.* Typically, a pipeline would be under-recovering its costs if it operated in a competitive market and hence had to offer discounted rates to shippers. *See* JX 1139 at 11. FERC also cited other possibilities that would obviate the need to adjust rates, such as "an existing rate settlement [that] provides for a rate moratorium" or the existence of contracts providing for negotiated rates. *See* JX 580 ¶¶ 45, 48-49.

3. The Notice Of Inquiry

The third of the March 15 FERC Actions was a notice of inquiry that sought industry comment on the effect of the Tax Act and the Revised Policy on recourse rates. In particular, **[*41]** FERC sought comment on how it should address ADIT. *See* JX 576 (the "ADIT NOI").

In requesting comment on ADIT, FERC distinguished between the "[t]reatment of ADIT for [p]artnerships" and the treatment of ADIT for other regulated entities. *Id.* ¶¶ 24-25. For partnerships, FERC specifically asked that "commenters . . . address whether previously accumulated sums in ADIT should be eliminated altogether from cost of service or whether those previously accumulated sums should be placed in a regulatory liability account and returned to ratepayers." *Id.* ¶ 25.

4. The Order On Remand

The fourth and final of the March 15 FERC Actions was the issuance of an order implementing the *United Airlines* decision for the ongoing proceeding involving SFPP. JX 553 (the "Order on Remand"). The Order on Remand required SFPP to revise its rate filing consistent with the Revised Policy and prohibited SFPP from claiming an income tax allowance. *Id.* ¶¶ 28, 58(B). That was the only binding and immediately applicable component of the March 15 FERC Actions, and it did not affect Boardwalk.

Also on March 15, 2018, FERC initiated two proceedings under *Section 5 of the NGA* against interstate natural gas pipelines. FERC initiated one proceeding against Dominion **[*42]** Energy Overthrust Pipeline, a natural gas pipeline owned by an MLP, based on an estimated calculation that the pipeline achieved ROEs for calendar years 2015 and 2016 of 23.4% and 19.9%, respectively. The order initiating the proceeding noted that "[i]f Overthrust's ROEs for 2015 and 2016 were recalculated consistent with the Revised Policy Statement, its ROEs would have been 36.4 percent and 30.9 percent, respectively." PTO ¶ 133.

FERC also initiated a proceeding against Midwestern Gas Transmission Company, a natural gas pipeline, based on an estimated calculation that Midwestern had achieved ROEs for calendar years 2015 and 2016 of 15.8% and 16.6%, respectively The order initiating the proceeding noted that "if the reduced 21 percent corporate income tax rate had been in effect during 2015 and 2016, Midwestern's ROE for those years would have been 19.2 percent and 20.2 percent, respectively." PTO ¶ 133.

E. The Reaction To The March 15 FERC Actions

The March 15 FERC Actions triggered a flurry of activity from industry participants. Over the next four months, shippers, pipelines, trade associations, and others filed thirteen requests for rehearing, 108 comments, sixteen reply comments, **[*43]** and numerous other submissions. *See* PDX 9 at 12; Court Tr. 858. Each participant sought to persuade FERC to adopt its preferred outcome. Matters were very much in flux.

The resulting uncertainty generated market reactions. The trading price of Boardwalk's units dropped by more than 7% from its closing price on March 14, 2018, the day before the March 15 FERC Actions. PTO ¶ 135; *see* JX 1802 at 1. The Alerian Index, which tracks an index of MLPs in the oil and gas industry, fell by 4.6%. Collectively, MLPs lost $15.8 billion in market capitalization. Plaintiff James McBride tweeted, "Blood in the street. Where's the buying opportunity?" JX 1839 at 3. Barry Sullivan, a respected FERC consultant who worked for Boardwalk, emailed its executives saying, "I hope you guys are still breathing. That was unbelievable. Sorry." JX 546 at 1.

Several MLPs issued press releases stating that they did not anticipate that the March 15 FERC Actions would have a material impact on their rates, primarily because their customers were locked into negotiated rate agreements. McMahon Tr. 498-99; Siegel 735-36; *see, e.g.*, JX 592 (Spectra Energy Partners press release stating that it "anticipates no immediate impact **[*44]** to its current gas pipeline cost of service rates as a result of the revised policy"). One industry analyst report stated that although "FERC dropped a bombshell on the industry," stock prices were rebounding "as companies issued statements saying minimal impact." JX 624 at 4, 6. Horton, Boardwalk's CEO, told Loews' senior management that the analyst report offered "a pretty good summary" of what had happened. *Id.* at 1.

F. Boardwalk's Initial Assessment: No Material Effect On Rates, But A Chance For Loews To Exercise The Call Right.

After the announcement of the March 15 FERC Actions, Horton instructed Ben Johnson, Boardwalk's Vice President of Rates and Tariffs, to conduct an expedited analysis of the possible impact on Boardwalk's three interstate pipelines. JX 565 at 1. The day's events prompted questions that Boardwalk's management team needed to answer. Siegel and Thomas Hyland, an outside director on the GPGP Board, asked Jamie Buskill, Boardwalk's Chief Financial Officer, for his "thoughts on the economic impact on [Boardwalk]." JX 567 at 1; *see also* JX 548. Molly Whitaker, Boardwalk's Director of Investor Relations and Corporate Communications, fielded similar inquiries from **[*45]** approximately a dozen investors and analysts. JX 550 at 1.

To answer these questions, Johnson used an analysis that Boardwalk had performed in early February 2018 to project the effect of the March 15 FERC Actions on the rates that each of the three pipelines could charge. By that evening, he had preliminary answers.

Johnson viewed Gulf Crossing as "relatively protected" from any impact on its rates. JX 572 at 1. Almost all of Gulf Crossing's contracted volumes were subject to negotiated rates, meaning that a change in cost-of-service-based rates would not affect the pipeline. *Id.* at 2. Johnson also viewed Gulf South as "relatively protected." *Id.* at 1. A majority of its contracts provided for negotiated or discounted rates, and Gulf South was also subject to a rate case moratorium until May 2023. *See* PTO ¶ 409; JX 604; JX 1139 at 6.

Texas Gas was the only pipeline that had potential exposure to a rate case, but it too had factors that would help in defending against any challenge to its rates. Among other things, Texas Gas served highly competitive markets, and a majority of its contracts with shippers provided for negotiated or discounted rates. *See* JX 1139 at 6. Assuming a rate case **[*46]** was filed, Johnson estimated that the downside impact of eliminating the income tax allowance would be about $20.5 million. *See* JX 572 at 1-2.

Importantly, Johnson characterized his estimate of the downside as a floor, because it "ignores any bounce from rate base increase associated with removal of ADIT." *Id.* Elaborating in a later email, he explained that "it's unclear on what they [FERC] would do with [Boardwalk's] current ADIT" balance, and he observed that FERC could decide that the ADIT balance should be "zeroed out because there's no income taxes (because there would be no difference between book and tax depreciation)." JX 602 at 1. Johnson thus recognized at the outset that the treatment of ADIT would be critical for understanding the implications of the March 15 FERC Actions. For purposes of his analysis, Johnson "assume[d] that [the ADIT balance] would just remain until it's amortized off." *Id.*

Having reached the conclusion that the March 15 FERC Actions would not have a materially adverse impact on the rates that Boardwalk's subsidiaries could charge, Boardwalk's management team noted that other MLP pipelines had issued press releases expressing similar views about their own **[*47]** rates. Boardwalk's management team worried that if Boardwalk did not issue a similar statement, then the market participants would infer the March 15 FERC Actions would have an adverse effect on Boardwalk's rates, which Boardwalk had determined not to be the case. *See* McMahon Tr. 498-99; Alpert Tr. 322.

Horton therefore instructed Michael McMahon, Boardwalk's General Counsel, to draft a short press release that described the extent to which Boardwalk's pipelines were protected from any impact on their rates. JX 568 at 1. In his first draft, McMahon pointed out that FERC had invited pipelines to "file statements explaining why an adjustment to rates to reflect the impact of the Commission's decisions is not required." JX 571 at 7. McMahon noted that this path seemed tailor-made for Boardwalk's pipelines. As he put it, "[t]his option recognizes the unique competitive circumstances of each pipeline, for example, essentially all of the contracts on our Gulf Crossing and a number of the contracts on Texas Gas are negotiated rate agreements and Gulf South is currently under a rate moratorium until 2023 . . . ." JX 571 at 7.

Buskill proposed making the release stronger by stating that the overall **[*48]** impact to Boardwalk and its rates would not be material. JX 571 at 1. McMahon agreed that "the elimination of the income tax allowance will not result in a material impact." *Id.* Neither Buskill nor McMahon addressed the possible upside of eliminating ADIT. *See id.*

By late evening on March 15, 2018, Boardwalk management was satisfied with the language of the release. But as discussed below, the draft would go through a series of revisions once Loews' personnel got involved.

In the meantime, Buskill responded to the inquiries about the effect of the March 15 FERC Actions by explaining that they would not have a material impact on Boardwalk. During the evening of March 15, 2018, Buskill told Hyland, the outside director on the GPGP Board, that virtually all of the shippers at Gulf Crossing and Gulf South were under negotiated or discounted rate agreements, that Gulf South was under a rate moratorium until 2023, and that only about 20% of Texas Gas' revenues were from tariff rates. JX 548 at 1. Buskill concluded: "Based on our interpretation of the rules, we don't think it will have a material impact to Boardwalk." *Id.*

Buskill conveyed similar information to Siegel, who immediately forwarded **[*49]** the information to Jim Tisch, the CEO of Loews, and Ben Tisch, another senior officer of Loews. JX 566 at 1. The Loews executives quickly focused on ADIT. JX 601 at 2. At Ben Tisch's request, a Loews employee analyzed the March 15 FERC Actions and reported that "the loss of 100 percent of taxes in calculating allowed ROE's would be a flesh wound for the long haul pipes like . . . [Boardwalk]." *Id.* at 1. But if FERC required that pipelines return their ADIT balances to ratepayers, then that "would be the a-bomb outcome" and would be "extremely painful." *Id.* The treatment of ADIT dominated the analysis.

1. A Chance To Exercise The Call Right

When the March 15 FERC Actions took place, Buskill and McMahon were each angling to succeed Horton as CEO of Boardwalk. Both immediately realized that the March 15 FERC Actions might give Loews the ability to exercise the Call Right. That course of action could be attractive to Loews because the Purchase Price was calculated using a trailing market average.

In addition to the stock drop resulting from the March 15 FERC Actions, there was reason to believe that Boardwalk's market price continued to reflect a shock that Boardwalk had delivered by slashing **[*50]** its distributions in 2014. As an asset class, common units in MLPs are a yield-based investment, and MLPs generally make regular quarterly distributions to their investors. In 2014, Boardwalk stunned investors by cutting its quarterly distribution from $0.5325 to $0.10 per unit, making Boardwalk one of the lowest yielding MLPs in the industry. Boardwalk's trading price fell from the low $30s to the low $10s almost overnight. The unit price never again approached its former levels. *See* Horton Dep. 52; PDX 11 at 9.

Between 2014 and 2017, Boardwalk spent $2.077 billion on capital expenditures, including $1.6 billion in growth capital expenditures. PTO ¶ 85-86. During the same period, Boardwalk distributed $405.1 million to unitholders. *Id.* ¶ 85. There is evidence that investors were unsure about how to value the growth capital expenditures. *See* PTO ¶ 87.[4]

On March 15, 2018, Buskill and McMahon each made a point of flagging the Call Right for Loews. Buskill emailed Siegel and described the opportunity presented by the Call Right as "compelling" because Loews could "buy back all units when the units are trading well below book value." JX 567 at 1. Siegel told Buskill that he "need[ed] **[*51]** to better understand the deferred taxes," namely ADIT. *Id.*

McMahon contacted Marc A. Alpert, Loews' Senior Vice President and General Counsel. He told Alpert that "FERC's actions might have triggered the call." McMahon Tr. 552; PTO ¶ 136-37. McMahon recommended that Alpert contact Rosenwasser, who had since joined Baker Botts LLP, to ask whether he could issue the Opinion that would enable the General Partner to exercise the Call Right. McMahon Tr. 552-53. McMahon told Alpert that while practicing at Vinson & Elkins, Rosenwasser was "one of the principal draftspersons of the [C]all [R]ight." Alpert Tr. 325, 330; *see* Rosenwasser Tr. 39-40; McMahon Tr. 503; McMahon Dep. 31-32.

Alpert liked the idea of hiring Baker Botts and Rosenwasser. Baker Botts had ten nationally ranked practice groups, including groups providing regulatory, litigation, and transactional advice to the oil and gas sector. JX 1498 at 149. Rosenwasser was highly regarded and considered the "[D]ean of the MLP Bar." Alpert Tr. 325. And although Rosenwasser was a principal drafter of the Call Right, Baker Botts as a firm had never done any work for Boardwalk, which Loews and Boardwalk viewed as a helpful fact. *See*

---

[4] As this court has observed in other settings, an advantageous time for a controller to acquire a controlled company is when the controlled company has invested capital in net-positive-value projects, but when minority investors have not yet received the benefit of those investments. *See, e.g., In re Dole Food Co., Inc. S'holder Litig.*, 2015 Del. Ch. LEXIS 223, 2015 WL 5052214, at *36 (Del. Ch. Aug. 27, 2015); *Del. Open MRI Radiology Assocs., P.A. v. Kessler, 898 A.2d 290, 315-16 (Del. Ch. 2006)*.

Rosenwasser **[*52]** Tr. 54-55; Alpert Tr. 324-25; McMahon Tr. 503.

2. Alpert Calls Rosenwasser.

On March 16, 2018, Alpert called Rosenwasser. PTO ¶ 137. Rosenwasser's secretary transcribed Alpert's message as saying there was "something urgent that he needs to speak with you about." *Id.* At trial, Rosenwasser recalled a brief and measured conversation in which Alpert described the assignment as whether Baker Botts could advise one way or the other about whether it could give the Opinion. Rosenwasser recalled saying only that he would "look into it." Rosenwasser Tr. 55.

Consistent with an urgent and significant assignment, Rosenwasser quickly assembled a team within Baker Botts. He brought in a group of senior Baker Botts attorneys to act as an *ad hoc* opinion committee. Rosenwasser had to assemble an *ad hoc* opinion committee because Baker Botts does not typically utilize opinion committees and does not have a standing committee. Its members were:

• Andy Baker, the Chair of the firm;

• Mike Bengtson, the Chair of the firm's corporate practice group and a member of the Executive Committee;

• Michael Bresson, the leader of the firm's energy capital markets tax practice;

• Joshua Davidson, the leader of the firm's **[*53]** capital markets practice;

• Richard Husseini, a partner focused on tax litigation; and

• Julia Guttman, the firm's General Counsel.

To perform the substantive work, Rosenwasser recruited three other Baker Botts partners:

• Greg Wagner, a FERC practitioner who was representing shippers in their rate disputes with SFPP, including in the *United Airlines* case;

• Michael Swidler, a transactional partner and longtime colleague of Rosenwasser who previously had worked at Vinson & Elkins as part of the team that drafted the Call Right; and

• Seth Taube, a former federal prosecutor and SEC official whose practice includes securities and commercial litigation.

Rosenwasser and his colleagues spent the weekend reviewing a package of documents from Alpert.

3. The Loews-Approved Press Release

Meanwhile, Loews weighed in on the press release about the March 15 FERC Actions. Loews delayed its publication and edited it heavily, admittedly with an eye to the potential exercise of the Call Right. Alpert Dep. 36 ("I certainly had [the Call Right] in my mind when I looked at the press release."). Boardwalk issued the Loews-approved draft on the morning of March 19.

Cognizant of the Call Right, Loews changed the wording of the **[*54]** release to address revenues rather than rates. Recall that the General Partner's ability to exercise the Call Right turned on whether a law firm could opine that Boardwalk's status as a pass-through entity for tax purposes "has or will reasonably likely in the future have a material adverse effect on the maximum applicable *rate* that can be charged to customers." PA § 15.1(b) (emphasis added). In changing the language of the press release, Loews focused on the fact that the language of the Call Right did not mention revenues.

The draft press release prepared by Boardwalk's management explained that the March 15 FERC Actions were unlikely to have a negative impact on Boardwalk's rates. *See* JX 607. Other pipeline companies likewise issued press releases that focused on rates. *See, e.g.*, JX 592 (Spectra Energy Press Release: "Any future impacts would only take effect upon the execution and settlement of a rate case. In the event of a rate case, all cost of service framework components would be taken into consideration which we expect to offset a significant portion of any impacts related to the new FERC policy.").

As prepared by Boardwalk's management, the draft press release contained three **[*55]** sentences identifying the factors FERC had cited as mitigating the need for any rate adjustment and explaining how they applied to Boardwalk's pipelines. Loews struck those statements. *See* JX 607 at 3. Loews also drafted the headline to focus on revenue rather than rates.

After the Loews edits, the press release read, "Boardwalk Does Not Expect FERC's Proposed Policy

Revisions To Have A Material Impact On Revenues." JX 615. The body of the press release elaborated on the effect on revenues:

> Based on a preliminary assessment, Boardwalk does not expect FERC's proposed policy revisions to have a material impact on the company's revenues. All of the firm contracts on Boardwalk's Gulf Crossing Pipeline and the majority of contracts on Texas Gas Transmission are negotiated or discounted rate agreements, which are not ordinarily affected by FERC's policy revisions. Gulf South Pipeline currently has a rate moratorium in place with its customers until 2023. Boardwalk will continue to evaluate the potential impact these proceedings could have on its interstate pipelines, and the company plans to submit comments to FERC.

Id.

At his deposition, Rosenwasser tried to distance himself from the press **[*56]** release. He speculated that "somebody was pressured at Boardwalk to get something out quickly" and issued the press release "with just . . . thoughts and without analysis." Rosenwasser Dep. 97. This was not accurate: Rosenwasser's speculation notwithstanding, Boardwalk had analyzed the effect on its subsidiaries' rates, and Loews was thinking about the Call Right when its personnel revised the language of the release. Implicitly recognizing that the release was problematic for the exercise of the Call Right, Rosenwasser testified adamantly that he "had nothing to do with this disclosure[]. And if [he] had, it wouldn't have said this." Rosenwasser Dep. 95; *see also id.* at 95-98.

4. The Post-Press Release Call With Baker Botts

Several hours after Boardwalk issued the Loews-approved press release, Alpert convened a call with Rosenwasser and other members of the Baker Botts team. Loews wanted answers to two questions. First, had the contents of the press release affected Baker Botts' ability to issue the Opinion? Second, were the March 15 FERC Actions sufficiently concrete to enable Baker Botts to issue the Opinion?

The next day, Baker Botts answered both questions. On the press release, **[*57]** Loews got the answer it wanted. Baker Botts advised that, "[g]iven [the press release's] focus on [Boardwalk's] revenues, and not on the maximum applicable rate that can be charged by [Boardwalk's] interstate gas pipelines, we are not concerned that the release precludes any strategic analysis or action of the type that we were discussing." JX 627 at 1. Loews' edits had paid off, and Alpert quickly forwarded the response to members of Loews' senior management. JX 632 at 1.

Baker Botts also addressed whether the March 15 FERC Actions constituted a sufficient triggering event. On this issue, the answer did not meet Loews' expectations.

Wagner explained that there were "two FERC actions that directly affect the analysis: the Revised Policy and the Notice of Inquiry." JX 626 at 1. Absent further regulatory developments, neither would have an effect on Boardwalk's rates:

> The Revised Policy Statement, in which FERC announced its new policy prohibiting MLP-owned gas pipelines from including an income tax allowance in their cost of service, is effective now as a statement of FERC policy. Standing alone, it does not require pipelines to take any action but it announces how FERC intends to treat **[*58]** the issue on a going-forward basis. The Revised Policy Statement will be implemented through the proposed regulations, which when adopted, will require all interstate gas pipelines to make informational filings revising their cost of service, which may lead to rate challenges. These regulations would be administrative in that they will not announce new policy. I expect that any litigated rate challenges would not be resolved and therefore result in decreased rates until 2020 at the soonest.
>
> The second action is the Notice of Inquiry in which FERC is seeking comment on how to address overfunded deferred tax balances held by MLP pipelines. Comments will be due in late May, 60 days after the notice is published in the Federal Register. Any policy emerging from this proceeding would have the potential to further reduce gas pipelines' cost of service. Unlike the proposed rulemaking, FERC is simply gathering information and there is no proposed timetable for action. FERC may issue a Policy Statement on Deferred Taxes announcing a generally applicable policy or it may determine that it will address the issue in individual litigation. My best judgment is that FERC should act in this proceeding **[*59]** by the end of 2018. Any FERC decision is not likely to be self-implementing and would require additional

proceedings to reflect the policy in pipeline rates.

Id. In simple terms, Wagner recognized that the March 15 FERC Actions did not have any immediate effect. The Revised Policy did not require any action, and nothing would happen until FERC issued regulations. The same was true for the ADIT NOI. Even then, there would not be any effect on rates absent litigated rate cases.

Four minutes later, Alpert requested a second call with Baker Botts. JX 626 at 1. During the call, Alpert criticized Wagner's analysis as having "[t]oo much nuance." JX 646 at 5. Alpert wanted a direct answer addressing when Loews could get the Opinion. *Id.* ("When do we can [sic] get [the] opinion? When [would it be] prudent to act?").

Rosenwasser told Alpert what Loews wanted to hear. He said that the "most important thing <u>has happened</u>" so that "we're already there." JX 646 at 5. But because Wagner had provided a well-reasoned explanation supporting a different conclusion, Alpert asked Baker Botts to confirm Rosenwasser's view that "we're already there." *Id.* at 7 ("2x check that we think issuance of [the Revised **[*60]** Policy Statement] is appropriate triggering event for issuing opinion."). After the call ended, Alpert updated Loews' senior leadership. Copying Rosenwasser, Wagner, and Swidler, Alpert reported that Baker Botts would analyze whether the Revised Policy was a sufficient trigger "in the context of all the facts and the likelihood of future actions changing materially the outcome of the conclusions that would support any opinion of counsel." JX 625 at 1. Alpert also cautioned Loews' executives to "address [all emails on this matter] to me and cc others so we can best argue communications are privileged." *Id.*

G. Baker Botts Reframes The Analysis.

Alpert scheduled a follow-up call with Baker Botts and Boardwalk for March 29, 2018. That gave Baker Botts just over a week to take a position on rendering the Opinion. To get to the outcome Loews wanted, Rosenwasser crafted a syllogism.

1. Rosenwasser's Syllogism

Rosenwasser knew that the Call Right was intended to address a business problem. He was, after all, the one who drafted it. Rosenwasser Dep. 40 (characterizing Section 15.1(b) of the Partnership Agreement as "a business point . . . not a legal point"). The Call Right sought to protect Loews **[*61]** against a regulatory change that would have a materially adverse effect on Boardwalk. The provision referred to rates because rates generate revenue. The Call Right was not intended to create a trapdoor that Loews could open based on a regulatory change that had no real-world effect. Rosenwasser Dep. 45 (describing the Call Right as not "easy to trigger" as indicated by the fact that the "[O]pinion takes lots of thought and it takes lots of analysis to make certain that the [O]pinion could be given").

But the Call Right's reference to "rates," combined with Loews' careful parsing of that distinction when editing the March 19 press release, gave Rosenwasser an opening. Rosenwasser decided to take the view that the Call Right was not concerned with the actual economic impact on Boardwalk; it was only concerned with the abstract concept of "maximum applicable rates." *See* JX 679 at 5, 8. If a regulatory change could have a materially adverse effect on the abstract concept of "maximum applicable rates," then the Call Right could be exercised. And because a tax allowance had been part of the cost-of-service calculation, a policy change eliminating the tax allowance could be said to lead ineluctably **[*62]** to a change in that abstract concept.

On March 21, 2018, Rosenwasser explained his approach to Wagner, who took contemporaneous notes. JX 637. Wagner's transcription memorializes the Rosenwasser syllogism:

> 1 — A pipeline charges COS [cost-of-service] rates
> 2 — COS includes ITA [income tax allowance]
>> [No] ITA → material effect
>> No examination of FERC actions/shipper actions
>> COS/over/under-recovery
>> Just saying [no] ITA = lower COS
>> = MAE on
>> max applicable rates

JX 639 at 1. As Wagner correctly and immediately perceived, Baker Botts was "[j]ust saying" that no income tax allowance meant a lower cost of service, which would equate to a material adverse effect on maximum applicable rates. *Id.*

For Baker Botts, the beauty of Rosenwasser's syllogism was that it did not require any type of predictive exercise about when an actual rate case might be brought or what the outcome of a full-blown, litigated, cost-of-service proceeding might be. *See* JX 639 at 1 ("No examination of FERC actions/shipper actions" or Boardwalk's "over/underrecovery" of its pipelines' costs of service). Indeed, the syllogism did not require any real factual analysis about the effect of the March 15 FERC Actions. The principal step **[*63]** involved elementary subtraction.

To implement Rosenwasser's syllogism, Baker Botts asked Boardwalk "what would FERC allow them to charge" in a hypothetical world that assumed "there was a full mkt for services." JX 646 at 3. Swidler found reassurance for this approach in the fact that the Call Right did not contain any language addressing "the commercial conditions that might prevail in setting rates (e.g., whether or not the pipeline's capacity is in high demand)." JX 645 at 1.

Rosenwasser's syllogism did not account for ADIT. No one knew what would happen with ADIT. *See* JX 644 at 1 ("[G]iven the lack of clarity on FERC's eventual policy on this [ADIT] issue, [McMahon] had no estimates" concerning "the potential effect of a return of ADIT to ratepayers"). But Baker Botts knew that FERC's treatment of ADIT could "affect the rate impact on the pipelines substantially." JX 619 at 1. The known unknown of ADIT defeated Rosenwasser's syllogism, but Baker Botts went ahead anyway.

2. The March 29 Memorandum

In preparation for the scheduled meeting with Loews and Boardwalk on March 29, 2018, Baker Botts prepared a memorandum that worked through the issues that had to be resolved before Baker Botts **[*64]** could render the Opinion. JX 679 (the "March 29 Memorandum"). There were many, and Baker Botts resolved them all in Loews' favor.

One issue was the Call Right's use of the term "maximum applicable rates," which had no established meaning in FERC regulatory parlance. The FERC lexicon equates the terms "maximum rates," "tariff rates," "cost-of-service rates," and "recourse rates." Only in the context of its capacity release regulations had FERC used a similar phrase—"applicable maximum rate." PTO ¶ 89. An investor or a court might interpret the idiosyncratic insertion of the word "applicable" to refer to the actual rates applicable to a particular pipeline's customers, including discounted rates or negotiated rates. Without an established meaning, the term could be regarded as ambiguous, and under the doctrine of *contra proferentem*, a court applying Delaware law would interpret the term against the general partner and its affiliates and in favor of the limited partners.

To solve this problem, the March 29 Memorandum interpreted "maximum applicable rates" as synonymous with "the maximum rates Boardwalk can charge, as a legal matter, not as an economic matter." JX 679 at 5. Baker Botts asserted **[*65]** that the Call Right's drafters would not have used the words "maximum" and "can be charged to customers" if they had meant for the Call Right to focus on the rates that Boardwalk actually charged its customers. *Id.* at 5-6. Without explanation, the March 29 Memorandum concluded that the word "applicable" "certainly does not mean actual." *Id.* at 6.

To support its interpretation, Baker Botts looked to extrinsic evidence in the form of references in Boardwalk's Form S-1 from its IPO. That document indeed contained passages that seem to equate "maximum applicable rates" with recourse rates. *See* PTO ¶¶ 90-91. Other Boardwalk filings, such as its Form 10-Ks, use the term in similar ways. *See id.* ¶ 92. Baker Botts also found orders that FERC issued in rate cases involving Boardwalk, where Boardwalk seemed to have used the term as a substitute for recourse rates. *See* JX 637 at 1. Baker Botts could not identify any broader uses of the term. *Id.*

Another issue was the need for an analysis of Boardwalk's rates. One of the ostensible justifications for Rosenwasser's syllogism was that the legal opinion addressed a question of law that did not require predicting the outcome of a rate case. The March **[*66]** 29 Memorandum could not keep up that pretense. Recognizing that factual analysis was required, the March 29 Memorandum stated, "Boardwalk will need to prepare an analysis of each pipeline's regulatory cost of service" and counsel would need "certificates from Boardwalk's officers" so that counsel could rely on it. JX 679 at 6. Recognizing that the ratemaking principles would be implicated, the March 29 Memorandum stressed "[c]ounsel will need to review that analysis in detail to confirm that the analysis is being prepared consistent with counsel's understanding of federal regulatory rate making requirements." *Id.*

Yet another problem was how to interpret the term "material adverse effect." If interpreted consistent with Delaware cases like *In re IBP S'holders Litig., 789 A.2d 14 (Del. Ch. 2001)*, and its progeny, then that standard would be difficult to meet. The Baker Botts team acknowledged that the drafters "did not want to make it easy" for there to be a sufficient effect. JX 679 at 7. But even though the term appeared in a partnership agreement governed by Delaware law, the Baker Botts team found "no reason to think the drafters of Section 15.1(b) intended to incorporate the meaning the Delaware courts have applied to merger and acquisition **[*67]** MAC clauses to the words 'material adverse effect.'" *Id.* Instead, Baker Botts planned to interpret the phrase by looking to federal securities law, where "something is material if an investor would consider it important in making an investment decision." *Id.; see id.* at 6 ("Those rates [that Boardwalk's subsidiaries charge] are regulated by federal law. The opinion requested therefore involves an analysis of federal law."). Baker Botts also asserted that the doctrine of *contra proferentem* would permit the Call Right to be interpreted in favor of its drafter—contrary to what the doctrine contemplates. *See id.* at 7. Once again, the March 29 Memorandum could not keep up the pretense that the analysis was purely a legal question. The memorandum concluded: "Materiality is not, however, a fundamentally [] legal concept. Therefore, in giving any opinion required by Section 15.1(b), counsel will need to rely heavily on Loews and Boardwalk." JX 679 at 7.

The March 29 Memorandum also flagged an issue raised by the Acceptability Condition: Who would determine on behalf of the General Partner whether the Opinion was "acceptable"? Would that determination be made by Holdings, the Sole Member of **[*68]** the GPGP, where all the decision-makers were Loews insiders, or would the decision be made by the GPGP Board, which included outside directors? JX 679 at 7-8. Baker Botts concluded that Holdings was the correct decision-maker. As Baker Botts saw it, because the General Partner could exercise the Call Right "at its option" and in its individual capacity, it did not make sense for there to be any constraint on the General Partner's ability to determine in its own interest that the Opinion was acceptable. JX 679 at 7-8.

3. The March 29 Meeting

On March 29, 2018, Rosenwasser and Wagner spoke with Alpert and McMahon as planned. They agreed on the outcome that favored Loews: The March 15 FERC Actions "met the procedural predicate" for the exercise of the Call Right. JX 688 at 1; *see id.* ("Policy Statement sets up factual predicate for [t]he P[artnership] [contract] [.]"). Even though the March 15 FERC Actions were not final, and despite the known unknown of ADIT, they decided that enough had happened for Baker Botts to proceed with the Opinion that could enable Loews to exercise the Call Right.

H. The Financial Data

To generate the Opinion, Baker Botts needed what the Opinion would refer to **[*69]** as "Financial Data." Johnson took charge of providing it. On April 4, 2018, Johnson reported that he had numbers that "should get us where we need to go." JX 713 at 1. He sent McMahon an email attaching two analyses for use by Baker Botts, a "Form 501-G Analysis" and a "Rate Model Analysis." JX 727 at 4.

The Form 501-G Analysis contained the information that Boardwalk would include in a Form 501-G filing if FERC adopted regulations consistent with the NOPR. The proposed Form 501-G contemplated that each pipeline would disclose its cost-of-service requirement for 2017 and how much revenue the pipeline actually collected. Each pipeline then would recalculate those figures using a tax allowance based on the lower tax rate of 21% established by the Tax Act and a hypothetical tax rate of 0% to reflect the absence of any tax allowance. JX 580 ¶ 32. The Form 501-G also included lines for amortization of ADIT, but it did not specify a methodology for treating ADIT. JX 558.

The following table summarizes Johnson's Form 501-G Analysis:

Form 501-G Analysis:

Go to table2

JX 727 at 4. In reaching these results, Johnson assumed that each pipeline's ADIT balance would be returned to ratepayers through amortization over the life of each pipeline, an approach known as the "Reverse South Georgia Method." *Id.* at 1. At that time, FERC had not decided how to treat ADIT balances. One option, which pipelines favored, would be to eliminate the ADIT balance entirely. Another option, which shippers favored, would be to require a cash refund of the ADIT balance. Intermediate options involved amortizing the ADIT balance over various periods. The Baker Botts attorneys and Boardwalk executives knew that FERC could handle ADIT in a number of ways, each of which would result in a different outcome. Yet because they believed the Reverse South Georgia Method was the most likely, that was the only one they analyzed.

The Form 501-G Analysis did not include the actual revenue calculations that the Form 501-G contemplated. If Johnson had performed them, they would have shown that both Gulf South and Gulf Crossing were under-recovering **[*71]** their cost of service, generating ROEs that would not warrant a rate case, and were in no danger of having their rates lowered. *See* JX 644 at 1. Boardwalk's actual Form 501-G submissions, filed in late 2018, confirmed that fact: Gulf South's ROE in 2017 was 4.9%, and Gulf Crossing's was 4.7%. Webb Report Ex. 16 at 6765 (Gulf Crossing ROE); *id.* Ex. 17 at 6770 (Gulf South's ROE). Texas Gas, on the other hand, faced some risk of a rate case, because its indicative ROE was 24.3%, and historically FERC would file a rate case if a pipeline's ROE was above 20%. JX 1064; Sullivan Dep. 168. Nevertheless, Wagner and Sullivan "share[d] the opinion that there is a low probability that Texas Gas would face a *section 5* case in the next 1-2 years." JX 1064 at 1. "Beyond that time frame," they concluded, "there are too many variables to make a prediction with any confidence." *Id.*

Johnson's Rate Model Analysis followed the same basic steps as the Form 501-G Analysis. JX 727 at 2. But unlike the Form 501-G Analysis, which used FERC's indicative ROE of 10.55%, Johnson performed the calculations in the Rate Model Analysis using an ROE of 12.0%. That decision increased the cost-of-service requirement. In his cover **[*72]** email, Johnson explained that his choice of an ROE of 12.0% was "[t]he biggest driver as to the difference in Cost of Service from the Form 501-G analysis." JX 727 at 2. At trial, Johnson testified that he found that rate in an annual report issued by a shipper-side advocacy group that lobbies FERC to pursue rate cases against pipelines. Johnson Tr. 617, 658-59. It was not an unreasonable selection, but it also was not a pro-pipeline selection. It is, however, another indication that Loews and Boardwalk did not think that the March 15 FERC Actions necessarily would be implemented as proposed.

The following tables summarize the results of Johnson's Rate Model Analysis:

Rate Model Analysis:

Go to table3

Go to table4

JX 727 at 4. The Rate Model Analysis thus resulted in a bigger percentage change than the Form 501-G Analysis.

Baker Botts used the Rate Model Analysis to render the Opinion. No one on the Boardwalk team prepared any sensitivity analysis using different treatments of ADIT or different ROE calculations. *See* Webb Report ¶¶ 128, 134-35; JX 1757 (Webb Rebuttal) ¶¶ 29-30.

Although Johnson claimed at trial to have followed all of the steps of cost-of-service ratemaking in his analysis, he plainly did not. The Rate Model Analysis presented a hypothetical cost-of-service calculation, subtracted the income tax allowance, and concluded that the new total was lower. FERC does not calculate rates by changing a single element in a cost-of-service calculation. Instead, FERC evaluates all elements of a pipeline's cost of service when calculating a pipeline's rates. Court Report ¶¶ 146-48; Webb Report ¶¶ 129-33.

Sullivan, the rate expert that Baker Botts hired to assist with the Opinion, testified that the Rate Model Analysis was "not a recourse rate calculation." Sullivan Dep. 151. **[*74]** While Johnson attempted to justify his approach by contending that the Rate Model Analysis generated an "indicative rate" for each of Boardwalk's pipelines, Sullivan made clear that "an indicative rate doesn't mean anything." *Id.* 168-69. Sullivan explained that

> [t]o really find out what the true rate reduction is, you have to do the billing determinant adjustments . . . where you take into account how much of the billing determinants are discounted, how much are negotiated discounted rates, how much is [interruptible transportation], how much are firm recourse rates. You have to do all those calculations to properly calculate a rate reduction.

Id. at 120. The Rate Model Analysis did not do that. *Id.*

In his cover email circulating the Rate Model Analysis, Johnson explained the limitations of the exercise he conducted. JX 727 at 2. As pertinent here, he stated:

> In order to provide a comparable rate assessment for each of the assets to assist in business decision-making, we have provided indicative rates that are postage stamp (i.e., every shipper pays the same maximum rate for each molecule) and unadjusted (i.e., does not adjust the maximum tariff rate for any under-recoveries of cost associated **[*75]** with either discounted or negotiated rate capacity that is below the maximum tariff rate). This provides the cleanest approach to understanding the relative rate impact of changes in the income tax rate and income tax policy within each of the three pipes and removes any argument

> as to subjective adjustments to volumes tied to a calculated rate reflected on the summary.

Id.

In reality, Boardwalk's pipelines do not have just one rate. In April 2018, they had 167 total recourse rates on file with FERC.[5] Those rates covered nine different pipeline zones and incorporated forty-six different rate schedules. Webb Report ¶¶ 91-93. In the real world, the "postage stamp" approach does not work for assessing the rates charged by Boardwalk's subsidiaries.

The abbreviated analysis that Johnson conducted contrasts with the voluminous record generated for a rate case. In their most recent rate cases, Texas Gas and Gulf South submitted hundreds of pages of complex calculations to determine cost-based recourse rates. *See* Johnson Tr. 652-53. In stark contrast, the Rate Model Analysis contained approximately five pages of calculations for each pipeline. *Id.* at 640. The Rate Model Analysis gave no consideration **[*76]** to issues of competition, discounting, or other adjustments that would affect the determination of recourse rates in a FERC rate case.[6] By assuming that a change in cost of service would translate directly into a change in recourse rates, the Rate Model Analysis ignored critical elements of rate design. Johnson effectively admitted as much. Johnson Tr. 648-49, 651-52.

Perhaps most significantly, the Rate Model Analysis ignored the reality that rate changes are not self-implementing. Even if a pipeline's cost of service changes, recourse rates do not change unless and until there is a litigated rate case.[7] If a pipeline is unlikely to face a rate case, then it is all the more unlikely that its recourse rates will change.

The Rate Model Analysis made no effort to incorporate the risk of a rate case. It easily could have. The NOPR contemplated using the Form 501-G to assess the need for a rate case. FERC also identified factors that could obviate the need to change a pipeline's rates, all of which applied to Boardwalk's subsidiaries. Gulf South and Gulf Crossing faced no risk of a rate case in the foreseeable future. For Texas Gulf, the rate case risk was low through April **[*77]** 2020; beyond that, it was impossible to predict the likelihood of a rate case "with any confidence."[8] Yet the Rate Model Analysis implicitly assumed a 100% likelihood that all three pipelines would face a rate case immediately, lose the rate case, and each have their rates reduced by an amount determined by singe-issue ratemaking.

I. Alpert Adds Skadden To The Team.

Shortly after hiring Baker Botts, Alpert hired Skadden, Arps, Slate, Meagher & Flom LLP ("Skadden") to supplement the legal team. Alpert had considerable

[5] Webb Report Ex. 1 at 8-26 (Texas Gas, 114 recourse rates); Webb Report Ex. 2 at 10-37 (Gulf South, 42 recourse rates); Webb Report Ex. 3 at 3-5 (Gulf Crossing, 11 recourse rates).

[6] When competition pressures a gas pipeline to provide services at a discount to applicable recourse rates, the pipeline is no longer recovering its full cost of service. In its next rate case, the portion of the pipeline's cost of service that would have been allocated to the discounted services is reduced, and the difference is reallocated to the pipeline's less price sensitive customers. Webb Report ¶ 177. That way, FERC permits the pipeline to raise its remaining undiscounted recourse rates so that it can recover its full cost of service. All three of Boardwalk's pipelines have emphasized in FERC filings that they face significant competition. The actual recourse rates of Texas Gas and Gulf South reflect that competition. Webb Report ¶ 95 (Texas Gas); *id.* ¶ 96 (Gulf South); *id.* Ex. 4 at 443; *id.* Ex. 6 at 626. Texas Gas and Gulf South earn less than a third of their revenue from recourse rates; Gulf Crossing earns essentially none. *Id.* ¶ 194. McMahon's statement that Gulf Crossing will be undersubscribed by the time its contracts expire in 2023 evidences a likelihood that discount adjustments will figure prominently in its next rate case. Finally, in transmittal letters attached to the Form 501-G filings that Boardwalk submitted on behalf of its pipelines in late 2018, Johnson identified significant and apparently increasing competition as a reason FERC should not require them to lower their rates. *See* Webb Report ¶ 198 & n.175.

[7] Wagner Dep. 77-79; Sullivan Dep. 79-80; *see* McMahon Tr. 507-08, 512-13.

[8] *See* JX 1064 (Wagner advising Loews that Texas Gas had a low rate-case risk for "the next 1-2 years"); *see* Wagner Tr. 245, 248 (Wagner testifying that there was some risk of a rate case at Texas Gas due to its ROE, but that because of FERC's workload, a rate case was unlikely in the next one to two years); Johnson Tr. 632-34 (testifying that Texas Gas faced some risk of a rate case); *see also* JX 1807 at 6 (Wagner noting that Sullivan believed FERC would use an ROE of 20-30% to screen for rate cases). The defendants' FERC expert testified at trial that Texas Gas would have an ROE of between 17.5% and 24.3%, which was high enough to create some risk of a rate case. *See* Kelly Tr. 1104. The plaintiffs' rate expert agreed that FERC historically pursued rate cases when pipelines had ROEs in this range. Webb Tr. 1007-08.

experience working with Skadden, and the firm had a deep bench in FERC matters, extensive experience with MLPs, and expertise in Delaware law. Rosenwasser Tr. 61-62; Alpert Tr. 326-27. Richard Grossman, a corporate partner, led the Skadden team. Jennifer Voss, a litigation partner in Skadden's Delaware office, provided advice on Delaware issues.

Alpert hired Skadden after Rosenwasser suggested that bringing in another law firm to advise on whether the Opinion was acceptable might further protect Loews from liability. *See* JX 975 at 1. The Partnership Agreement contains language exculpating the General Partner and its Affiliates from monetary liability unless **[*78]** it engages in fraud, bad faith acts, or willful misconduct. PA § 7.8(a). The Partnership Agreement also states that the General Partner will be "conclusively presumed" to have acted in good faith if it "reli[ed] upon the advice or opinion [of legal counsel] (including an Opinion of Counsel)." *Id.* § 7.10(b). Rosenwasser and Alpert thought that if Skadden advised the General Partner that Baker Botts was qualified to render the Opinion and that the Opinion was acceptable, then those additional protections would apply.[9] At the time, Alpert also thought that Skadden would handle any litigation challenging the exercise of the Call Right. *See* Alpert Tr. 445-46; JX 1136. He later would decide not to use Skadden for any litigation after Skadden balked at giving Alpert the advice he wanted.

The first issue that Skadden looked at was Baker Botts' assertion that Holdings was the proper entity to decide whether the Opinion was "acceptable to the General Partner." *See* JX 679 at 7-8. Rosenwasser had struggled with this question, which the Partnership Agreement did not plainly address. *See* JX 596 (Rosenwasser's handwritten notes on the Partnership Agreement); Rosenwasser Dep. 65. By late March, Rosenwasser had **[*79]** taken the position that Holdings, rather than the GPGP Board, would determine acceptability. *See* JX 679 at 8. On March 27, Alpert suggested that Skadden "confirm" that "the redemption was the sole decision of the [General Partner]—such that the [GPGP] [B]oard will not need to act." JX 669 at 1.

Instead of confirming Rosenwasser's position, Voss reached the exact opposite conclusion. In an insightful internal email that carefully worked through the issues, she expressed the view that "the MLP Agreement likely requires that the [GPGP] Board make the determination to accept the Opinion of Counsel. Or, at a minimum, it is ambiguous." JX 747 at 1.

Skadden subsequently prepared a memorandum for Alpert, where Skadden framed its concerns in more lawyerly and less direct language. Skadden began by noting that the Call Right

> is atypical and, to the best of our knowledge, notwithstanding the many MLP cases (and MLP contract terms) that have been litigated, no Delaware court has interpreted such a provision. . . . [I]t's also fair to say that courts generally dislike the interpretive difficulties often inherent in MLP agreements. . . . And, here, we think that any "question marks" or ambiguities **[*80]** likely would be decided against the "sophisticated drafter" and not the minority unitholders.

JX 773 at 1. Skadden also flagged arguments that a plaintiff could make about the circumstances surrounding the exercise of the Call Right, such as "purported efforts to depress the price of the units prior to the exercise of the right by, for example, increasing capital expenditure" or "purported partnership 'admissions' about the 'lack of materiality' of the FERC's March 15 policy statement." *Id.*

Setting aside those issues, Skadden agreed with Baker Botts that Holdings had the right to exercise the Call Right in its individual capacity. But Skadden perceived that to be a different question than who had the ability to determine whether the conditions for exercising the Call Right were met. Skadden noted the following:

• "[T]he 'right to purchase' . . . does not seem to arise unless and until certain preconditions exist, including acceptance by the General Partner of a specified 'Opinion of Counsel.'" *Id.* at 2.

• "A plaintiff could argue that this Opinion of Counsel must be acceptable to the General Partner in its capacity as general partner and not in its individual capacity." *Id.*

• "[T]he words **[*81]** 'exercisable at its option' (indicating 'individual capacity') do not appear in the 'precondition' portion of the provision." *Id.*

• "At a minimum, the matter is arguably ambiguous." *Id.*

Skadden also discussed the structure of the Partnership Agreement. Skadden observed that if the Acceptability Condition existed to benefit the General Partner in its

[9] Rosenwasser Tr. 61; Alpert Tr. 325-26, 407; JX 1100 (Skadden engagement letter dated April 23, 2018).

individual capacity, then it followed that an affiliate of the self-interested General Partner could determine acceptability. But if the Acceptability Condition was intended to introduce some check on the quality of the Opinion for the benefit of the limited partners, then enabling the self-interested General Partner to make the decision did not make sense. It was "akin to permitting the fox to guard the henhouse." *Id.* at 3. Instead, "the added 'layer' of [GPGP] Board involvement serves a purpose and must occur before the right to call arises." *Id.* Skadden reiterated that "at a minimum, there is arguable ambiguity here." *Id.* To address the resulting litigation risk, Skadden recommended that the GPGP Board determine whether the Acceptability Condition had been met. *Id.* at 2. Skadden also recommended that the outside directors on the GPGP Board **[*82]** participate in and not abstain from the determination. *Id.* at 4.

Skadden plastered its analysis with caveats about its views being "preliminary" and "for discussion purposes only." *Id.* at 1. Skadden also downplayed its internal conclusion regarding ambiguity by adding the adjective "arguable" in the memorandum it provided to Alpert. *Id.* at 2. But the overall tenor of Skadden's memo was clear, and Skadden presented its advice with the understanding that Loews would rely on it.

Loews begrudgingly did just that. Alpert and McMahon found Skadden's recommendation "frustrating" and viewed the firm as a "pain in the ass." *See* JX 874 at 1 (Layne handwritten notes); Layne Dep. 111-12. But consistent with Skadden's reasoned analysis, Loews initially decided to have the GPGP Board make the acceptability determination. *See* JX 948 at 2; JX 979 at 1.

J. Baker Botts Struggles With The Material Adverse Effect Inquiry.

By the second week of April 2018, Baker Botts was struggling with the need to conclude that the March 15 FERC Actions would have an effect that was both material and adverse. They wanted Skadden's help. *See* JX 770 at 1; JX 772. But as a matter of firm policy, Skadden does not render opinions **[*83]** on whether an event constitutes a material adverse effect, and Grossman was not willing to give Baker Botts any analysis that might be construed as expressing an opinion on it. *See* JX 771 at 1.

For its part, Skadden was skeptical about the claim that a 10-15% change in a maximum applicable rate could be deemed in the abstract to qualify as a material adverse effect. JX 772 at 1. The Skadden attorneys believed that an 11% change in the maximum applicable rate was "likely insufficient" under Delaware law, although they acknowledged that the duration of the change would be a pertinent consideration. *See id.* The Skadden attorneys did not think anyone could assess whether a change in the range of 10-15% constituted a material adverse effect without delving into the facts. *Id.*

Alpert wanted Grossman to support Baker Botts. But during a call with Alpert, Grossman held the line on not providing any analysis that might be construed as an opinion on the existence of a material adverse effect. Alpert emailed his colleague, Tom Watson, that Grossman was "pissing [him] off." JX 798 at 1. Watson's response was more telling:

> Yes, these calls are getting really annoying. Too many lawyers doing nothing **[*84]** but muddying the waters on what is a clear question (to me). If people think the language says that the relevant test is what is the real world effect, then we have an issue. I think it's crystal clear that we're talking hypothetical future max FERC rates.

Id. In other words, Watson understood that the material adverse effect analysis only worked under Rosenwasser's syllogism based on "hypothetical future max FERC rates." Under Rosenwasser's syllogism, the answer was baked into the assumptions. But in the real world, the March 15 FERC Actions did not have any meaningful effect, much less a material and adverse effect.

Grossman ultimately agreed to provide Baker Botts with a description of the key cases "so that they did not miss a key case or an important factor looked at by the Delaware courts." JX 777 at 1. Grossman also had Mike Naeve, a Skadden partner and former FERC Commissioner, speak with Wagner, Alpert, and McMahon about the various issues presented by the Opinion. *See* JX 790 at 2. Going into a call on April 10, 2018, Naeve had doubts about what "maximum applicable rates" meant. But after talking it over with the group, he thought that "recourse rates" was a more reasonable **[*85]** reading of "maximum applicable rates" than "the maximum rate that can be charged a specific customer under a negotiated or discounted rate agreement." *Id.* To get Naeve "more comfortable" with the Baker Botts position, Wagner sent Naeve over 500 pages culled from Boardwalk's Form S-1 and the FERC orders involving Boardwalk's pipelines that used the term "maximum applicable rates" as a synonym for recourse rates. *Id.*

After speaking with the Baker Botts team, Naeve identified a number of issues surrounding the material adverse effect analysis in discussions with Grossman and other Skadden partners. Naeve immediately flagged the question of whether any of Boardwalk's pipelines actually faced a risk of a rate case. As Naeve explained,

> [t]he risk that a customer will ask for a new rate case and that FERC will agree to grant that request will depend on whether there is substantial evidence that a new rate case will result in materially lower rates. A reduction in the revenue requirement to take out taxes would suggest lower rates, but it is possible that any reduction might be offset by other factors such as recent facility investments expenditures or changes in allowed ROE.

JX 800 at 1. In **[*86]** other words, Naeve recognized that whether the March 15 FERC Actions would have a material adverse effect on recourse rates depended on both the risk of a rate case *and* on the full ratemaking exercise that would take place in a rate case. It was much more than just a function of Rosenwasser's syllogism and its subtraction of a tax allowance.

Naeve and his Skadden colleagues also discussed whether the inquiry into a material adverse effect needed to account for Boardwalk's existing contracts for negotiated rates and discounted rates or any rate-case moratoriums at its pipelines. *See* JX 800 at 2. Those were real-world factors with real-world impacts, and FERC had cited them as reasons why a change in rates might not be warranted. But Baker Botts had no intention of taking those issues into account. Baker Botts instead was taking the position that

> because pipelines are long-lived assets, and because the relevant language refers to the potential for material adverse rate effects in the future, their analysis need not be affected by discounts or moratoria that will be lifted within the next several years.

JX 800 at 2.

K. Baker Botts Works Towards A "Preliminary" Opinion.

Rosenwasser wanted to **[*87]** be in a position to provide Loews with a "preliminary" version of the Opinion by the end of April 2018. *See* JX 1956. The preliminary version would turn out to be an all-but-signed version that Baker Botts could render formally if and when Loews requested it.

Rosenwasser and his drafting team prepared an initial draft of the Opinion dated April 4, 2018. *See* JX 726 (the "April 4 Draft"). Like the preliminary Opinion and the final Opinion, the April 4 Draft was a non-explained opinion that identified background information, flagged assumptions, and stated a conclusion, but did not provide reasoning or cite authority to support the conclusion.

Throughout April, Rosenwasser and his drafting team worked with the senior Baker Botts lawyers comprising the *ad hoc* opinion committee. The senior lawyers raised a number of concerns that highlight how difficult it was for Baker Botts to reach the outcome necessary to render the Opinion.

A persistent problem was the meaning of "maximum applicable rates." The April 4 Draft simply stated that it addressed "maximum applicable rates" without explaining how Baker Botts interpreted that term. JX 726 at 2. The next significant draft, dated April 17, 2018, **[*88]** sought to address the ambiguity inherent in the term by stating,

> Based on the wording of Section 15.l(b)(ii) and supported by disclosure in the Registration Statement and discussions with representatives of the Partnership who assisted in preparing the Registration Statement, it is our judgment that . . . we should not consider the impact of negotiated rates, discounted rates, contractual rates, settlement rates, market-based rates, rate moratoria, or other market-related factors when interpreting the term "maximum applicable rates that can be charged to customers."

JX 935 at 2. That language telegraphed all the market-based, real-world considerations that Baker Botts was leaving out, and subsequent drafts continued to dispense with any analysis of the real-world impact of facts that would affect the actual "maximum applicable rates that can be charged to customers." Rosenwasser continued to claim that the Opinion would not look at real-world effects, which he characterized as "speculation about real market conditions and their impact on rates." JX 879 at 1.

Another persistent problem was that the March 15 FERC Actions would not have any effect on Boardwalk's recourse rates unless those **[*89]** rates changed through a rate case. The April 4 Draft addressed that issue head on by expressly assuming that Boardwalk's pipelines would file rate cases and take any other actions necessary to permit them to charge the reduced recourse rates that would generate a material adverse effect. *See* JX 726 at 2 ("[W]e have requested that the Partnership assume that the Subsidiaries will file rate cases and take any other appropriate and legal action to be permitted to charge the maximum rates permitted under the applicable cost of service rules and regulations regardless of competitive conditions or any other non-legal factor."). But by including this explicit assumption, the April 4 Draft both highlighted the role of rate-case risk and openly assumed that Boardwalk and its subsidiaries would act contrary to their own interests. By April 17, Baker Botts had deleted this language and substituted an assumption that Boardwalk's pipelines would charge customers their new recourse rates, without addressing how those rates would come about. The new assumption reached the same result, but without advertising the counterintuitive premise. *See* JX 935 (omitting reference to Boardwalk's subsidiaries **[*90]** filing rate cases).

Yet another problem was the fact that the March 15 FERC Actions were not final, could be revised significantly, and required clarification. The April 4 Draft contained language recognizing that reality, while assuming that the March 15 FERC Actions would not be revised. *See* JX 726 at 2 (acknowledging that "[i]mportant details of implementing the Revised Policy require clarification"). By April 17, Baker Botts had eliminated that acknowledgment of uncertainty. *See* JX 935 at 2. That draft instead sought to strengthen the assumption that the March 15 FERC Actions would not be revised, would be implemented as written, and would be applied by FERC in individual regulatory proceedings. *See id.* Subsequent drafts took the same approach. *See id.*

The senior Baker Botts lawyers also flagged other issues with the language of the Call Right. One debate concerned the reference to Boardwalk's "status as an association not taxable as a corporation." *See* JX 1958 at 1, 8; *see also* JX 878 at 2; JX 939 at 1. That phrase seemed to refer to Boardwalk's status as an entity taxed as a partnership, but that created an issue for the Opinion because the Revised Policy did not affect all entities **[*91]** taxed as partnerships. It was thus difficult to say that Boardwalk's status as an entity taxed as a partnership had a causal effect on the rates it could charge. *See* JX 1958 at 1; JX 1957 at 5.

The senior Baker Botts lawyers also questioned whether Baker Botts should be giving an opinion under Delaware law about the existence of a material adverse effect. *See* JX 878 at 4. The April 4 Draft only addressed federal law, and it did not contain any discussion of the term "material adverse effect." *See* JX 726 at 2.

Once Baker Botts came to grips with the fact that the existence of a material adverse effect under the Partnership Agreement was a question of Delaware law, the firm was out of its depth. Baker Botts generally rendered enforceability opinions under the Delaware Revised Uniform Limited Partnership Act, but that was it. The firm did not render opinions more broadly on Delaware issues. *See* JX 878 at 4. By April 17, the draft included language which noted that the term "material adverse effect" was "not defined in the Partnership Agreement" and stated that Baker Botts had considered "what we believe to be relevant law." JX 935 at 3. As Grossman had anticipated, the senior Baker Botts **[*92]** lawyers wanted to rely on Skadden's work product on this issue. *See* JX 878 at 4-5; JX 892 at 2.

The senior Baker Botts lawyers also wanted reassurance on the Financial Data. The April 4 Draft referred only to information provided by the Partnership about its "cost of service . . . , and the related maximum rates that can be charged." JX 726 at 2. By April 17, the draft contained language discussing the Financial Data and containing assumptions that it was "prepared in a reasonable manner and in good faith." JX 935 at 3. By April 19, the extent of the assumptions regarding the Financial Data had grown further. *See* JX 1005 at 3.

Rosenwasser was concerned that the Financial Data alone might not be enough. He sought to bolster the case for a material adverse effect by asking Johnson to expand his analysis beyond the Financial Data to include projections for 2020 and add "DCF, EBIDTA, and EBIT (Operating Income) comparisons." *See* JX 775 at 1; *see also* JX 797. He thus sought to include the real-world effects of changed rates when considering their effect on Boardwalk, despite persisting in refusing to consider real-world effects when evaluating whether the March 15 FERC Actions would have **[*93]** any effect on rates.

During this timeframe, Johnson simplified the presentation of the Financial Data by dropping the scenarios that involved a tax rate of 35%. JX 775 at 3-4; JX 785 at 1-2. A version of the Financial Data from April 10 presented the information as follows:

Form 501-G Analysis:

Go to table5

Rate Model Analysis:

Go to table6

Go to table7

JX 775 at 3-4; JX 785 at 1-2. Compared to the April 4 figures, the percentages for Texas Gas in the Rate Model Analysis had creeped up from 11.96% (cost of service) and 11.91% (indicative rate) to 12.19% (cost of service) and 12.12% (indicative rate). **[*94]** Otherwise, the figures remained the same as in the information Johnson had provided on April 4.

By this point, however, Boardwalk's management team was preparing comments in response to the ADIT NOI and was focused on the implications of ADIT. Horton expressed concern that the Financial Data gave up Boardwalk's argument that "the [Revised Policy] essenti8ally [sic] eliminates ADIT," meaning that Boardwalk's pipelines "do not have a reduction of rate base." JX 797 at 1. He wanted to caveat Johnson's analysis to make clear "that it does not include any impact from adjusting the ADIT balances to account for the reduction or the elimination of income taxes." *Id.*

Like Boardwalk's management, the Baker Botts lawyers knew that the treatment of ADIT would have a significant effect on the Financial Data. Wagner was representing the shippers on remand in the *United Airlines* case, so he understood that different industry participants were arguing for different outcomes.

The Baker Botts team had retained Sullivan as a rate expert,[10] and Wagner asked Sullivan to examine how the Financial Data treated ADIT:

> It seems to us that different assumptions on how to handle that issue could affect the calculations. Have they **[*95]** assumed that they will flow back the ADIT over the remaining life of the assets (with the corresponding reversals of the reduction to rate base)? Or is there another method used here?

JX 868 at 2. Sullivan reported that Johnson was using the Reverse South Georgia Method, which Sullivan thought was appropriate. *See* JX 868 at 1. Boardwalk's executives and the Baker Botts lawyers thought that was the most likely regulatory outcome. But they also understood that the approach FERC took on ADIT would have a big effect. Wagner's handwritten notes show him regularly wrestling with the uncertainty generated by how FERC would treat ADIT. *See* JX 646 at 8; JX 1400 at 1; JX 1807 at 3-4 ("[T]he effect on ADIT is unknown & unknowable."). In one set of notes, he commented, "Will want to run scenarios on ADIT flowback." JX 1807 at 12. Another set of notes stated: "ADIT NOI — Policy Statement w/ no immediate effect. 501-G filings do not acct for ADIT. No idea what they'll do w/ ADIT. If there's litigation coming from 501-Gs, ADIT policy will prob factor in there." JX 1216 at 3.

After conducting further review of the Financial Data, Sullivan advised Wagner that "the spreadsheet work done by Boardwalk appropriately **[*96]** represents *the cost of service* for each Boardwalk interstate pipeline, the federal income tax impact at 21%, and the potential reduction in the cost of service for each pipeline if FERC reduces the income tax allowance to 0." JX 960 at 2 (emphasis added). Wagner did not think that a statement about a cost of service analysis was sufficient. He asked Sullivan to let him know "[o]nce you're able to state definitively that you agree with their *rate* analyses." *Id.* (emphasis added).

On April 18, 2018, Sullivan told Wagner that he had finished his review. He did not provide the representation that Wagner wanted. Instead, Sullivan stated:

> I have confirmed that Boardwalk has properly used the correct financial and accounting entries in the calculated *cost of service* for each of its pipelines. In my expert judgment Boardwalk's spreadsheets provide an accurate presentation of the *cost of service* impact of the January 2018 federal income tax change from 35% to 21%. Boardwalk's spreadsheets also provide an accurate presentation of the *cost of service* impact of the potential reduction in the *cost of service* for each pipeline if FERC eliminates the federal income tax allowance for MLP owned interstate **[*97]** pipelines as proposed in Docket No. PL17-1.

JX 960 at 1 (emphases added). In his deposition, Sullivan explained persuasively that the Financial Data

[10] Sullivan had thirty-eight years of experience working in the oil and gas industry, including twenty-five years working at FERC, and he had testified in FERC proceedings more than fifty times. PTO ¶ 154; JX 1498 at 151. His expertise is unchallenged.

did not attempt to engage with principles of rate design and did not address the risk of a rate case. *See* Sullivan Dep. 101, 126, 149, 150-51.

In a separate call with Loews, Sullivan addressed the risk of a rate case at Texas Gulf, where the Financial Data indicated an ROE of approximately 24.3% after the elimination of the tax allowance and using the Reverse South Georgia Method for ADIT. Although returns at that level had caused FERC to initiate rate cases in the past, Sullivan thought that resource constraints on the agency meant that the probability was low that Texas Gas would face a rate case in the next one to two years. JX 1064 at 1. The likelihood of a shipper filing a rate case was also low. *See id.* No one thought that the risk of a rate case at Gulf Crossing or Gulf South was worth discussing.

Sullivan's work confirmed what everyone knew. In the real world, any potential effect on Boardwalk's rates could not be understood without a FERC determination regarding ADIT. And even if FERC implemented the March 15 FERC Actions, the regulations **[*98]** would not have a material adverse effect on Boardwalk's rates because there was no risk of a rate case at Gulf Crossing or Gulf South and only a low risk of a rate case at Texas Gas. The March 15 FERC Actions only had an effect in the hypothetical world of Rosenwasser's syllogism, and only if supported by a coterie of assumptions necessary to generate the result that Loews wanted.

L. Baker Botts Calls On Richards Layton.

As noted previously, the senior Baker Botts lawyers wanted to be able to rely on Skadden's work product for purposes of the material adverse effect issue. *See* JX 878 at 4-5; JX 892 at 2. When they received Skadden's description of the Delaware cases, it fell short of their expectations. *See* JX 913 at 1 (Baker Botts attorney David Kirkland telling Rosenwasser, "I was expecting more analysis than this"); *see also* JX 936 at 1. Rather than analyzing the Call Right, Skadden's memorandum explicitly disclaimed any intent to do so. JX 900 at 2.

Seeking to reassure his partners that Baker Botts still should render the Opinion, Rosenwasser reported that Loews only would exercise the Call Right if Skadden advised that Baker Botts' Opinion met the Acceptability Condition. JX 913 **[*99]** at 1. Rosenwasser's partners wanted that condition built into the Opinion, so the Baker Botts attorneys added language to the preliminary draft which stated that Baker Botts' Opinion was "based on," and its delivery "conditioned on," the fact that "other counsel has advised [the General Partner] that [its] reliance on this opinion when delivered should provide the benefits set forth in Section 7.10(b) of the Partnership Agreement." JX 1955 at 6 (draft from April 17, 2018); JX 1959 at 7 (draft from April 18, 2018). Perhaps anticipating pushback from Skadden, Baker Botts subsequently eliminated the "based on" and "conditioned on" language. *See* JX 1960 (draft from April 19, 2018).

The senior Baker Botts lawyers also wanted reassurance on the analysis of a "material adverse effect." And Baker Botts was on a deadline, because Loews had made clear that it wanted an indication from Baker Botts that it could deliver the Opinion by Friday, April 20, 2018. Rosenwasser knew that Boardwalk and Loews had quarterly security filings to make and that Loews' CEO, Jim Tisch, was planning to hold board meetings before the end of month to approve those filings. Rosenwasser understood that Tisch wanted **[*100]** to know where Baker Botts stood going into those meetings. *See* JX 914 at 1.

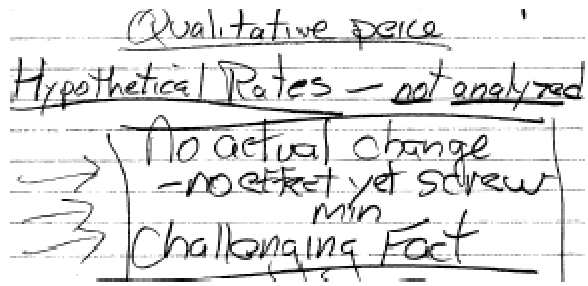
To satisfy his partners, Rosenwasser contacted Srinivas Raju, a partner at Richards, Layton & Finger, P.C. *See* JX 957 at 1; JX 975 at 1. In a call on Wednesday, April 18, 2018, Rosenwasser told Raju that a FERC rate expert had modeled a "decrease of 12.19% on top line revenue" for Texas Gas, an "11.70% decrease" for Gulf South, and a "15.62% decrease" for Gulf Crossing. JX 975 at 1; *see also id.* ("top line revenue impact — excess of 10% impact"). In reality, those figures referred to the percentage changes in cost of service and indicative rates under the Rate Model Analysis that Johnson prepared. JX 775 at 3; JX 785 at 2. Those figures would only translate into a comparable effect on topline revenue if Boardwalk's subsidiaries charged recourse rates for a high percentage of their volumes. They did not.

Rosenwasser also told Raju that the FERC rate expert had projected that EBIT would decrease by 21-22% and distributable cash flow would decrease by "closer to 25%." JX 975 at 1; *see also id.* ("21% decline in net income" and "even higher in distribution"). Sullivan had not addressed the effect on EBIT or distributable **[*101]** cash flow. Sullivan Dep. 140-42 (discussing final Financial Data in JX 1398); *see also id.* at 141 (Q: "Did you offer an opinion regarding the calculation of DCF, EBITDA or EBIT?"; A: "I do not believe I did specifically cite to EBITDA, EBIT or the DCF."). Rosenwasser told Raju about those factors because he wanted to be able to consider real-world effects on Boardwalk's business, as well as real-world stock market reactions, when determining whether a material adverse effect had occurred.[11] Yet he continued to want to ignore the real-world reasons why the March 15 FERC Actions would not have any material effect on the rates that Boardwalk's pipelines could charge.

Having provided these representations, Rosenwasser asked Raju to consider whether "material adverse effect" is "only measured based on the effects on the 'maximum rate' or is . . . measured by the effect on the business as a result of the decline in the maximum rate." JX 975 at 1; *see also* JX 957 at 2. He also asked whether Richards Layton could support the assertion that an adverse effect in "excess of 10%" would be sufficient under Delaware law. JX 1502 at 21.

Less than twenty-four hours later, Raju and his team gave advice orally to Baker Botts via teleconference. JX 956 at 1. Raju advised that the "[b]etter [r]eading" was to "look [at] rates more, not effects." JX 1007 at 1. He also cautioned that a Delaware court would "construe ambig[uity] ag[ai]nst [the] drafter." *Id.*

In response, the Baker Botts team clarified that their rate expert had not analyzed the Revised Policy's effect on Boardwalk's rates. Instead, the analysis considered "Hypothetical Rates." JX 1007 at 1. Notes taken by a Baker Botts partner reveal that everyone focused on the core issue: There would be "no actual change—no effect yet screw min[ority]." *Id.* That was obviously a "challenging fact." **[*103]** *Id.*


Qualitative peice
Hypothetical Rates — not analyzed
No actual change
-no effect yet screw
min
Challenging Fact

Turning to the magnitude of the change in rates that would be necessary for a material adverse effect, Raju advised that he would have a "hard time saying [12% in perpetuity is] not material." *Id.* at 2. Raju noted that there was "not a lot of precedent" and, in any event, "no cases against us" because "MAC cases [are] different" and the rate change was assumed to have an effect in "perpetuity." *Id.*

Raju agreed to put his advice into an email. But he cautioned that it would be caveated by "assumptions and carve-outs" and say "[n]othing stronger" than that existence of a material adverse effect based on a change of 12-13% to rates in perpetuity represented the "better argument." JX 975 at 1. Raju also stressed that Baker Botts could not reference his advice in the Opinion. *Id.; see* Raju Dep. 113-14.

Raju's advice reassured Rosenwasser's partners. After the call, Rosenwasser emailed Raju, telling him "[y]ou are so good." JX 1003 at 1. Baker Botts sent Richards Layton a copy of their preliminary opinion. The next day, Raju told Baker Botts, "We stand by what was discussed on the call yesterday, and nothing in the draft opinion changes our thinking." JX 1031 at 1.

M. Baker Botts Makes Clear [*104] That It Can Deliver The Opinion.

As noted, Loews had been pushing Baker Botts to provide an indication that it could deliver the Opinion, and Loews wanted an answer by Friday, April 20, 2018. *See* JX 914 at 1. After his call with Raju, Rosenwasser told Alpert and Siegel that there was "no show stopper yet," but that Baker Botts still needed to secure internal approvals. *See* JX 1006 at 1. Alpert and Siegel were not pleased. *Id.*

The internal approval that Rosenwasser needed was signoff from the firm's chairman, Andy Baker. Baker could not provide the signoff by Friday because he was in the United Kingdom attending his daughter's wedding. Rosenwasser told Loews that because of Baker's

---

[11] Rosenwasser's back-up memorandum offers further insight into what he wanted to consider to reach a conclusion that the effect on Boardwalk was "not immaterial." PTO ¶ 161. There, he wrote:

> The fact that so many regulated pipelines have requested that the FERC reconsider the Revised Policy is an indication they considered the changes caused by the Revised Policy are not immaterial. The magnitude of the adverse effect that the Revised Policy had on the trading market for many MLPs that own regulated pipelines is an indication that the matter is not immaterial. The fact that several MLPs that owned regulated pipelines have indicated that they are converting to corporate tax status is an indication that the matter **[*102]** is not immaterial.

Id.

absence, Baker Botts would not be able to get his signoff until Monday. JX 1019 at 2. That did not sit well with Loews. Siegel wanted to know why Baker Botts had not raised this issue earlier, since "[t]hey must have known for weeks that Baker would be in London." *Id.* Jim Tisch wanted Alpert to ask Rosenwasser "why they didn't anticipate this problem, and whether this is an indication that there may be a problem with the opinion committee." JX 1020 at 1.

Alpert told Tisch and Siegel that Rosenwasser was just **[*105]** "trying to be emotionally intelligent with his partners in an effort to obtain the desired result." *Id.* at 1. But he nevertheless pressed Rosenwasser "to make absolutely sure" that there was no way to reach Baker on April 20. JX 1033 at 3. On April 20, 2018, at 6:47 a.m., Alpert asked Rosenwasser for a call that morning. JX 1059. One hour later, at 7:51 a.m., Alpert sent a follow-up email. He told Rosenwasser that "[y]our timing affects many things, especially our disclosure, [Siegel's] conversations with board members and Loews special board meeting being held next week." JX 1033 at 3. He also conveyed that the senior Loews executives did not understand why no one anticipated the issues created by Baker's absence. *Id.*

Eleven minutes after the second email, Rosenwasser emailed his partners, telling them that Tisch "need[ed] board support for his plans" and "need[ed] to tell [the] board this afternoon" about whether Baker Botts could issue the Opinion. JX 1032 at 1. In response to Rosenwasser's email, Baker Botts attorneys David Kirkland and Mike Bengtson separately considered whether to try to reach Baker. *Id.* Kirkland told Bengtson that he had "already been lobbied by Mike R[osenwasser] **[*106]** this morning to let him give Jim T[isch] the thumbs up this morning." *Id.*

Rosenwasser's lobbying was successful. Around 11:00 a.m., Rosenwasser emailed Alpert that "we are still working but believe at this point that we will be able to give the General Partner the Opinion of Counsel if and when requested." JX 1065.

At 12:09 p.m., Rosenwasser sent Alpert a draft of the Opinion. JX 1045 at 1 (the "Preliminary Opinion").[12] The Preliminary Opinion was in substantially the same form as the final Opinion delivered more than two months later on June 29. *Compare* JX 1045 (Preliminary Opinion) *with* JX 1522 (Opinion).

N. Skadden Makes Clear That It Will Say That The Opinion Is Acceptable.

After securing a "thumbs up" from Baker Botts, Alpert sought confirmation from Skadden that, if and when asked, it would advise the GPGP Board that the Opinion was "acceptable." Alpert anticipated that Skadden's advice would protect the GPGP Board when determining that the Opinion was acceptable for purposes of the Acceptability Condition. Everything would be buttoned down.

After receiving the draft from Baker Botts, Alpert forwarded it to Grossman and asked for an answer by the afternoon of Tuesday, April 24 "at **[*107]** the latest." JX 1121 at 1. Skadden objected to the language in the draft stating that other counsel "has advised you that your reliance on this opinion when delivered should provide the benefits set forth in Section 7.10(b) of the Partnership Agreement." JX 1056 at 5. Skadden had feared that Baker Botts would try to rely on its work, and the Skadden attorneys viewed this language as a backdoor attempt to do that. *See* JX 1094 at 1. Skadden asked to strike language. JX 1126 at 1.

Alpert was furious, and he "threatened to fire Skadden." JX 1116 ("I told Skadden tell me today if [they] can't get there or I'll hire other counsel."). Alpert told Rosenwasser he was "in no mood to negotiate with [Skadden]" and that he had "senior management back-up to move to another firm if [Skadden] is not reasonable." JX 1113 at 1. In an email to Skadden, Alpert made his expectations "absolutely clear." *Id.*

> I thought we were absolutely clear on the following, but if not, we need to be. I need to know that if we ask for the opinion from Baker Botts, that Skadden can and will advise the [GPGP] [B]oard that based on Baker Bott's [sic] experience, the diligence and process they conducted, the wording of the

[12] At his deposition, Rosenwasser denied that Baker Botts provided Loews any commitment on April 20. Instead, he claimed that Baker Botts gave Loews an indication that it was "more likely than not" that Baker Botts could deliver the Opinion. Rosenwasser Dep. 122, 129, 257-82. That testimony was not credible. Baker Botts made clear that it was prepared to deliver the Opinion if asked. *See* JX 1234 at 2; Grossman Dep. 76-77. Loews did not want to receive the formal Opinion at the end of April because it would create a disclosure issue and start a ninety-day clock for Loews to exercise the Call Right. Loews wanted to control the timing of the issuance of the Opinion, which would start the clock for exercising the Call Right.

> opinion **[*108]** and other factors, it is reasonable for the board to accept the Baker Botts opinion.

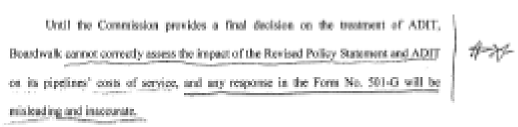
Id. at 1-2.

Skadden relented. Alpert told his colleagues that Skadden "fell into line," but that he "[r]eally had to beat on them." JX 1136 at 1. Alpert had planned to use Skadden for any litigation challenging the exercise of the Call Right. Now he decided that he would "look to other firms re potential litigation." *Id.*

O. Boardwalk's Public Comments On The NOPR

While Baker Botts was working on a legal opinion that treated the NOPR and other March 15 FERC Actions as final, Boardwalk's management team filed public comments on the NOPR, consistent with the fact that it was not final. It was the eventual regulations, not the NOPR, that would matter. Indeed, Naeve, the former FERC commissioner, noted that "If I were Baker Botts I would prefer to wait until FERC acts on the comments." JX 1076 at 1.

On April 25, 2018, Boardwalk filed its public comments on the NOPR. JX 1139. Rosenwasser printed out a physical copy of the comments and made handwritten annotations. *See* JX 1130. A section that addressed the treatment of ADIT caught his attention, and he underlined and double-starred key text:


Until the Commission provides a final decision on the treatment of ADIT, Boardwalk cannot correctly assess the impact of the Revised Policy Statement and ADIT on its pipelines' costs of service, and any response in the Form No. 501-G will be misleading and inaccurate.

Id. at 14. That, of **[*109]** course, was exactly what Baker Botts was doing in the Opinion—purporting to correctly assess the impact of FERC's actions on its pipelines' costs of service. And Baker Botts was relying on a Rate Model Analysis that largely paralleled the Form 501-G analysis, which Boardwalk said "will be misleading and inaccurate" unless and until FERC had addressed ADIT. And Baker Botts was going further. Baker Botts was not just addressing cost of service. Under Rosenwasser's syllogism, Baker Botts was claiming that eliminating one component of the cost of service—the income tax allowance—would have a material adverse effect on maximum applicable rates.

When Skadden saw the comments the next day, Voss focused on the same passage. She noted dryly, "this seems to be relatively unhelpful." JX 1207 at 2. Another Skadden attorney asked if the comment "could be problematic." *Id.* at 1.

The passage that Rosenwasser double starred appeared within the following larger section that Rosenwasser annotated:

2. The Commission Must Align the Timing of Its Actions Under This NOPR and the ADIT NOI.

> Contemporaneous with the NOPR, the Commission has issued the ADIT NOI, which seeks comment on how the Commission should **[*110]** address changes related to ADIT as a result of the Revised Policy Statement. ADIT is a critical issue in analyzing a pipeline's maximum recourse rates. Although ADIT is a *non-cash* item—merely the function of the timing difference between book depreciation and tax depreciation—certain shippers have and will continue to argue that ADIT should be treated in a manner that results in a large and immediate *cash* refund from the pipelines. Significant dollars and the validity of certain portions of the Form No. 501-G are at stake. The Commission should not sideline the ADIT issue while it attempts to rush the Form No. 501-G NOPR to be ready for decision by its July meeting.
>
> ☆
>
> ADIT is a key element of the proposed Form No. 501-G, and the ADIT NOI raises a number of questions fundamental to the treatment of this rate component under the Revised Policy Statement. For example, will the Commission adhere to normalization methodologies? The uncertainty surrounding how to handle ADIT is particularly problematic for an MLP like Boardwalk, which, as a result of the Revised Policy Statement, owns pipelines that are no longer allowed to collect income taxes in their rates but still have large ADIT balances **[*111]** on their FERC books. Boardwalk intends to address these and other questions in more detail in response to the ADIT NOI.
>
> Until the Commission provides a final decision on the treatment of ADIT, Boardwalk cannot correctly assess the impact of the Revised Policy Statement and ADIT on its pipelines' costs of service, and any response in the Form No. 501-G will be misleading and inaccurate.
>
> ☆☆

> The comment date for the ADIT NOI is not until May 21, 2018 (approximately thirty days *after* comments are due in this NOPR proceeding), and the date of final Commission action on the ADIT NOI is unknown. It is improper for the Commission to require the industry to complete a new form, a key element of which is directly tied to the cost of service intended to be addressed by the Form No. 501-G, and which is still under review. Without resolution of the ADIT issues, the Form No. 501-G will be misleading and inaccurate, and will substantially hamper a pipeline's ability to have meaningful settlement discussions with its customers, since the calculation of a key element of rate base will be subject to change. Pipelines may also be discouraged from selecting the option to file a limited *section 4* rate case with the **[*112]** potential to face additional risk regarding ADIT in a subsequent proceeding which would render that proposed option in the NOPR moot. The Commission must resolve the issues raised in the ADIT NOI at the same time or before it issues a final rule in this proceeding to ensure that pipelines have the necessary information to complete the Form No. 501-G accurately, select the appropriate filing option, and/or to engage in meaningful settlement discussions with their customers.

JX 1130 at 13-15 (underlining and annotations in original) (footnotes omitted).[13]

In this passage, Boardwalk explained that without a determination on ADIT, matters were so unsettled that pipelines could not even have meaningful discussions with shippers about rates. Yet Baker Botts was claiming for purposes of its Opinion that matters were so settled that the firm could opine as a matter of law that the March 15 FERC Actions would have a material adverse effect on Boardwalk's recourse rates.

Other aspects of the comments were equally problematic for purposes of the Opinion. For example:

• Boardwalk pointed out that the Policy Statement was "not a binding rule" and that FERC had not justified its application. JX 1139 at **[*113]** 2. The Opinion treated the Policy Statement as a binding rule. Rosenwasser drew a line next to this paragraph, and also made an unintelligible note. JX 1130 at 2.

• Boardwalk objected to FERC instructing pipelines to complete the Form 501-G that evaluated changes in cost-of-service requirements based solely on changes in income taxes, then using the revised cost-of-service requirements to identify an "Indicative Rate Reduction." Boardwalk explained that using that procedure to establish rates constituted improper "single-issue rulemaking." JX 1139 at 12, 30-31; *see* JX 1296 at 9. The Rate Model Analysis on which the Opinion depended took the same approach that Boardwalk criticized.

• Boardwalk made clear that the Commission's treatment of ADIT was not known and that different outcomes were possible. *See* JX 1139 at 13-14. Yet the Rate Model Analysis operated as if the treatment of ADIT under the Reverse South Georgia Method was a known fact.

• Boardwalk asserted that its "fixed negotiated rate agreements—almost all of which expressly state that they will apply 'without regard' to the pipeline's maximum or minimum applicable rates—should not be affected by any potential impact to recourse **[*114]** rates." JX 1139 at 16. The Opinion ignored the existence of Boardwalk's fixed negotiated rate agreements.

• Boardwalk asserted that there is no impact on Gulf South's revenue requirements due to the rate case moratorium that extended through May 1, 2023. JX 1139 at 20. The Opinion ignored the existence of the rate moratorium and assumed a rate impact at Gulf South.

What Boardwalk conspicuously did *not* argue in its comments was that FERC should eliminate the ADIT balance entirely as a natural consequence of removing the income tax allowance. Boardwalk instead argued that FERC should instruct pipelines to amortize the ADIT balances over the remaining depreciation life of the asset, using the Reverse South Georgia Method. That was the method that Boardwalk was using in the Rate Model Analysis, and it was where Boardwalk management and Sullivan thought FERC ultimately would come out.

---

[13] At trial, Rosenwasser claimed that he was not "reading it that closely" and that he starred or double-starred passages so that he could "go back and read it again." Rosenwasser Tr. 82. That testimony was not credible. Rosenwasser underlined, starred, and double-starred aspects of Boardwalk's comments because they fatally undermined the syllogism that drove the Opinion. Revealing that he was reading the comments for problematic language, Rosenwasser wrote "nothing bad here" next to a passage reciting the procedural history of the ADIT NOI. JX 1130 at 9.

Many other pipelines, however, argued explicitly that FERC should eliminate the ADIT balance entirely. PTO ¶ 337. Shippers generally took the opposite side of the issue, arguing that FERC should require pipelines to pay a cash refund of the ADIT balance or require amortization on an accelerated schedule. *Id.* **[*115]** ¶ 339.

P. Loews Prepares To Make The Potential Exercise Disclosures.

Well before Baker Botts gave Loews the "thumbs up" that it could issue the Opinion if and when asked, Loews took a number of steps in anticipation of exercising the Call Right.

One task involved preparing the disclosures that Boardwalk and Loews would issue in their quarterly reports on their respective Form 10-Qs, assuming Baker Botts gave the anticipated "thumbs up." Those discussions involved Loews, Boardwalk, Baker Botts, and Skadden, as well as Loews' outside securities counsel Davis Polk & Wardell LLP, and lawyers from Vinson & Elkins. *Id.* ¶ 229.

The evolution of Boardwalk's Form 10-Q reveals at least two things. First, there was a widespread understanding that the March 15 FERC Actions were not final, that their effects could not be predicted, and that they would not be likely to have a material adverse impact on Boardwalk. Second, despite that widespread understanding, Loews pushed the disclosures in a contrary direction that would facilitate the exercise of the Call Right.

On April 4, 2018, Baker Botts sent Loews a first draft of the Boardwalk Form 10-Q. *Id.* ¶ 230. The draft contained relatively nuanced disclosures **[*116]** about the March 15 FERC Actions, including that "[i]mportant details of implementing the new policy statement require clarification and the Company will continue to assess the financial impacts as more information becomes available." *Id.* Similar statements about the lack of finality surrounding the March 15 FERC Actions did not appear in the final Form 10-Q.

On April 4, 2018, Vinson & Elkins sent Boardwalk a first draft of the Form 10-Q. *Id.* ¶ 232. Like the Baker Botts draft, it flagged that the March 15 FERC Actions were not final and noted that "[r]equests for rehearing or clarification of the Revised Policy Statement may change the outcome of the FERC's decision on these requests." *Id.* It stated that as a result, the "impacts that such changes may have on the rates we can charge for natural gas transportation and storage services are unknown at this time." *Id.* The draft likewise observed that the NOPR proposed a new rule, that rule was not final, and that, as a consequence, "[a]t this time, we cannot predict the outcome of the NOPR, but adoption of the regulation in its proposed form could impact the rates we are permitted to charge our customers." *Id.* ¶ 233. The Vinson & Elkins **[*117]** draft also recognized that the treatment of ADIT was an open issue and that there was no necessary connection between the elimination of the income tax allowance and a change in the treatment of ADIT and a reduction in rates, explaining that "[a]lthough changes in these two tax related components may decrease, other components in the cost-of-service rate calculation may increase and result in a newly calculated cost-of-service rate that is the same as or greater than the prior cost-of-service rate . . . ." *Id.* ¶ 236. Similar statements did not appear in the final Form 10-Q.

On April 10, 2018, McMahon circulated his draft, using the Vinson & Elkins draft as a starting point. *Id.* ¶ 237.

• McMahon retained the statement that "requests for rehearing or clarification of the Revised Policy Statement may change the outcome of the FERC's decision on this issue" and stated that the "ultimate outcome regarding the Revised Policy Statement could impact the maximum rates we are permitted to charge." *Id.* ¶ 238.

• McMahon retained the statement that "any potential impacts from final rules or policy statements issued following the NOI on the rates we can charge for transportation services are unknown **[*118]** at this time." *Id.* ¶ 239.

• McMahon added language stating that Boardwalk "cannot predict the outcome of the NOPR, but adoption of the regulation in its proposed form could ultimately impact the rates we are permitted to charge our customers." *Id.* ¶ 240.

The Boardwalk draft was thus relatively neutral and balanced.

Later on April 10, 2018, Alpert circulated Loews' comments, which took a different approach.

• The Loews draft stated, "we do not expect the FERC to reverse [the Revised Policy Statement] or otherwise revise the policy in a manner favorable to master limited partnerships." *Id.* ¶ 245.

• Loews deleted the language stating that "[a]t this time, we cannot predict the outcome of the NOPR, but adoption of the regulation in its proposed form could ultimately impact the rates we are permitted to charge our customers." *Id.* ¶ 246.

• Loews added language stating, "[a]s we do not expect FERC's Revised Policy Statement to be reversed or modified in a manner favorable to master limited partnerships, we believe that our status as a pass-through entity for tax purposes will reasonably likely in the future have a material adverse effect on the maximum applicable rates" that Boardwalk's subsidiaries **[*119]** could charge. *Id.* ¶ 247.

• Loews added language stating, "[i]n addition, the ultimate outcomes of the NOI and NOPR may have further material adverse effects." *Id.*

Viewed charitably, Loews sought to characterize events in a way that would facilitate Loews' exercise of the Call Right.

McMahon and Horton objected to aspects of the Loews draft. Horton believed that Loews' language resulted in Boardwalk "rendering an opinion on the materiality issue." *Id.* ¶ 249. McMahon regarded the draft as tilted in favor of Loews. *Id.*

A push and pull ensued over the disclosures. *See id.* ¶¶ 250-64. Loews took a particular interest in eliminating the language which stated that "[a]lthough changes in these two tax-related components may decrease, other components in the cost of service rate calculation may increase and could result in a newly calculated cost of service rate that is the same as or greater than the prior cost of service rate." *See id.* ¶ 254. Loews also pushed for language focusing on the effects on Boardwalk's rates, rather than on revenue or other aspects of Boardwalk's business. *See id.* ¶¶ 263-64.

In addition to editing Boardwalk's disclosures, Loews analyzed the effect of the disclosures on **[*120]** the trading price of Boardwalk's common units with the assistance of investment bankers from Barclays. *See id.* ¶¶ 271-74. The analyses projected a short-term bump in the trading price, followed by a steady decline over time. *See* JX 822; JX 882; JX 915; *see also* JX 1051 at 3. Barclays attributed the decline in part to "[u]ncertainty regarding timeline" and the "[p]robability Loews doesn't" exercise the Call Right. JX 915 at 15-16. Because the lower trading price would feed back into the formula for the Call Right, Loews would pay a lower exercise price the longer it waited.

Loews also began lining up the members of the GPGP Board to make the determination that the Opinion was acceptable. In the leadup to a meeting of the GPGP Board on April 26, 2018, Siegel contacted each director. *See* Siegel Dep. 232-34; Alpert Dep. 172. Siegel reported that Loews had "retained Baker Botts to determine whether it can give the opinion." JX 1069 at 2; *see also* Alpert Dep. 90. He also explained that although Holdings would determine whether to exercise the Call Right, "the [GPGP] Board would be required to make a narrow determination as to whether the opinion is an acceptable opinion." JX 1069 at 2. The **[*121]** outside directors had a "hostile reaction" and asked "shouldn't we have independent counsel[?]" JX 874 at 5; *see* Layne Dep. 160.

Alpert and Siegel had approached the GPGP Board based on Skadden's advice in the hope of eliminating any litigation risk posed by the uncertainty over which decision-maker would make the acceptability determination. With the solution creating additional problems, Loews reversed course. *See* JX 874 at 5 ("→ Alpert's view — getting board involved was to take an issue off the table = probably not going to the directors, & L[oews] will exercise").

Around April 27, 2018, Alpert asked Richards Layton to "take a fresh look" at whether the GPGP Board's involvement was necessary. Alpert Dep. 224; JX 1340 at 5. Alpert did not tell Richards Layton about Skadden's prior advice or the GPGP Board's reaction. Raju Tr. 809, 843. The question of who would determine the acceptability of the Opinion would play out over the ensuing days.

Q. Boardwalk And Loews Issue The Potential Exercise Disclosures.

On April 30, 2018, Boardwalk and Loews each filed their Form 10-Qs. PTO ¶ 222. As discussed in the prior section, Boardwalk and Loews coordinated their filings in advance to ensure **[*122]** that the disclosures were consistent. *See id.*

After the push-and-pull of the prior month, Boardwalk's Form 10-Q contained disclosures regarding the March 15 FERC Actions that were largely consistent with the initial press release Boardwalk had issued on March 18, 2018. The Form 10-Q stated: While we are continuing to review FERC's Revised Policy Statement,

> [Notice of Inquiry,] and NOPR, based on a preliminary assessment, we do not expect them to have a material impact on our revenues in the near

> term. All of the firm contracts on Gulf Crossing and the majority of contracts on Texas Gas Transmission, LLC are negotiated or discounted rate agreements, which are not ordinarily affected by FERC's policy revisions. Gulf South currently has a rate moratorium in place with its customers until 2023, which we believe will be unaffected by these actions.

JX 1201 at 40. The only addition was the reference to the absence of any material effect on revenue "in the near term." Boardwalk's initial press release had not limited the absence of a material impact to the near term, and the record does not suggest any additional analysis that would have shortened the time horizon of any effect. In reality, **[*123]** Boardwalk did not anticipate any material impact on revenue for the foreseeable future.

Despite this reassuring language, the Form 10-Q went on to disclose that in light of FERC's actions, Boardwalk's General Partner was evaluating the potential exercise of the Call Right (the "Potential Exercise Disclosures"). *See* JX 1201 at 40-42, 48. The Form 10-Q stated flatly: "***[O]ur general partner has a call right that may become exercisable because of recent FERC action. Any such transaction or exercise may require you to dispose of your common units at an undesirable time or price, and may be taxable to you***." *Id.* at 48. Continuing, the Form 10-Q explained:

> [A]s has been described in our SEC filings since our initial public offering, our general partner has the right under our partnership agreement to call and purchase all of our common units if (i) it and its affiliates own more than 50% in the aggregate of our outstanding common units and (ii) it receives an opinion of legal counsel to the effect that our being a pass-through entity for tax purposes has or will reasonably likely in the future have a material adverse effect on the maximum applicable rate that can be charged to customers by our **[*124]** subsidiaries that are regulated interstate natural gas pipelines. Because our general partner and its affiliates hold more than 50% of our outstanding common units, this call right would become exercisable if our general partner receives the specified opinion of legal counsel.
>
> The magnitude of the effect of the FERC's Revised Policy Statement may result in our general partner being able to exercise this call right. Any exercise by our general partner of its call right is permitted to be made in our general partner's individual, rather than representative, capacity; meaning that under the terms of our partnership agreement our general partner is entitled to exercise such right free of any fiduciary duty or obligation to any limited partner and it is not required to act in good faith or pursuant to any other standard imposed by our partnership agreement. Any decision by our general partner to exercise such call right will be made by [Holdings], the sole member of [GPGP], rather than by our Board. . . . *We have been informed by [Holdings] that it is analyzing the FERC's recent actions and seriously considering its purchase right under our partnership agreement in connection therewith*.

[*125] *Id.* at 48 (emphasis added).

In its Form 10-Q, Loews made similar disclosures. PTO ¶ 223. In addition to issuing its Form 10-Q, Loews amended its previously filed Schedule 13-D to state as follows:

> In light of the FERC announcement, the General Partner is analyzing the FERC's recent actions and seriously considering its purchase right under the Limited Partnership Agreement in connection therewith. The exercise of the purchase right would be subject to the approval of the Board of Directors of Loews. There is no assurance that the Loews Board will authorize the purchase or that the pre-conditions to the exercise of the purchase right under the Limited Partnership Agreement will be satisfied, and even if such preconditions are met, there is no assurance that there will be a determination by the General Partner to exercise the purchase right discussed herein or the timing thereof.

Id. ¶ 224.

Later on April 30, 2018, Boardwalk held an earnings call. *Id.* ¶ 225. During the call, Horton explained the formula for calculating the exercise price for the Call Right. *Id.* ¶ 226. He noted that the decision on the Call Right was for Loews to make and stated that "given where we are in this process, we **[*126]** need to rely on the disclosures and the relevant SEC filings and are unable to answer questions concerning the decision-making process or the possible timing of any such decision." *Id.* ¶ 227.

Loews made similar statements during its earnings call later that day. Jim Tisch informed investors that the FERC actions "may result in Loews being able to exercise a call right under the terms of the Boardwalk partnership agreement." *Id.* ¶ 228. He added:

> We at Loews are exploring all our options regarding these developments. Although we expect to be able to make a decision sometime this year, no decisions have yet been made. As you can imagine, we'll have to let our documents speak for themselves since we are constrained from answering any questions on this topic.

Id.

The initial market reaction to the announcements tracked the bump that Barclays anticipated. Boardwalk's units had closed at price of $11.04 per unit on April 27, 2018, the last trading day before the Potential Exercise Disclosures. *Id.* ¶ 277. On the day of the disclosures, Boardwalk's units traded up to a high of $12.70, before trading down to close at $11.37. *Id.*; JX 1774 at 2. Internally, Barclays bankers observed that the units **[*127]** were "up ~8.3% right now **-** firmly within the 7-10% estimate to which we guided." JX 1174 at 1.

After the initial market reaction, however, the implications of the Call Right began to sink in. On May 1, 2018, U.S. Capital Advisors downgraded Boardwalk "to Hold from Buy" and reduced its price target from $20 to $11. JX 1222 at 1. The report explained that any purchase by Loews "would be at a formula-derived price, which, if a deal were consummated, would likely result in limited upside on the price of BWP units." *Id.* at 2. McMahon was impressed by the analysis: "[a]mazing how good they are." *Id.* at 1. Alpert circulated the note to Loews management. JX 1232.

Subjected to the overhang of the pricing formula, Boardwalk's trading price declined steadily. The units closed at $10.94 on May 1, then at $10.88 on May 2. On May 3, the price fell to $10.01. On May 4, it fell to $9.56. On May 7, the units closed at $9.26. PTO ¶ 277.

Fund managers and traders working for Bandera Partners LLC, one of the plaintiffs, initially viewed the price trend as a buying opportunity. On May 8, 2018, a fund manager emailed a colleague that "we should buy heavily at this price." *Id.* ¶ 278. On May 9, the colleague **[*128]** reported that "we bought with both hands today . . . [and] we will likely get more stock tomorrow." *Id.*

But as investors began to understand the effect of the Call Right, they became outraged. TAM Capital Management published an open letter criticizing Loews. *See* JX 1915. After seeing that letter, the Bandera representatives began drilling down into the mechanics of the Call Right. *See* PTO ¶ 279.

On May 6, 2018, Deutsche Bank explained the "Prisoner's Dilemma" that Loews had created. JX 1270 at 2.

> Stakeholders could expect no higher price for shares of BWP than $11.50 unless Loews chose voluntarily to tender at a higher share price (or chose not exercise at all). Given that the probable "best" the stakeholders could do seemed to be around $11.50 in August 2017, there seemed to be little incentive to hold onto BWP shares above that price. And so the stock has begun to fall. However, as the stock falls, so too does the 180-average price for which Loews can demand tender. This has engendered a real-time game theory practice known as "the prisoner's dilemma." By this logic, the stakeholders assume the worst of their fellow stakeholders and aim to sell first in order to arguably . . . get **[*129]** a better price than those who wait. This has created a pile-on where stakeholders are willing to part with their shares below what some might argue is fair value. And no shareholder has the incentive to pay more than this price if Loews has the option to tender below that price level.

Id.

On May 10, 2018, Barclays issued a research report that expressed concern about the potential exercise of the Call Right. The report noted that

> [w]hile the FERC actions could change the max rates the pipelines could charge, we note that Gulf Crossing is 100% negotiated rates while cost of service only makes up ~25% on Gulf South and Texas Gas, making it a bit difficult to see how [Boardwalk's] cash flows would be materially impacted later on as the FERC changes primarily impact cost of service contracts.

PTO ¶ 284. Barclays suggested that Loews appeared was using a "loophole" in the Partnership Agreement "to buy in the assets for what we believe is an extremely attractive price." *Id.* The report explained that

> the more appropriate thing for Loews to have done, if they were going to indeed buy in [Boardwalk], was to get the legal opinion and then just announce it would be buying in the MLP rather than just **[*130]** tease the market that they were "seriously considering" it, putting pressure on the

> stock and in essence, trying to time the potential purchase at a time that would be most favorable to them.

Id.

Loews' management did not like the report, particularly since Loews had used Barclays for advice on the Call Right. Siegel contacted Gary Posternack, Head of Global M&A at Barclays, to express his "dissatisfaction" with the report. *Id.* ¶ 285. Posternack emailed Jes Staley, Barclay's then-CEO, with a heads up that he might be "getting a call in the next day from Jim Tisch at Loews, who is very upset about some equity research commentary that our analyst put out. I should brief you before you speak." *Id.* The call ultimately did not take place.

On May 15, 2018, with Boardwalk's trading price continuing to fall, JP Morgan issued an analyst report that described it as "fundamentally undervalued at this juncture." *Id.* ¶ 288. JP Morgan expressed the view that Loews should exercise the Call Right "at least at the ~$13/unit 180 trading VWAP leading up to the April 30 announcement should the company seek to avoid the perception of securities manipulation." *Id.* ¶ 289. JP Morgan subsequently issued a clarification **[*131]** stating that its report included "certain wording [which] could have inadvertently been construed as implying a legal conclusion." *Id.* ¶ 290.

By May 21, 2018, Bandera's views about Loews' actions had changed. Bandera issued a public letter addressed to Loews asserting that its actions had caused a "catastrophic collapse in the market price of Boardwalk's units" and that the "[t]he units' 180 consecutive trading day average, which sets the purchase price, is considerably lower than it would have been without this announcement." *Id.* ¶ 291. Bandera also cited Boardwalk's decision in 2014 to cut its distributions and the implications for the unit price:

> We believe that you, as stewards of Boardwalk's capital, made a tough but wise decision to slash the partnership's cash distribution, and invest substantial funds into the existing base of assets. While these strategic actions depressed unit prices, they were implemented to drive meaningful long-term returns for investors. We estimate that Boardwalk has raised over $3 billion from its limited partners to execute this long-term strategy. The benefits of these investments should accrue to all of the partnership's investors, not just Loews. **[*132]** This is why we believe the best outcome for unitholders would be for Loews to pass on its purchase right altogether. If Loews does exercise its option, we think that, at a minimum, it must do so only at a fair price and in accordance with straightforward procedures that accord with unitholders' reasonable expectations of fairness.

Id. ¶ 293.

R. Loews Ties Off The Acceptability Issue.

While the Potential Exercise Disclosures were having their effect on the market, Loews was tying off the loose ends created when the outside members of the GPGP Board had a hostile reaction to determining whether the Opinion satisfied the Acceptability Condition. In response to Alpert's appeal for expedited advice, Richards Layton had advised orally that it felt the "far better view" was that Holdings had the authority to make both the acceptability determination and the exercise decision. Raju Tr. 809, 842. Richards Layton "did not know Skadden had been asked to analyze this issue until after [Richards Layton] had given [its] oral advice to Loews." *Id.* at 809. It was only after Richards Layton provided this advice that Alpert sent over Skadden's analysis. *See* JX 1197. He then asked Richards Layton to speak **[*133]** with Skadden to see "if they can get on the same page." Alpert Dep. 224. When the firms connected on May 1, Skadden's "main point" was that "there is ambiguity and ambiguity is construed against the General Partner." JX 1228 at 1.

On May 1, 2018, Richards Layton sent Alpert an email memorializing their advice. JX 1225. The email stated that "[w]hile there is some ambiguity and arguments can certainly be made to the contrary, we think that the *better view* is that the [acceptability determination] is within the sole authority of the Sole Member [Holdings] pursuant to Section 5.6 of the LLC Agreement." *Id.* at 2-3 (emphasis added). The email included the following caveat:

> [I]f the Board of Directors is approached and declines to determine that the Opinion of Counsel is acceptable and the Section 15.1(b) call right is exercised by the Sole Member anyway, *that would be a difficult fact to overcome in any future litigation* regarding the exercise of the Section 15.1(b) call right.

Id. at 3 (emphasis added). It was not until discovery in this litigation that Richards Layton learned that Loews had approached the GPGP Board and that the outside directors had reacted negatively to making the determination. *See* Raju Tr. 843.

Less **[*134]** than two hours after receiving the email, Alpert drafted and circulated new talking points for Siegel to deliver to the GPGP directors. JX 1213 at 1. Alpert's talking points represented that "*[w]e and outside counsel agree* that the documents provide that [Holdings'] authority to exercise the call right *includes* the ability to determine that the opinion of counsel is acceptable." *Id.* at 2 (emphasis added). That description did not match Skadden's view, so when the Skadden lawyers saw the talking points, they struck the "[w]e and outside counsel agree" and substituted "[w]e believe the better reading . . . is." *See* JX 1863; 1864 at 1. At first, Alpert accepted the change. *See* JX 1852; 1853. But five minutes later, he reintroduced the reference to "outside counsel" and added: "—as we are confident that the sole member has the ability and authority to make the determination of an acceptable opinion." *See* JX 1850; 1851 at 1. Alpert sent the revisions to Baker Botts and Richards Layton but not to Skadden. *See* JX 1850.

That evening, Alpert, McMahon, Rosenwasser, Layne, and Richards Layton had a call "to get on the same page" about the acceptability determination. *See* McMahon Tr. 576-77; JX **[*135]** 1237 at 1. Alpert told Richards Layton that its email was too "measured" and did not reflect the strength of their oral advice. Alpert Dep. 214. After the call, Richards Layton sent Alpert a revised email saying that it was the "far better view" that Holdings could make the acceptability determination, but otherwise maintained its comments about ambiguity. *See* JX 1265 at 4.

Siegel then held follow-up calls with the members of the GPGP Board and told them that their involvement was not required after all. PTO ¶ 323; Siegel Dep. 235-36. The reversal of position worried the outside directors, who requested "a board call to discuss the partnership agreement and [their] obligations under that agreement." PTO ¶ 325; JX 1319 at 1.

On May 14, 2018, the GPGP Board met telephonically. JX 1318; *see also* JX 1435 at 1. Instead of having Skadden or Richards Layton lead the discussion, Alpert tapped Layne of Vinson & Elkins. Alpert knew Layne "was of the firm view . . . even stronger than Rosenwasser, that the proper entity was the sole member, [Holdings]." Alpert Tr. 394. Unlike Skadden and Richards Layton, Layne never prepared a written analysis of the acceptability issue, and contemporaneous documents **[*136]** suggest that when presenting to the Board, he lumped together the question of authority to exercise with the determination of acceptability.[14]

In any event, the GPGP's outside directors were "pleased that they did not have to be part of this very awkward process." Siegel Tr. 739. With the GPGP Board out of the picture and Baker Botts and Skadden prepared to deliver their opinions when asked, Loews was ready to exercise the Call Right.

S. The ADIT Issue Gets Worse.

With Loews preparing to exercise the Call Right, the uncertainty regarding the known unknown of ADIT grew worse. On May 14, 2018, SFPP submitted a compliance filing in response to the Order on Remand that FERC had issued in response to the *United Airlines* decision. The Order on Remand had directed SFPP to revise its filings in accordance with the Revised Policy. SFPP not only removed the income tax allowance, but also eliminated ADIT. *See* JX 1330 at 185-86. If SFPP had treated ADIT correctly, then the result would be a boon for Boardwalk, but fatal to the Opinion.

Loews, Boardwalk, and their advisors immediately focused on this development. *See* Johnson Tr. 684. Baker Botts **[*137]** was particularly attuned to the news, because Wagner was representing BP West Coast

---

[14] Documents created on or around May 14 suggest that Layne only discussed who had the authority to exercise the Call Right and did not separately address the question of acceptability. *See* JX 1325 at 1; JX 1331 at 2; JX 1343 at 1; JX 1812 at 1. Two weeks later, Layne, McMahon, and trial lawyers at Vinson & Elkins and Foley & Lardner LLP signed off on minutes which only documented Layne addressing the Call Right's exercise. JX 1435 at 1, 3. It was not until May 31, 2018, that McMahon revised the minutes to add a reference to the question of acceptability. JX 1444 at 1, 3. In pertinent part, McMahon revised the minutes to read, "Layne stated that if the 15.1(b) right is exercised, the outside directors would not approve that decision *or the appropriateness of the Opinion of Counsel*." *Id.* at 3 (emphasis added). In his cover email, McMahon explained that "some changes" were "suggested by certain of the outside directors," and requested that Layne and the litigators call him if they "ha[d] any questions about them." JX 1444 at 1. Layne testified that he told the GPGP Board that, "under the LLC [A]greement, the board of directors did *not* have authority with respect to exercise of the call *or acceptability* of the opinion." Layne Dep. 216 (emphasis added).

Products LLC and ExxonMobil Oil Corporation in the proceedings involving SFPP and filed a submission on their behalf that opposed SFPP's filing. *See* Wagner Tr. 304-05; Wagner Dep. 387-89; JX 1465 at 37.

The ADIT NOI process was also unfolding. Between May 21 and June 20, sixty industry participants filed comments, reply comments, or both in FERC's ongoing NOI proceeding. Court Report ¶ 74. The vast majority of comments from shippers and organizations aligned with their interests took the position that ADIT balances should be refunded or amortized on an accelerated basis. The vast majority of comments from pipelines and organizations aligned with their interests took the position that ADIT balances should be eliminated. *See* Webb Rebuttal ¶ 40 n.46 & Ex. 25; JX 1549 ¶ 9.

Van Ness Feldman and Vinson & Elkins, two of Boardwalk's go-to law firms, argued in favor of eliminating the ADIT balances on behalf of multiple pipeline clients. *See, e.g.*, JX 1382 at 2, 18-23; JX 1460 at 4, 6-7, 18. They did not make that argument on behalf of Boardwalk, even though its subsidiaries had accumulated ADIT balances totaling **[*138]** at least $750 million. *See* JX 644 at 1. The reality was that Boardwalk could not advocate publicly to eliminate its ADIT balance without undercutting the Rate Model Analysis and the assumptions driving the Opinion. Instead, Boardwalk publicly advocated for a middle ground—either the Reverse South Georgia Method or the Average Rate Assumption Method. JX 1388 at 11 (NOI Comments).

Privately, however, Boardwalk wanted FERC to eliminate ADIT. *See* JX 797 at 1 (Boardwalk not wanting to "give up [the] argument" that "the Policy Statement essenti8ally [sic] eliminates ADIT"). To advance that position, Boardwalk management lobbied FERC through the Interstate Natural Gas Association of America ("INGAA"). *See* JX 1457 (INGAA NOI Comments) at 7; Horton Dep. 183. Boardwalk has been a member of INGAA for almost three decades. McMahon Tr. 565-66. McMahon, Boardwalk's general counsel, is the Chairman of INGAA's Legal and Rates Committee, serves on INGAA's Board of Directors, and served as the Chair of INGAA's Board of Directors in 2016. *See* McMahon Dep. 23-24. Johnson also serves on INGAA's Legal and Rates Committee, along with two other Boardwalk executives. *See* Johnson Dep. 78; McMahon Tr. 566-67. **[*139]** Attorneys at Van Ness Feldman reviewed the comments, and the defendants' privilege log reveals Boardwalk executives and Van Ness Feldman were heavily involved. McMahon Tr. 572-73; McMahon Dep. 29-30; JX 1881 (Privilege Log) at Rows 3527-44, 3565-76, 3580-83.[15]

McMahon and Johnson also met with FERC staff on June 12, 2018, "as part of a group from [INGAA]" to discuss "Taxes and ADIT." JX 1680 at 45; JX 1464 at 1. McMahon and Johnson had helped INGAA prepare a supporting presentation, but FERC ended up prohibiting the discussion of ADIT at the last minute. *See* JX 1463 at 1; JX 1471 at 2. The presentation nevertheless made a compelling case that ADIT represented "a cost-free form of financial capital," was "not a loan from customers but from the federal government," and should be handled in accordance with IRS normalization rules, all of which were premises for the argument that ADIT balances should be eliminated. *See* JX 1476 at 6-8.

Even though it was obvious that ADIT was an unsettled issue, and even though everyone knew that different outcomes for ADIT were possible, Baker Botts did not update its analysis. No one prepared sensitivity analyses for different outcomes regarding ADIT. **[*140]** The Preliminary Opinion provided the answer Loews wanted, and developments in the real world were not going to change that.

T. This Litigation And The Original Settlement

On May 24, 2018, two holders of common units (the "Original Plaintiffs") filed this action and moved for expedited proceedings. The Original Plaintiffs wanted to prevent the General Partner from exercising the Call Right using a 180-day measurement window that included trading days that had been affected by the Potential Exercise Disclosures. The defendants opposed the motion, arguing that the dispute was not ripe because the General Partner had not yet elected to exercise the Call Right.

Five days after the action was filed, the court held a hearing on the motion to expedite. The court agreed with the defendants and denied the motion.

Having defeated the motion to expedite on the theory that the claims were not yet ripe, defense counsel contacted the lawyers for the Original Plaintiffs the very next day to explore settling the non-justiciable claims. A

---

[15] Despite this evidence, at their depositions and at trial, McMahon and Johnson attempted to distance themselves from INGAA's comments. *See* McMahon Dep. 30-31; Johnson Dep. 183-84.

settlement in this litigation would give the defendants the ultimate protection: a global release of claims relating to the exercise of the Call Right.

The lawyers for **[*141]** the Original Plaintiffs understood that Loews wanted to exercise the Call Right. They offered up a settlement, including a global release, if Loews did what it wanted to do. As part of the negotiations with the defendants, lead counsel made precisely that argument, telling defense counsel, "Your clients want to make this purchase. Getting a release on a deal they want to make anyway is actually an amazing outcome for them." Dkt. 56 Ex. 1.

The Original Plaintiffs initially proposed settling if the General Partner agreed to exercise the Call Right using June 1, 2018, as the end date for the 180-day measurement period, which would have included twenty-four trading days after the issuance of the Potential Exercise Disclosures in the calculation of the Purchase Price. The defendants countered with an end date of September 1, 2018, which would have included sixty-four trading days after the issuance of the Potential Exercise Disclosures in the calculation.

On June 11, 2018, eighteen days after the lawsuit was filed, the parties agreed that Loews would exercise the Call Right on or before June 29, 2018. The resulting period included forty-four affected days in the pricing formula. Using that **[*142]** end date, the formula yielded a Purchase Price of $12.06 per unit.

On June 22, 2018, the parties informed the court by email that they had reached an agreement in principle and asked the court to review the settlement papers *in camera*. JX 1487. The court rejected that request as seeking a non-public advisory opinion. Dkt. 26.

That night, the parties filed a stipulation of settlement. JX 1496 (the "Original Settlement"). Under its terms, the defendants would receive a global release as long as the General Partner exercised the Call Right on or before June 29, 2018—the day that Barclays had projected Loews might exercise. *Id.* at 15-16; JX 915 at 15. That date was optimal for the defendants because it ensured that purchases under the Call Right would close before FERC's regularly scheduled meeting on July 19, when FERC was expected to make additional announcements regarding the subject matter of the March 15 FERC Actions. *See* PA §15.1(c) (governing timing of exercise, notice and purchase date); JX 793 at 1 ("[T]he Commission indicated its desire to issue an order on the [NOPR] in its July meeting which will take place on July 19."). The Original Settlement contemplated a fee award for plaintiffs' **[*143]** counsel "in an amount not to exceed $1.8 million." JX 1496 at 20.

U. Baker Botts Renders The Opinion.

Believing that they had secured a settlement that would extinguish and release any challenges to the exercise of the Call Right, Loews asked its advisors to finalize their work product. *See* JX 1489 at 1 (Richards Layton email thread reporting that "Loews is likely to settle its litigation this evening and is likely to exercise the purchase right on Friday").

On June 29, 2018, Baker Botts delivered the Opinion. JX 1522. It was substantially unchanged from the Preliminary Opinion that Baker Botts had provided on April 29.

The Opinion resembled a closing opinion in that it expressed a conclusion, without supporting reasoning or citations to legal authority. The Opinion did not reference a single case or statute, much less provide any discussion or application. The Opinion thus proceeded as if Baker Botts were opining on a routine issue, such as the due formation of an entity, its good standing, or its authority to enter into an agreement.

As is customary in a closing opinion, the Opinion began by listing the materials that Baker Botts had consulted. The Opinion next provided its conclusion, **[*144]** consisting of the following statement:

> On the basis of the foregoing, and subject to the assumptions, limitations, and qualifications set forth herein, we are of the opinion that the status of the Partnership as an association not taxable as a corporation and not otherwise subject to an entity-level tax for federal, state or local income tax purposes has or will reasonably likely in the future have a material adverse effect on the maximum applicable rate that can be charged to customers by subsidiaries of the Partnership that are regulated interstate natural gas pipelines (the "**Subsidiaries**").

Id. at 2.

The Opinion then provided two paragraphs summarizing the Financial Data. Those paragraphs stated:

> In rendering this opinion, we have requested and received from the Partnership cost, rate and other

financial information, including projections, estimates and pro forma information ("**Financial Data**") relating to the Partnership and the Subsidiaries, which we have relied upon. We have been assisted in our review of the Financial Data by a consultant engaged by us with expertise in the calculation of the cost of service of regulated interstate natural gas pipelines. The Financial Data includes **[*145]** a calculation of the estimated cost of service of each of the Subsidiaries under two scenarios. In preparing Financial Data pertaining to both scenarios, the Partnership made several assumptions, including that each Subsidiary would charge all its customers the maximum applicable rate, and as a result, each Subsidiary would recover its entire cost of service. The first scenario included in the cost of service of each Subsidiary an income tax allowance derived from the current federal, state and local income tax rates. The second scenario excluded an income tax allowance from the cost of service of each Subsidiary. We have participated in conferences with officers and other representatives of the Partnership, [the General Partner] and [the GPGP] in which the Financial Data, as well as other matters, were discussed. The purpose of our engagement, however, was not to establish or confirm the accuracy of factual matters or the reasonableness of projections, estimates or pro forma information provided to us or reviewed by us. Therefore, we have assumed that the Financial Data is correct in all material respects, that all calculations were performed accurately in all material respects and **[*146]** that the Financial Data was prepared in a reasonable manner and in good faith.

With regard to the Financial Data, in rendering our opinion referred to above, we relied substantially on the fact that the Financial Data indicated that the removal of the income tax allowance derived from the current federal, state and local income tax rates from the cost of service of the Subsidiaries would result, in the case of each Subsidiary, in an estimated reduction in excess of ten percent in the maximum applicable rates that can be charged to the customers of each of the Subsidiaries on a long-term basis. The Financial Data included a "Rate Model Analysis for 2017," which compared an estimate of (a) the maximum applicable rate that each Subsidiary could charge its customers, based on the development of a system wide rate for each Subsidiary and assuming each Subsidiary could include an income tax allowance derived from the current federal, state and local income tax rates in its cost of service with (b) the maximum applicable rate that each Subsidiary could charge its customers, based on the development of a system wide rate for each Subsidiary and assuming that each Subsidiary could not include **[*147]** any income tax allowance in its cost of service. The Rate Model Analysis indicates that elimination of an income tax allowance from the cost of service would result in an estimated 12.12% decline in the maximum applicable rate for Texas Gas Transmission, LLC, an estimated 11.68% decline in the maximum applicable rate for Gulf South Pipeline Company, LP, and an estimated 15.62% decline in the maximum applicable rate for Gulf Crossing Pipeline Company LLC. We also took notice that, because these reductions in the maximum applicable rates would not be offset by any reduction in costs incurred by the Subsidiaries, the reductions in the maximum applicable rates would have a substantially larger percentage impact on the earnings before interest and taxes and on the cash available for distribution of each of the Subsidiaries assuming each Subsidiary could actually charge and collect its maximum applicable rate.

Id. at 3.

The remainder of the Opinion consisted of a series of assumptions. *Id.* at 3-5. They included the following:

• "[T]he Revised Policy will not be revised, reversed, overturned, vacated, modified or abrogated in any relevant manner by any court or administrative or executive body, **[*148]** including the FERC, or by an act of Congress;" and

• "[T]he Revised Policy will be applied to individual FERC regulatory proceedings involving the Subsidiaries in accordance with its terms . . . ."

Id. at 4.

This section of the Opinion also included descriptions of how Baker Botts interpreted the terms "maximum applicable rate" and "material adverse effect." On the issue of "maximum applicable rate," the Opinion stated:

> Based on the wording of Section 15.l(b)(ii) of the Partnership Agreement, other provisions of the Partnership Agreement and support in the Registration Statement (particularly the final prospectus included therein), in rendering the opinion set forth above, we have, in using our

> judgment, interpreted the words (a) "maximum applicable rate that can be charged to customers by subsidiaries that are regulated interstate natural gas pipelines of the Partnership," to mean the recourse rates of the Subsidiaries now and in the future as that term is used by the FERC in its regulations, rulings and decisions, and (b) "status as an association not taxable as a corporation," to mean status as an entity not taxable as a corporation.

Id. at 4.

On the issue of "material adverse effect," **[*149]** the Opinion stated:

> The term "material adverse effect" as used in Section 15.1(b)(ii) of the Partnership Agreement is not defined in the Partnership Agreement or in the Delaware Revised Uniform Limited Partnership Act. In rendering the opinion set forth above, we have considered Delaware case law construing such term. Our analysis leads us to the conclusion that there is no case directly applicable to this situation and no bright-line test regarding what is a "material adverse effect," although the case law has provided us some guidance.

Id. at 4.

Baker Botts limited its Opinion to "applicable federal law of the United States, the Delaware Revised Uniform Limited Partnership Act, the Delaware Limited Liability Company Act, and, only to the extent relevant, in our judgment, to the opinion set forth above, Delaware law as it applies to the interpretation of contracts." *Id.* at 5. A non-Delaware law firm thus rendered a non-explained opinion on the existence of a material adverse effect, a subject on which both a Delaware law firm (Richards Layton) and a national law firm with a Delaware office (Skadden) would not opine.

On the same day that Baker Botts rendered the Opinion, the firm's rate **[*150]** expert—Sullivan—testified in a proceeding before FERC that it was impossible to assess the effects of changing the income tax allowance without a determination on the treatment of ADIT. Webb. Tr. 949.

V. The General Partner Exercises The Call Right.

After receiving the Opinion, Loews management recommended that Loews cause the General Partner to exercise the Call Right. *See* JX 1515 at 2; JX 1523 at 2-3. In their "Updated Base Case," management estimated that the transaction would generate more than $1.5 billion in "Value Creation" for Loews. JX 1515 at 9. After discussion, the Loews board of directors adopted resolutions authorizing Holdings to exercise the Call Right on behalf of the General Partner. JX 1523 at 4.

The Holdings Board met afterwards. *See* JX 1509. Skadden made a presentation concluding that "it would be within the reasonable judgment of [Holdings] to find that" the Opinion was acceptable. JX 1518 at 23. Comprised of three Loews insiders, the Holdings Board approved resolutions deeming the Opinion acceptable and exercising the Call Right. *See* JX 1509 at 5-9.

Later that day, Boardwalk announced that the General Partner had elected to purchase all outstanding units at a price **[*151]** of $12.06 per common unit, for approximately $1.5 billion in total consideration. JX 1526 at 1. Ten days later, on July 18, 2018, the transaction closed on schedule. *See* JX 1547 at 2.

W. FERC Makes Its Determinations.

Hours after the closing, FERC issued an order on rehearing of the Revised Policy and a final rule in response to the NOPR. JX 1549 (the "Order on Rehearing"); JX 1546 (the "Final Rule"). In the Order on Rehearing, FERC reiterated that its policy would not automatically permit MLP pipelines to recover an income tax allowance in their cost of service, but MLPs would not be precluded from arguing in a rate case that they were entitled to an income tax allowance based on an evidentiary record. JX 1549 ¶ 8.

Critically, FERC stated that MLPs that were no longer entitled to an income tax allowance could eliminate their overfunded ADIT balances without returning the balances to rate payers (whether by refund or amortization). *See id.* ¶ 10. The Commission based its ADIT decision on the arguments raised by pipeline-side commenters in the NOI docket and INGAA's presentation to FERC staff. *Id.* ¶ 13.

In its Final Rule, FERC adopted the procedures proposed in the NOPR with certain modifications, **[*152]** required all interstate natural gas pipelines to file a Form 501-G, provided options for each pipeline to address the recovery of tax costs (including filing a statement explaining why an adjustment to rates was not needed), and reiterated that a rate reduction might not be justified for a significant number of pipelines for several reasons. *See* JX 1546. Consistent with the Order on Rehearing, FERC "modifie[d] the proposed Form 501-G so that, if a pass-through entity state[d] that it d[id] not pay taxes, the form w[ould] not only eliminate its income tax allowance *but also eliminate ADIT*." *Id.* ¶ 132 (emphasis added). The Commission reasoned that doing otherwise would violate the prohibition against retroactive ratemaking. *Id.* ¶¶ 133-34. The DC Circuit ultimately agreed that returning ADIT to shippers would violate the prohibition against retroactive ratemaking. *SFPP, 967 F.3d at 801* (dismissing shippers' contrary arguments as "non-starters").

The Final Rule meant there would be no effect on Boardwalk's recourse rates. When one of his colleagues who had worked on the Opinion commented that the news "sounds pretty good for MLPs," Rosenwasser responded: "Seems all mitigates adverse effect without changing **[*153]** policy. Loews buy in of [B]oardwalk closed day before order came out." JX 1569 at 1.

Johnson circulated the news within Boardwalk. One of the executives responded, "Maybe I wish we were still publically [sic] traded..... [sic]." JX 1532 at 1.

On August 3, 2018, Wagner sent McMahon a summary of FERC's actions, copying Rosenwasser and Alpert. Confirming that the March 15 FERC Actions had opened the door to changes in ADIT, he explained that "FERC's March 2018 Revised Policy Statement created an issue of first impression by prohibiting MLP-owned pipelines from collecting a tax allowance, which raised the issue of how to treat the ADIT." JX 1578 at 1. He also confirmed the effect of the Order on Rehearing: "FERC announced that MLP-owned pipelines may reduce the balance to zero without providing any refunds or rate reductions. *This has the net effect of reducing the pipeline's exposure to rate reductions*." *Id.* (emphasis added).

X. The Current Plaintiffs Pursue The Litigation.

The current plaintiffs objected to the Original Settlement. On September 28, 2018, the court declined to approve the Original Settlement. Because the current plaintiffs had prevailed on their objections, the court permitted **[*154]** them to take over the litigation.

The court subsequently certified a plaintiffs' class consisting of:

> Any natural person or entity who held Boardwalk limited partnership units on July 18, 2018 and whose units were purchased on that date by Boardwalk GP, LP, together with their heirs, assigns, transferees, and successors in interest, but excluding Defendants, their successors in interest and assigns, and any natural person or entity that is a director, officer or affiliate of any of the foregoing

Dkt. 194 ¶ 1. The case proceeded through discovery and to trial.

II. LEGAL ANALYSIS

The plaintiffs proved that the General Partner breached the Partnership Agreement by exercising the Call Right without first satisfying the Opinion Condition or the Acceptability Condition. By acting manipulatively and opportunistically, the General Partner engaged in willful misconduct when it exercised the Call Right, and the exculpatory provisions in the Partnership Agreement therefore do not protect the General Partner from liability. This decision does not reach the plaintiffs' other claims.

A. Governing Principles Of Contract Law

The plaintiffs' principal claim asserts that the General Partner breached the Partnership **[*155]** Agreement, which is a contract governed by Delaware law. Delaware law therefore governs the claim for breach of the Partnership Agreement.

Under Delaware law, the elements of a breach of contract claim are (i) a contractual obligation, (ii) a breach of that obligation by the defendant; and (iii) causally related harm to the plaintiffs. *WaveDivision Hldgs. v. Millennium Digit. Media Sys., L.L.C., 2010 Del. Ch. LEXIS 194, 2010 WL 3706624, at *13 (Del. Ch. Sept. 17, 2010)*. No one disputes the status of the Partnership Agreement as a binding contract. No one disputes that the General Partner exercised the Call Right and acquired the publicly held units, thereby causing the resulting effects on the plaintiffs. The central issue is the question of breach. If the General Partner breached the Partnership Agreement, then the court must determine the quantum of harm, which also logically will serve as the measure of damages.

To determine the scope of a contractual obligation, "the role of a court is to effectuate the parties' intent." *Lorillard Tobacco Co. v. Am. Legacy Found., 903 A.2d 728, 739 (Del. 2006)*. "If a writing is plain and clear on its face, *i.e.*, its language conveys an unmistakable meaning, the writing itself is the sole source for gaining an understanding of intent." City Investing Co. Liquidating Tr. v. Cont'l Cas. Co., 624 A.2d 1191, 1198 (Del. 1993). A writing is plain and clear on its face "[w]hen the plain, common, and ordinary meaning of the words lends itself **[*156]** to only one reasonable interpretation . . . ." Sassano v. CIBC World Mkts. Corp., 948 A.2d 453, 462 (Del. Ch. 2008). When a writing is plain and clear, the court "will give priority to the parties' intentions as reflected in the four corners of the agreement, construing the agreement as a whole and giving effect to all its provisions." In re Viking Pump, Inc., 148 A.3d 633, 648 (Del. 2016) (internal quotations omitted).

A writing that is ambiguous is not plain and clear on its face, and the text of the agreement therefore cannot be the exclusive source of contractual meaning. "[A] contract is ambiguous only when the provisions in controversy are reasonably or fairly susceptible of different interpretations or may have two or more different meanings." Rhone-Poulenc Basic Chems. Co. v. Am. Motorists Ins. Co., 616 A.2d 1192, 1196 (Del. 1992). "A contract is not rendered ambiguous simply because the parties do not agree upon its proper construction." *Id.*

If the language of a contract is ambiguous, then a court may look beyond the contract itself to determine the parties' shared intent. Under appropriate circumstances, extrinsic evidence sheds light on "the expectations of contracting parties" and can "reveal[] . . . the way contract terms were articulated by those parties." SI Mgmt. L.P. v. Wininger, 707 A.2d 37, 43 (Del. 1998). Because its purpose is to elucidate "the expectations of contracting parties," extrinsic evidence is only relevant when **[*157]** it "can speak to the intent of *all* parties to a contract." *Id.* "Thus, it is proper to consider extrinsic evidence of bilateral negotiations when there is an ambiguous contract that was the product of those negotiations . . . ." *Id.* It follows that if there have not been "bilateral negotiations," then "extrinsic evidence is irrelevant to the intent of *all* parties at the time they entered into the agreement." Id. at 43-44.

A partnership agreement for an MLP is not the product of bilateral negotiations; the limited partners do not negotiate the agreement's terms. Extrinsic evidence therefore cannot speak to the intent of all parties to the agreement. In that setting, Delaware courts apply the doctrine of *contra proferentem* and "construe ambiguous provisions of the partnership agreement against the general partner." Martin I. Lubaroff et al., *Lubaroff & Altman on Delaware Limited Partnerships* § 14.02[B], at 14-39 (2d ed. 2021 Supp.); *see* Dieckman v. Regency GP LP, 155 A.3d 358, 366 n.18 (Del. 2017); Norton v. K-Sea Transp. P'rs L.P., 67 A.3d 354, 360 (Del. 2013). In addition to recognizing that extrinsic evidence is unhelpful in that setting, the doctrine of *contra proferentem* "protects the reasonable expectations of people who join a partnership or other entity after it was formed and must rely on the face of the [entity] **[*158]** agreement to understand their rights and obligations when making the decision to join." Stockman v. Heartland Indus. P'rs, L.P., 2009 Del. Ch. LEXIS 131, 2009 WL 2096213, at *5 (Del. Ch. July 14, 2009).

B. The Failure To Satisfy The Opinion Condition

Before the General Partner could exercise the Call Right, the General Partner had to satisfy the Opinion Condition. For that condition to be satisfied, the General Partner had to receive "an Opinion of Counsel that the Partnership's status as an association not taxable as a corporation and not otherwise subject to an entity-level tax for federal, state or local income tax purposes has or will reasonably likely in the future have a material adverse effect on the maximum applicable rate that can be charged to customers." PA § 15.1(b)(ii). If the General Partner exercised the Call Right without satisfying the Opinion Condition, then the exercise of the Call Right breached the Partnership Agreement. The General Partner obtained the Opinion, but the plaintiffs proved at trial that the Opinion was not a *bona fide* "Opinion of Counsel" that could satisfy the Opinion Condition. The General Partner therefore breached the Partnership Agreement.

When parties to a contract agree that the delivery of an opinion of counsel is necessary to satisfy a condition precedent, **[*159]** "it is [counsel]'s subjective good-faith determination that is the condition precedent." Williams Cos., Inc. v. Energy Transfer Equity, L.P., 2016 Del. Ch. LEXIS 92, 2016 WL 3576682, at *11 (Del. Ch. June 24, 2016), *aff'd*, *159 A.3d 264 (Del. 2017)*. Counsel renders on opinion in subjective good faith by applying expertise to the facts in an exercise of professional judgment. *Id.*

Beyond that foundational principle, Delaware decisions have not expounded on what it means for an opinion giver to act in subjective good faith. In a related setting, the Delaware Supreme Court has held that a general partner violated the implied covenant of good faith and fair dealing by relying on an opinion "that did not fulfill its basic function." Gerber v. Enter. Prod. Hldgs., LLC, 67 A.3d 400, 422 (Del. 2013), *overruled on other grounds by* Winshall v. Viacom Int'l, Inc., 76 A.3d 808 (Del. 2013). That holding implies that an opinion giver cannot render an opinion in good faith if the opinion giver knows that the opinion does not fulfill its basic function.

Authorities on the rendering of closing opinions confirm related and self-evident propositions about what it means for an opinion giver to render an opinion in good faith.[16] For example, an opinion giver plainly must have competence in the particular area of law. *See* Glazer et al., *supra*, § 2.7.1 at 61-62. An opinion giver who knowingly lacks competence in the area of law and nevertheless proceeds is not acting in good **[*160]** faith. In that setting, the opinion giver must look elsewhere for the relevant experience, and an opinion giver who lacks the competence to opine on an area of law may rely on an opinion from counsel with competence in that area. *See id.*; TriBar Report, *supra*, § 5.1 at 637-39.

These principles apply equally to the rendering of opinions on matters of Delaware entity law, where it is nevertheless customary for sophisticated law firms to provide third-party closing opinions on routine matters, such as due formation. Glazer et al., *supra*, § 2.7.1 at 94.

> Non-Delaware lawyers, however, normally do not render opinions on more difficult questions of Delaware corporation law or on questions arising under Delaware commercial law. In those circumstances, they usually rely on an opinion of Delaware counsel or deal with the issue in some other way, for example by relying on an express assumption.

Id. § 2.7.3 at 64-65. Although **[*161]** the quoted passage discusses Delaware corporate law, those same principles apply to opinions involving other types of Delaware entities. *See id.* § 2.7.3 at 65.

It is also self-evident that an opinion giver must act in good faith when establishing the factual basis for an opinion, including when making assumptions. Legal opinions "do not address the law in the abstract. Rather, they apply the law to real companies in real transactions." *Id.* § 4.1 at 82. Legal opinions accordingly "require grounding in the facts as well as the law." *Id.* The opinion giver usually will have firsthand knowledge of some of the facts necessary to render the opinion, but rarely will the opinion giver have firsthand knowledge of all of the necessary facts.[17]

To establish the factual basis for an opinion, the opinion giver can rely in good faith on factual information provided by others.[18] An opinion giver cannot act in good faith by relying on information known to be untrue or which has been provided under circumstances that would make reliance unreasonable.[19] For example, an opinion giver could not rely in good faith on information if the opinion giver knew that the person providing the information **[*162]** had not done the work required to support it. *See* Glazer et al., *supra*, § 4.2.3.6 at 105. An opinion giver also could not rely in good faith on factual representations that effectively establish the legal conclusion being expressed. *See* Opinion Principles, *supra*, § III.C at 833. If the factual representations are "tantamount to the legal conclusions being expressed," then the opinion giver is regurgitating facts, not giving an opinion in good faith. *See id.*

In lieu of factual representations, an opinion giver may establish the factual predicate for an opinion by making assumptions that certain facts are true. *See* Glazer et al., *supra*, §§ 4.1, 4.3.1 at 83, 109; Restatement, *supra*, § 95 cmt. c. Whether the opinion giver can make an assumption in good faith depends on the nature of the opinion. If an assumption or set of assumptions

---

[16] *See, e.g.*, Restatement (Third) of the Law Governing Lawyers §§ 50, 51, 95, Westlaw (Am. L. Inst. database updated Oct. 2021) [hereinafter Restatement]; Donald W. Glazer et al., *Glazer & FitzGibbon on Legal Opinions* (2d ed. 2001); Legal Ops. Comm. of the ABA Section of Bus. L., *Legal Opinion Principles*, 53 Bus. Law. 831 (1998) [hereinafter Opinion Principles]; TriBar Op. Comm., *Third-Party "Closing" Opinions: A Report of the Tribar Opinion Committee*, 53 Bus. Law. 591 (1998) [hereinafter TriBar Report] *see also* Legal Ops. Comm. of the ABA Section of Bus. L., *Third-Party Legal Opinion Report, Including the Legal Opinion Accord, of the Section of Business Law, American Bar Association*, 47 Bus. Law. 167 (1991) [hereinafter ABA Accord]. As stated in the text, this decision regards the principles it articulates as self-evident manifestations of what it means for an opinion giver to act in subjective good faith. This decision cites the authorities as providing illustrative support for those principles.

[17] *See* Glazer et al., *supra*, § 4.1, at 83, 85-86; Opinion Principles, *supra*, § III.A at 833; Tribar Report, *supra*, §§ 2.1.1 to .1.2 at 608-09.

[18] *See* Glazer et al., *supra*, § 4.1 at 83; Restatement, *supra*, § 95 cmt. c.

[19] *See* Glazer et al., *supra*, §§ 4.1, 4.2.3 at 83, 95-96; Restatement, *supra*, § 95 cmt. c.; Opinion Principles, *supra*, §§ I.F, III.A at 832-33; TriBar Report, *supra*, § 2.1.4 at 610.

effectively establishes the legal conclusion being expressed, then the opinion giver cannot properly rely on those assumptions, as doing so vitiates the opinion. *See* Opinion Principles, *supra*, §§ III.C—D at 833; ABA Accord, *supra*, ¶ 4.6 at 189-90. As with factual representations, if the assumptions establish the legal conclusions being expressed, then the opinion **[*163]** giver is simply making assumptions, not giving an opinion in good faith.

Although an opinion giver cannot rely on factual information known to be untrue, an opinion giver can base an opinion in good faith on an assumption that is contrary to existing fact. The flexibility to rely on a counterfactual assumption enables an opinion giver to render an opinion based on facts that do not exist on the date of the opinion but that the giver and recipient are confident will exist in the future. *See* Glazer et al., *supra*, § 4.3.6 at 119. For example, an opinion giver might assume that stock will be duly authorized after the closing of a transaction once necessary filings are made. *Id.* Or the opinion giver may use counterfactual assumptions to address situations that are not expected to arise, but which the recipient wants the opinion giver to address, such as the possibility that the law of a particular jurisdiction may govern the transaction. *Id.*

To rely in good faith on a counterfactual assumption, the opinion giver must identify the assumption explicitly. The opinion giver cannot rely in good faith on an unstated factual assumption that is known to be untrue. *See* Glazer et al., *supra*, § 4.3.4 **[*164]** at 115; Restatement, *supra*, § 95 cmt. c; TriBar Report, *supra*, § 2.3(c) at 616.

In this case, the Opinion Condition limited the ability of the opinion giver to rely on assumptions. To satisfy the Opinion Condition, the opinion giver had to conclude that Boardwalk's status as a pass-through entity for tax purposes "has or will reasonably likely in the future have a material adverse effect on the maximum applicable rate that can be charged to customers." PA § 15.1(b)(ii). The Opinion Condition required an opinion about an actual event ("has . . . a material adverse effect") or a future event ("will reasonably likely in the future have a material adverse effect"). The opinion giver thus was not being asked to opine on a counterfactual event. To render that Opinion, the opinion giver could make good faith *predictions* about what would happen in the future, but the opinion giver could not *assume* what would happen in the future. In particular, the opinion giver could not construct a set of assumptions about the existence of future facts that would generate the conclusion that the Opinion Condition required.

The plaintiffs proved that the Opinion did not reflect a good faith effort to discern the actual facts and apply professional **[*165]** judgment. Instead, Baker Botts made a series of counterfactual assumptions that were designed to generate the conclusion that Baker Botts wanted to reach. Baker Botts then deployed those assumptions as part of a syllogism that turned on elementary subtraction. In the process, Baker Botts stretched its analysis in myriad other ways. The Opinion was a contrived effort to reach the result that the General Partner wanted.

1. The Assumptions

In the Opinion, Baker Botts made a series of counterfactual assumptions. One was explicit. The rest were not. Baker Botts did not make those assumptions legitimately because its client asked for a hypothetical opinion about a set of alternative facts. Instead, Baker Botts made those assumptions because Baker Botts knew they were the only way that the firm could purport to reach the outcome that its client wanted. By making those assumptions, Baker Botts did not address whether an event had occurred that "has or will reasonably likely in the future have a material adverse effect." Baker Botts addressed an imaginary scenario that was never reasonably likely to come to pass.

a. Counterfactual Assumption: The Revised Policy Was Final.

To facilitate the exercise **[*166]** of the Call Right, Baker Botts assumed that the Revised Policy was final such that FERC had "revers[ed] its prior policy of allowing interstate natural gas pipelines owned by publicly traded partnerships . . . to include an income tax allowance in their cost of service." JX 1522 at 1. Baker Botts also assumed that "the Revised Policy will be applied to individual FERC regulatory proceedings involving the Subsidiaries in accordance with its terms and will not be directly or indirectly revised to allow any of the Subsidiaries to recover an income tax allowance in its cost-of-service rates." *Id.* at 4. Those assumptions were contrary to known facts.

An agency's statement of policy "is not finally determinative of the issues or rights to which it is addressed," but rather, only "announces the agency's tentative intentions for the future." *Pac. Gas & Electric Co. v. FPC, 506 F.2d 33, 38, 164 U.S. App. D.C. 371 (D.C. Circ. 1974)*; *see* Consol. Edison Co. of NY, Inc. v.

FERC, 315 F.3d 316, 323, 354 U.S. App. D.C. 235 (D.C. Cir. 2003) ("'Policy statements' differ from substantive rules that carry the 'force of law,' because they lack 'present binding effect' on the agency." (quoting *Interstate Nat. Gas Ass'n v. FERC, 285 F.3d 18, 59, 350 U.S. App. D.C. 366 (D.C. Cir. 2002)*)). Because of these attributes, "when [an] agency applies [a general statement of] policy in a particular situation, it must be prepared to support the policy just as if the policy statement had never **[*167]** been issued." *Pac. Gas, 506 F.2d at 38*.

Those principles of law applied with greater force to the Revised Policy, which was subject to further regulatory proceedings. Court Tr. 861. FERC stated in the concurrently issued NOPR that it intended to promulgate regulations to address the effects of the Revised Policy "on the rates of interstate natural gas pipelines organized as MLPs." JX 579 ¶ 8. When announcing the March 15 FERC Actions, Commission personnel responded to a question asking when "FERC Jurisdictional Rates [would] actually change," by saying that "the NOPR anticipates that the deadlines for pipeline filings will be late summer or early fall [2018]. *We obviously have to go to a final rule first*." PTO ¶ 117 (emphasis added). Absent a final rule and the filing of a rate case, jurisdictional rates, i.e. recourse rates, would not change.

Over the next four months, Boardwalk joined other pipelines, shippers, trade associations, and other industry participants in seeking to change the Revised Policy. Collectively, they filed thirteen requests for rehearing, 108 comments, sixteen reply comments, and numerous other submissions in response to the March 15 FERC Actions. *See* PDX 9 at 12; Court Tr. 858. And while **[*168]** the regulatory process was unfolding, members of Congress were "grill[ing]" the FERC commissioners about whether they were pursuing an appropriate policy. *See* JX 1076 at 1. The regulatory situation was in flux, and no one could predict where matters would end up. *See* JX 1525 at 67 (Sullivan testifying that "FERC's income tax allowance policy for 'pass through entities' is still being determined").

Baker Botts understood that reality, and Wagner explained those facts to Alpert in an email on March 20, 2018. JX 626. Wagner observed that "[s]tanding alone, [the Revised Policy] does not require pipelines to take any action." *Id.* at 1. He noted that by issuing the NOPR, FERC had made clear that it would implement the policy through regulations. *Id.* He added that if the final regulations called for the contemplated Form 501(g) filing, then those filings "*may* lead to rate challenges," but that those challenges would not be resolved until 2020 at the earliest. *Id.* (emphasis added). Alpert, however, pushed Baker Botts to take the position that the March 15 FERC Actions were sufficiently final to render the Opinion. In a call that Alpert convened shortly after receiving Wagner's email, Rosenwasser **[*169]** told Alpert what Loews wanted to hear. Rosenwasser agreed that the "most important thing has happened" and that "we're already there." JX 646 at 5.

Rosenwasser knew that was not true. He knew about and understood Wagner's analysis. Later, he acknowledged in his backup memorandum that "FERC could choose in its discretion to change the Revised Policy." JX 1502 at 10. In the April 4 Draft, Baker Botts recognized that "[i]mportant details of implementing the Revised Policy require clarification, and as a result our understanding regarding the implementation of the Revised Policy could prove to be incorrect." *See* JX 1949 at 2. That candid language did not appear in the final Opinion.

Boardwalk's executives did not believe that the Revised Policy was final. In Boardwalk's comments on the NOPR, they pointed out that the Revised Policy "is not a binding rule." JX 1139 at 2. They asked FERC to modify the Revised Policy by "eliminat[ing] issues related to the MLP income tax allowance from the proposed rule," and they asserted that the Revised Policy was "arbitrary and capricious and not the product of reasoned decisionmaking." *Id.* They also cautioned that any determination by the Commission to **[*170]** implement the Revised Policy needed to take into account the related issue of ADIT. *Id.* at 5.

Rosenwasser reviewed and marked up Boardwalk's comments on the NOPR, and he double-starred Boardwalk's statement that "[u]ntil the Commission provides a final decision on the treatment of ADIT, Boardwalk cannot correctly assess the impact of the Revised Policy Statement and ADIT on its pipelines' costs of service." JX 1138 at 14. That was exactly what Baker Botts was purporting to do in the Opinion. And Baker Botts was going further by assuming that the Revised Policy was final not only for the purpose of determining Boardwalk's cost of service but also for purposes of assessing an effect on rates.

If Baker Botts had been asked to render an opinion for a client about what might happen in the hypothetical event that the Revised Policy became final, then these assumptions would not have been problematic. But the

Opinion Condition required that Baker Botts express a legal opinion based on a set of facts: whether there had been a regulatory development that "has or will reasonably likely in the future have a material adverse effect on the maximum applicable rate that can be charged to customers." **[*171]** The assumption that a sufficient trigger had happened drove the result.

In finding that Baker Botts improperly assumed that the Revised Policy was final, this decision clarifies an aspect of its ruling on the defendants' motion to dismiss, which the defendants invoke to support their arguments. In the complaint, the plaintiffs asserted that Baker Botts "relied on assumptions that Defendants knew to be false," including the assumption that the Revised Policy would not be changed, and argued that "the defendants purportedly 'knew on June 29, 2018[,] that FERC's March 15 Proposed [sic] Policy Statement would soon be 'revised, reversed, [or] modified.'" *Bandera Master Fund LP v. Boardwalk Pipeline Pr's, LP, 2019 Del. Ch. LEXIS 1296, 2019 WL 4927053, at *20 (Del. Ch. Oct. 7, 2019)*. The court rejected that allegation, explaining:

> This assumption was not false. FERC did not revise, reverse, or modify the Revised Policy Statement. FERC issued an order on July 18, 2018, in which it declined to reconsider the Revised Policy Statement and reaffirmed that FERC "will generally not permit MLP pipelines . . . to recover an income tax allowance in their cost of service." The Final Rule addressed other aspects of FERC's new rate-setting policies, including the treatment of ADIT balances, but it did not revise, reverse, or modify **[*172]** the Revised Policy Statement.
>
> The plaintiffs' allegations do not support a reasonable inference that Baker Botts failed to exercise its independent judgment when it assumed that the Revised Policy Statement would not be revised, reversed, or modified. The motion to dismiss this aspect of Count II is granted.

*2019 Del. Ch. LEXIS 1296, [WL] at *20* (citations omitted). The court understood the plaintiffs' argument at the motion to dismiss stage to be that the defendants *knew* that the Revised Policy in fact would be changed, rendering the assumption false. Because the Revised Policy was not changed, that allegation could not support a claim on which relief can be granted.

The trial record establishes that when Baker Botts rendered the Opinion, Baker Botts and the defendants knew that the policy *could be changed*. The policy on the tax allowance was not changed, but the related decision on the treatment of ADIT was so substantial as to operate as a change. By assuming that the policy was final when issued on March 15, Baker Botts accelerated the date when it could render the Opinion. That decision meant that Loews did not have to wait until the terms of the Revised Policy and the related treatment of ADIT were known. Instead, **[*173]** Loews could exercise the Call Right during a period of maximum market uncertainty, thereby benefitting itself.

The record presented at trial demonstrates that the Revised Policy was not final. The fact that the lawyers who wanted the General Partner to be able to exercise the Call Right convinced themselves over time that the Revised Policy was sufficiently final to render the Opinion—and testified to that belief at trial[20]—does not mean that it was final. The Opinion started from a counterfactual premise that Baker Botts knew was untrue.

b. Counterfactual Assumption: Recourse Rates Would Change Without A Rate Case.

To facilitate the exercise of the Call Right, Baker Botts assumed that the rates that Boardwalk's subsidiaries could charge would change to the subsidiaries' detriment without a rate case. Unlike its first assumption, Baker Botts did not make this second assumption explicitly. Without that unstated counterfactual assumption, Baker Botts could not have rendered the Opinion.

To satisfy the Opinion Condition, Baker Botts had to conclude in good faith that Boardwalk's status as a pass-through entity for tax purposes "has or will reasonably likely in the future have a material **[*174]** adverse effect on the maximum applicable rate that can be charged to customers." PA § 15.1(b)(ii). A threshold question was the meaning of "maximum applicable rates."

If "maximum applicable rates" meant the real-world rates applicable to the shippers who purchased capacity on the subsidiaries' pipelines, then the March 15 FERC Actions—even if they became final—would not have a meaningful effect, because the majority of the shippers on Boardwalk's pipelines paid negotiated or discounted rates. As discussed in greater detail below, Baker Botts sidestepped that issue by interpreting "maximum

[20] *See* Rosenwasser Tr. 65; Wagner Tr. 207; Alpert Tr. 335; McMahon Tr. 525.

applicable rates" to mean "recourse rates." But that solution created another problem: Recourse rates do not change without a rate case. Assessing whether there would be a material adverse effect on recourse rates therefore required evaluating the risk that someone would bring a rate case against one of Boardwalk's Subsidiaries. *See* JX 1138 at 2; JX 1307 at 7; Court Tr. 860. It also required assessing whether Boardwalk's rates would change if a rate case was brought. *See* Court Tr. 861-65.

Baker Botts assumed away these issues. The Opinion did not address either the risk that someone would bring a rate **[*175]** case or the risk that Boardwalk's rates would change as a result of a rate case. Instead, the Opinion implicitly made the counterfactual assumption that each of Boardwalk's subsidiaries would be involved in a rate case and lose. *See* Court Report ¶¶ 113-14.

The April 4 Draft made that assumption openly, stating: "[W]e have requested that the Partnership assume that the Subsidiaries will file rate cases and take any other appropriate and legal action to be permitted to charge the maximum rates permitted under the applicable cost of service rules and regulations regardless of competitive conditions or any other non-legal factor." *See* JX 1949 at 2. The April 4 Draft thus made clear that Baker Botts was assuming that the subsidiaries would act contrary to their own interests, file rate cases seeking to lower their rates, and eschew any arguments that might enable them to maintain or raise their rates.

The Opinion dropped the clear language from the April 4 Draft and omitted any reference to rate cases. In its place, the Opinion substituted the more laconic assumption "that each Subsidiary would charge all of its customers the maximum applicable rate." JX 1522 at 3. That outcome only could **[*176]** happen if someone filed rate cases in which Boardwalk's subsidiaries lost. The assumption from the April 4 Draft thus remained, but was now unstated. *See* Wagner Tr. 273-74; *see also* Rosenwasser Tr. 91.

Two of Boardwalk's subsidiaries did not face any rate case risk, and a third faced only low risk. *See* JX 571 at 7; JX 1064; JX 1521 at 16. When issuing the NOPR, FERC made clear that many pipelines had characteristics that would obviate the need for a rate adjustment, including (i) rate moratoria, (ii) negotiated rates, or (iii) under-recovery of costs. *See* JX 580 ¶¶ 45, 48-49. Typically, a pipeline under-recovers its costs because it operates in a competitive market and must offer discounted rates to capture business. *See* JX 1139 at 11.

Those criteria mapped onto Boardwalk's pipelines. *See* JX 571 at 1.

• Virtually all of Gulf Crossing's contracted volumes were subject to negotiated rates. PTO ¶ 139; JX 572 at 2-3. Gulf Crossing also operated in highly competitive markets, was under-recovering its cost of service and would be "highly under-subscribed" as its negotiated-rate contracts rolled off. *See* JX 644 at 1; JX 676 at 8.

• A majority of Gulf South's contracts provided for negotiated **[*177]** or discounted rates. Gulf South was also subject to a rate case moratorium until May 2023. And Gulf South operated in highly competitive markets and thus was under-recovering its cost of service. *See* PTO ¶ 139; JX 604 at 1; JX 644 at 1; JX 676 at 8; JX 1139 at 6; JX 1521 at 16.

• A majority of Texas Gas' contracts with shippers provided for negotiated or discounted rates. See JX 1139 at 6. Only 20% of its volumes were shipped at recourse rates and potentially subject to any effect. *See* JX 548 at 1. It too served highly competitive markets. *Id.*

Loews, Boardwalk and their advisors concluded there was "[n]o expected near-term rate case risk for Gulf South or Gulf Crossing" and that over the long-term, rate case risk was minimal because "current RoE [was] likely to be below allowable RoE." JX 1521 at 16; *see* Wagner Tr. 269. After some initial concern about the rate case risk at Texas Gas, Baker Botts and its rate expert assured Loews that the rate case risk at Texas Gas was "low" through April 2020. JX 1064 at 1. Beyond that, Baker Botts and its rate expert believed it was impossible to "make a prediction with any confidence." *Id.; see* JX 1078.

The Opinion rested on an unstated counterfactual **[*178]** assumption about the inevitability of an adverse decision in a rate case. If Baker Botts had been asked to render an opinion for a client about what might happen in a hypothetical world where all three subsidiaries faced rate cases and lost, then an opinion based on explicit assumptions to that effect would have been acceptable. But the Opinion Condition required that Baker Botts express a legal opinion about whether Boardwalk's status as a pass-through entity for federal tax purposes has or "will reasonably likely in the future have a material adverse effect on maximum applicable rates." Rendering that opinion required assessing the risk of a material adverse effect on rates, not making the unstated counterfactual assumption that each subsidiary would face and lose a rate case.

c. Counterfactual Assumption: Hypothetical Indicative Rates Are The Same As Recourse Rates.

To facilitate the exercise of the Call Right, Baker Botts made yet another counterfactual assumption: Recourse rates are the same as hypothetical indicative rates. Like the second counterfactual assumption, the third assumption was unstated.

As discussed previously, the Opinion Condition required that the Opinion address **[*179]** whether there has been or will reasonably likely be a material adverse effect on the "maximum applicable rate that can be charged to customers" The Partnership Agreement did not define "maximum applicable rate," and FERC has not defined it either. *See* Court Report ¶¶ 152-55; Rosenwasser Dep. 365. None of defendants' advisors, nor their FERC expert in this litigation, identified a FERC order or ruling that defined or explained that phrase. *See* Court Report ¶¶ 157-69; JX 1756 (Court Rebuttal) ¶¶ 11-17. At trial, Rosenwasser conceded that the meaning of "maximum applicable rate" was a "key" question his team "had to grapple with." Rosenwasser Tr. 64.

Multiple law firms generated analyses of the phrase, in part because Baker Botts was unable to identify any settled meaning of the term in its first attempt. *See* JX 637 (email from Baker Botts interpreting the term); JX 781 at 1 (same); JX 800 at 2 (notes from Skadden interpreting the term); JX 1375 (memorandum from Baker Botts interpreting the term); JX 1437 (email from Van Ness Feldman interpreting the term). Naeve, the Skadden partner and former FERC Commissioner, believed that the phrase reasonably could mean either (1) "the maximum rate **[*180]** applicable to customers taking into consideration discounted contracts that have been filed at FERC," or (2) "the maximum rate contained in the tariff which the pipeline could have charged and is free to charge other customers[.]"[21] Layne, the Vinson & Elkins transactional partner, similarly observed that there were multiple reasonable interpretations.[22]

The Opinion implicitly conceded that the term "maximum applicable rates" was ambiguous. Rather than asserting that the claim had a plain meaning, Baker Botts stated that

> we have, *in using our judgment*, interpreted the words . . . "maximum applicable rate that can be charged to customers by subsidiaries that are regulated interstate natural gas pipelines of the Partnership," to mean the recourse rates of the Subsidiaries now and in the future as that term is used by the FERC in its regulations, rulings and decisions . . . .

JX 1522 at 4 (emphasis added).

Everyone knew that a Delaware court would apply the doctrine of *contra proferentem* and construe ambiguous language against the General Partner and in favor of the minority unitholders. Yet to reach the conclusion that the phrase meant "recourse rates," Baker Botts declined to **[*181]** apply the doctrine of *contra proferentem* and looked to two sources of extrinsic evidence: (i) Boardwalk's own use of the phrase in its public filings, and (ii) FERC's use of the phrase in orders in proceedings involving Boardwalk, where FERC was commenting on Boardwalk's filings.

If Baker Botts had reached that interpretive judgment, assessed each pipeline's risk of a rate case, relied on a full ratemaking analysis, and rendered opinions about the reasonably likely effect on recourse rates, then Baker Botts' decision to interpret "maximum applicable rates" as "recourse rates" would not have fatally undermined the Opinion. Although relying on extrinsic evidence to interpret ambiguous language runs contrary to how Delaware courts interpret MLP agreements, the Delaware Supreme Court has looked on occasion to the surrounding transactional context, including by considering language in an issuer's public filings, to give meaning to a disputed phrase. *See, e.g.,* [Airgas, Inc. v. Air Prods. & Chems., Inc., 8 A.3d 1182, 1189 (Del. 2010)]. Baker Botts thus could have reached a reasoned

[21] JX 800 at 2. Naeve discussed this concern with Alpert. *See id.*; Alpert Tr. 421. When Grossman raised the same point, Alpert was furious. *See* JX 798 at 1 ("Rich is pissing me off."). Baker Botts had to send Skadden a copy of Boardwalk's Form S-1 to "get [them] more comfortable" with the interpretation that Baker Botts needed to use. *See* JX 790 at 2. Baker Botts thus turned to extrinsic evidence to support its reading of "maximum applicable rates."

[22] *See* JX 733 at 1 ("One interpretation is that that means the maximum rates that could be charged, assuming the customers were paying maximum cost of service rates. On the other hand, because of the discounts, market based rates and negotiated rates (and presumably the possibility of all this getting changed by FERC again), REVENUE won't take a hit...even though theoretical maximum rates (if we could charge them) would be materially adversely effected [sic].").

conclusion that it was appropriate under the circumstances to consider extrinsic evidence in the form of Boardwalk's Form S-1, and Baker Botts could have concluded in good faith, based **[*182]** on that broader transactional context, that when drafting the Call Right, Rosenwasser meant to refer to recourse rates. In other words, to the extent that extrinsic evidence and judgment enter the picture, reading "maximum applicable rates" to mean recourse rates is a more persuasive reading than other possibilities.

But Baker Botts did not do those things. Baker Botts made an unstated assumption that resulted in the Opinion not actually interpreting the phrase "maximum applicable rate" as "recourse rates." Baker Botts instead considered the highest rates that FERC would allow Boardwalk to charge in a hypothetical world that assumed there was a full market for the pipelines' services. JX 646 at 3. As Wagner wrote in his contemporaneous notes: "'Max hypothetical rate.' This is not the recourse rate." JX 646 at 4. Other contemporaneous writings refer to the rates that Baker Botts examined as "indicative rates," "theoretical maximum rates," and "maximum hypothetical rates." *See* JX 727 at 2 ("indicative rates"); JX 733 at 1 ("theoretical maximum rates"); JX 798 ("[I]t's crystal clear that we're talking hypothetical future max FERC rates."); JX 1007 at 1 ("hypothetical rates").

In reality, **[*183]** the Opinion examined indicative rates, and Baker Botts' conclusion rested on the unstated counterfactual assumption that indicative rates were the same as recourse rates. If Baker Botts had been asked to render an opinion for a client about what might happen to "hypothetical future max FERC rates," then equating indicative rates with recourse rates would not have been problematic. The Opinion Condition, however, did not turn on "hypothetical future max FERC rates." The Opinion Condition required that Baker Botts express a legal opinion about whether Boardwalk's status as a pass-through entity for tax purposes "has or will reasonably likely in the future have a material adverse effect on maximum applicable rates." Once Baker Botts expressly assumed that "maximum applicable rates" were the same as "recourse rates," Baker Botts had to stick with that assumption. Instead, Baker Botts made an additional, unstated, and counterfactual assumption that recourse rates were the same as "hypothetical future max FERC rates."

d. Counterfactual Assumption: The Treatment Of ADIT Was Known.

To facilitate the exercise of the Call Right, Baker Botts made a fourth counterfactual assumption. Like the second **[*184]** and third assumptions, it too was implicit. This time, Baker Botts assumed that the open question of how FERC would treat ADIT was a known fact *and* that FERC would use the Reverse South Georgia Method. In reality, no one knew how FERC would treat ADIT, and it was impossible to determine what effect the March 15 FERC Actions would have on rates without knowing how FERC would treat ADIT.

In the March 15 FERC Actions, FERC made clear that the treatment of ADIT was an open issue. The ADIT NOI sought industry input on that very question. *See* JX 576 ¶ 25. FERC staff specifically flagged whether an MLP's accumulated ADIT balance should be eliminated from cost of service or whether those previously accumulated sums should be placed in a regulatory liability account and returned to ratepayers. *See id.*

Boardwalk understood that the treatment of ADIT was an open issue. In Johnson's initial analysis of the impact of the March 15 FERC Actions, he characterized his estimate of the downside as a floor, because it "ignores any bounce from rate base increase associated with removal of ADIT." JX 572 at 1-2. Elaborating in a later email, he explained that "it's unclear on what they [FERC] would do with **[*185]** [Boardwalk's] current ADIT" balance. JX 602 at 1. He further observed that FERC could decide that the ADIT balance should be "zeroed out because there's no income taxes (because there would be no difference between book and tax depreciation)." *Id.*

When the Loews executives examined Johnson's analysis, they likewise recognized that ADIT was the critical issue. JX 601 at 2. A Loews employee determined that losing the income tax allowance was "a flesh wound for the long haul pipes like . . . [Boardwalk]." *Id.* at 1. But if FERC required that pipelines return their ADIT balances to ratepayers, then that "would be the a-bomb outcome" and would be "extremely painful." *Id.*

Baker Botts knew that the future treatment of ADIT was an open issue. Just four days into Baker Botts' engagement, Wagner acknowledged that "FERC has not stated how to treat ADIT balances" and "[t]his can affect the rate impact on the pipelines substantially." JX 619 at 1. Wagner explained to Alpert in an email on March 20, 2018, that the ADIT NOI did not have a time frame for resolution but could be resolved by the end of 2018. JX 626 at 1. He noted that any regulation was "not likely to be self-implementing and would require **[*186]** additional proceedings to affect pipeline rates." *Id.*

During a call on March 22, 2018, Boardwalk executives and Baker Botts lawyers discussed whether they could estimate the effect of ADIT, concluding that they had "[n]o idea [because we] don't know rules." JX 646 at 1; *see* JX 644 at 1 (noting the "lack of clarity on FERC's eventual policy on" the treatment of ADIT and characterizing any possible effects as "highly speculative at this point"); JX 740 at 1 ("[W]e may want to see the results under a few different scenarios."); JX 868 at 2 ("[D]ifferent assumptions on how to handle [the ADIT] issue could affect the calculations."); *see also* JX 1525 at 67 (Sullivan testifying that FERC was still determining "how [ADIT] balances will be treated"). The Loews executives likewise understood that they did not have the answer on ADIT. *See* JX 567; JX 601 at 1-2.

A chorus of defense witnesses testified at trial that they believed that FERC would instruct pipelines to amortize ADIT using the Reverse South Georgia Method.[23] That was indeed one reasonable method, and the witnesses' testimony about their belief seemed convincing. The problem is that the Reverse South Georgia Method was only one possibility, **[*187]** and no one knew what FERC actually would do.

Without knowing how FERC would treat ADIT, it was impossible to determine what effects the March 15 FERC Actions would have. In its public comments on the NOPR, Boardwalk emphasized that, "[u]ntil the Commission provides a final decision on the treatment of ADIT, Boardwalk cannot correctly assess the impact of the Revised Policy Statement and ADIT on its pipelines' costs of service . . . ." JX 1130 at 14. Skadden understood what that meant for the Opinion. In a model of understatement, Voss described the language as "relatively unhelpful." JX 1164 at 1. Rosenwasser also knew the language posed a problem. In his personal notes on Boardwalk's NOPR comments, Rosenwasser underlined the text and double-starred it. *See* JX 1138 at 14.

Boardwalk's comment was more than just unhelpful. It established that Baker Botts had no basis for the Opinion.

The Opinion thus rested on the unstated counterfactual assumption that the treatment of ADIT was known and would follow the Reverse South Georgia Method. If Baker Botts had been asked to render an opinion for a client about what the effect on rates would be if FERC required amortization of ADIT using the **[*188]** Reverse South Georgia Method, then making that counterfactual assumption would have been fine. But the Opinion Condition required an opinion based on fact. Instead, Baker Botts assumed its way to a conclusion that a sufficient regulatory development had occurred.

2. The Factual Inputs

The foregoing assumptions formed the basis for Rosenwasser's syllogism. That exercise dictated the result of the Opinion by deploying elementary subtraction. Baker Botts then obtained information from Boardwalk to make the syllogism work.

a. Rosenwasser's Syllogism

As described in the Factual Background, Rosenwasser developed his syllogism so that Baker Botts could render the Opinion. Rosenwasser knew that the Call Right was intended to address a business issue by protecting Loews against a regulatory change that would have a materially adverse effect on Boardwalk. Rosenwasser Dep. 39-40. Rates were relevant because they led to revenue. McMahon Tr. 545. The Call Right was not intended to create a regulatory trapdoor that could be triggered by a change that "wasn't substantive, wasn't meaningful." Rosenwasser Tr. 46. In fact, Rosenwasser did not believe that "rates" were what the Call Right was designed to **[*189]** protect. JX 1502 at 34 ("Rates themselves are not what is being protected. It must be the entities charging the rates."). The Call Right was intended to provide Loews with an "off-ramp" if FERC changed its policy in a way that materially threatened Boardwalk as an entity. McMahon Tr. 480, 545.

That understanding comported with how Delaware cases approach the concept of a material adverse effect. Determining whether a material adverse effect is reasonably likely to occur involves forecasting, not fantasizing. "There must be some showing that there is a basis in law and in fact for the serious adverse consequences prophesied by the party claiming the MAE." *Akorn, Inc. v. Fresenius Kabi AG, 2018 Del. Ch. LEXIS 325, 2018 WL 4719347, at *65 (Del. Ch. Oct. 1, 2018)* (quoting *Frontier Oil v. Holly Corp., 2005 Del. Ch.*

[23] *See* Rosenwasser Tr. 78; Wagner Tr. 217-18, 223; Alpert Tr. 347; McMahon Tr. 497, 517; Johnson Tr. 619.

LEXIS 57, 2005 WL 1039027, at *36 n.224 (Del. Ch. Apr. 29, 2005)), *aff'd*, *198 A.3d 724 (Del. 2018)*. Simply "proclaiming that bad things can happen" is insufficient to establishing that a material adverse effect is reasonably likely to occur. *See Frontier Oil*, 2005 Del. Ch. LEXIS 57, 2005 WL 1039027, at *36 n.224.

The March 15 FERC Actions were not reasonably likely to have a material adverse effect on Boardwalk. The Boardwalk management team determined immediately that the March 15 FERC Actions were not reasonably likely to have a material adverse effect on Boardwalk's revenue. *See* JX 615 at 1; JX 733 at 1. The March 15 FERC Actions also were not reasonably likely to have a material **[*190]** adverse effect on recourse rates. Two of Boardwalk's pipelines had characteristics which meant that if the March 15 FERC Actions became final, they would not face a rate proceeding. For the third pipeline—Texas Gas—the risk of a rate proceeding was low, and any effect on revenue would be small.

To deliver the Opinion, Rosenwasser needed to shift from the real world into an imaginary one. He therefore took the position that the Call Right was not concerned with the actual economic impact; it was only concerned with the abstract concept of "maximum applicable rates." *See* JX 645 at 1; JX 679 at 5, 8. If a regulatory policy affected that abstract concept, then the Call Right could be exercised. And because a tax allowance had been built into the cost-of-service calculation, a policy change eliminating the allowance would lead ineluctably to a change in the maximum applicable rate, as Baker Botts was defining that term. When Wagner heard Rosenwasser's reasoning, he immediately understood what they were doing: "Just saying" that eliminating the tax allowance led to a lower cost of service and therefore a material adverse effect. JX 639.

The resulting syllogism turned on elementary subtraction, **[*191]** and it was fundamentally flawed. Boardwalk knew that. During a discussion of the March 15 FERC Actions, Jonathon Taylor from the FERC Office of General Counsel foreshadowed what would become Rosenwasser's syllogism when he explained that "when a tax expense decreases, so does the cost of service." JX 588 at 22. At the time, McMahon and his outside counsel ridiculed that line of reasoning. McMahon wrote to Gregory Junge, a regulatory lawyer: "That was a priceless statement[.] [T]axes go down[.] COS goes down[.] This is going to be a train wreck." JX 575 at 2. Junge responded: "That is . . . just [the] type of 1:1 thinking that we were trying to explain is not the case." *Id.* And in its comments to FERC on the NOPR, Boardwalk rejected that simplistic approach. Boardwalk asserted that it was "misleading" to equate a change in the cost of service stemming from the removal of the income tax allowance with a "rate reduction," because a cost-of-service change has "little bearing" on whether or not a rate reduction will occur. JX 1138 at 30 (NOPR Comments). If FERC tried it, then it would violate its policy against single-issue ratemaking. JX 1307 at 7; *see* Johnson Tr. 663.

Grasping for grounds **[*192]** to confirm that this approach was nevertheless justified, Rosenwasser relied on the fact that the Opinion called for a legal opinion from counsel, not a factual opinion from some other type of professional like a rate expert or an investment banker. *See* JX 646 at 3 ("This is a legal opinion, independent of what's happening in mkt. Not a primarily factual analysis."); *see also* JX 686 at 1; Rosenwasser Tr. 49-51. That is nonsensical; the notion that the Partnership Agreement called for a legal opinion did not mean that the opinion could ignore facts. Lawyers (and law-trained judges) apply the law to facts. Legal opinions turn on facts. *See* Glazer et al., *supra*, § 4.1 at 82.

Not surprisingly, Rosenwasser and Baker Botts could not maintain the pretense that the Opinion did not require considering real-world facts. Uncertain about whether it could opine that the effect on indicative rates was sufficiently material and adverse, Baker Botts wanted to consider other indications of materiality, such as the effect that a comparable reduction in revenue would have on Boardwalk's EBIT, EBIDTA, and distributable cash flow. *See* PTO ¶ 182; JX 775 at 1. Rosenwasser sought reassurance from Richards **[*193]** Layton that Baker Botts could consider these other effects, but Richards Layton advised the "[b]etter [r]eading" was to "look [at] rates more, not effects." JX 1007 at 1. Even then, Baker Botts referred to the pass-through effect in the Opinion, stating that

> [w]e also took notice that, because these reductions in the maximum applicable rates would not be offset by any reduction in costs incurred by the Subsidiaries, the reductions in the maximum applicable rates would have a substantially larger percentage impact on the earnings before interest and taxes and on the cash available for distribution of each of the Subsidiaries assuming each Subsidiary could actually charge and collect its maximum applicable rate.

JX 1522 at 3. Baker Botts thus considered real-world effects when doing so helped reach the result that its client wanted, but not when doing so might cut in the opposite direction.

Rosenwasser's syllogism ignored that the Call Right was drafted to address a business issue, not an abstract legal question. The syllogism ignored the absence of any real-world effect on revenue in favor of focusing on recourse rates. It ignored the question of rate case risk and the real-world events **[*194]** that would have to take place before there was any effect on recourse rates. The syllogism was a contrived exercise designed to achieve a particular result.

b. The Rate Model Analysis

To provide the factual basis for the Opinion, Baker Botts had Boardwalk prepare the Rate Model Analysis. That analysis implemented Rosenwasser's syllogism and was designed to "get us where we need to go." JX 713 at 1. The exercise generated declines in hypothetical indicative rates of 11.68%, 12.12%, and 15.62% under circumstances where the rates that shippers actually paid had not changed at all and where recourse rates were unlikely to change for the foreseeable future.

The Rate Model Analysis departed from ratemaking principles. The Rate Model Analysis calculated a single, hypothetical, indicative rate for each of Boardwalk's three pipeline subsidiaries. *See* JX 1415 at 3. It then projected that the indicative rate would drop as a result of the removal of income tax allowance. *See id.* In other words, the Rate Model Analysis changed only the income tax allowance variable while holding all else constant. *See, e.g.*, JX 639 at 1; Wagner Tr. 258; Webb Tr. 938. That is single-issue ratemaking.

Through single-issue **[*195]** ratemaking, the Rate Model Analysis avoided any meaningful assessment of how, if at all, a change in the cost of service might impact any of the 167 recourse rates that Boardwalk had on file with FERC. Sullivan, the rate expert hired by Baker Botts, testified in his deposition that FERC would not focus on an indicative rate because it does not "mean anything." Sullivan Dep. 169. He confirmed that the Rate Model Analysis calculated a cost-of-service reduction, not a rate reduction. *Id.* at 118. He explained that deriving an indicative rate reduction by changing one cost-of-service variable was "kind of meaningless" because a rate change does not depend on one cost-of-service variable. *Id.* at 101. He observed that the Rate Model Analysis could not be used to calculate the change to Boardwalk's actual recourse rates. *Id.* at 150. At trial, the plaintiffs' rate expert testified persuasively on these same points. *See* Webb Tr. 913-14 (describing indicative rates as "meaningless" and "hypothetical").

Because the Rate Model Analysis employed a simple syllogism, it only contained a few pages of analysis. The calculations for the purported rate impact at Texas Gas took only five pages. Johnson **[*196]** Tr. 640, 652. By contrast, the rate models used in actual rate cases involve hundreds of pages of complex calculations to determine cost of service and, ultimately, recourse rates. *See* Webb Report ¶ 174; *see also* Johnson Tr. 653 (conceding that Gulf South's initial submission in a recent rate case spanned 3,844 pages). The Rate Model Analysis was much shorter because it skipped essential steps in the ratemaking process. *See, e.g.*, Johnson Tr. 651-52 (conceding that the Rate Model Analysis did not calculate discount adjustments); *id.* at 648-49 (conceding that FERC requires use of zone-based rate design where pipelines employ zones but the Rate Model Analysis failed to do so). At the same time, the Rate Model Analysis applied a de-functionalizing step that is not part of ratemaking process. Webb Tr. 967.

The resulting simplified calculation was highly sensitive to assumptions about ADIT and ROE. The Rate Model Analysis thus confirms that Baker Botts could not opine on the effect of the March 15 FERC Actions on rates without knowing more about the regulations that FERC intended to adopt.

The Rate Model Analysis assumed that FERC would require amortization of ADIT using the Reverse South **[*197]** Georgia Method, which was one possibility. Virtually all of the pipelines (other than Boardwalk) publicly advocated for FERC to eliminate ADIT. Changing from the Reverse South Georgia Method to the elimination of ADIT would have eliminated Baker Botts' ability to claim a material adverse effect on indicative rates.

Go to table8

Webb Report ¶ 128 fig. 6. The changes at Texas Gas and Gulf South become minimal, and Gulf Crossing's rates move in the opposite direction.

The Rate Model Analysis was also sensitive to assumptions about ROE. While Baker Botts was working on the Opinion, some industry participants thought that FERC might permit pipelines to calculate their cost-of-service requirements using higher ROEs to offset the effect of the lost income tax allowance. *See, e.g.*, JX 910 at 9 ("Guggenheim [Partners, LLC] thinks . .

. . the change to the tax allowance might not be material, as the increased ROE could recover the cost lost by losing the tax allowance."). While he was acting as Baker Botts' rate expert, Sullivan gave testimony in which he advocated for increased **[*198]** ROEs. *See* Webb Report ¶¶ 132-33 (collecting Sullivan's advocacy); Sullivan Dep. 55 (conceding that he would have used a 13.5-14% ROE in a rate case).

Increasing the ROE in the Rate Model Analysis from 12% to 14% lowers the percentage change in rates by approximately five percent:

Go to table9

See Webb Report ¶ 134 fig. 7. The changes at all three pipelines fall below the level that Baker Botts opined could give rise to a material adverse effect.

Changing both variables in the Rate Model Analysis—eliminating ADIT and increasing the permissible ROE—reverses the direction of the change in indicative rates.

Go to table10

See Webb Report ¶ 136 fig. 8. Instead of a projected decrease (which Baker Botts reports as a positive percentage), there is a projected increase (reflected as a negative percentage). That means that indicative rates would increase, resulting in a beneficial effect rather than an adverse effect. The plaintiffs concede **[*199]** that these outputs do not mean that Boardwalk's recourse rates were reasonably likely to rise. *See* Webb Tr. 959. What they demonstrate is that the Rate Model Analysis depended heavily on assumptions, including an answer on the treatment of ADIT that no one knew when Baker Botts rendered its Opinion.

The Rate Model Analysis could not provide an adequate factual basis for the Opinion. The Rate Model Analysis simply implemented Rosenwasser's syllogism, which ignored real world effects but allowed Baker Botts to reach the conclusion its client wanted.

3. Other Efforts To Reach The Desired Conclusion

After making all of the foregoing efforts to create a structure that would permit the issuance of the Opinion, Baker Botts still had to stretch to render the Opinion. Those strained conclusions are signs of motivated reasoning.

Most notably, Baker Botts stretched on what constituted a material adverse effect. Richards Layton advised that "the better argument" was that a reduction in rates of 12-13%, in perpetuity, would suffice for a material adverse effect.[24] The Skadden attorneys believed that an 11% change was "likely insufficient" under Delaware law, although the duration of the change would **[*200]** be a pertinent consideration. *See* JX 772 at 1. In the Opinion, Baker Botts went further and took the position that a material adverse effect would result from "an estimated reduction *in excess of ten percent* in the maximum applicable rates that can be charged to the customers of each of the Subsidiaries on a long-term basis." JX 1522 at 3 (emphasis added); *see* Rosenwasser Tr. 96-98. Baker Botts had to dip below 12% because the Rate Model Analysis generated a decline of 11.68% in the hypothetical indicative rates that Texas Gas could charge. *See* JX 1522 at 3.

And Baker Botts stretched on other issues as well:

- Baker Botts was not sure what standard to use for "reasonably likely to have a material adverse effect." Rosenwasser decided to "call it more likely than not." JX 1807 at 12; *accord* Rosenwasser Tr. 98-99.

- Baker Botts viewed the reference to the Partnership's "status as an association not taxable as a corporation" as incorrect terminology. JX 939. Baker Botts decided to "tear off the band-aid and substitute 'entity' for 'association' in our statement of our opinion." *Id.* Thus, the real issue, as Baker Botts saw it, was the Partnership's status as an MLP. JX 733 at 1.

In substance, **[*201]** Baker Botts rewrote the Call Right so that it could render the Opinion. As written, the Call Right required an opinion that

> the Partnership's status as an association not taxable as a corporation and not otherwise subject to an entity-level tax for federal, state or local income tax purposes has or will reasonably likely in the future have a material adverse effect on the maximum applicable rate that can be charged to customers by subsidiaries of the Partnership that are regulated interstate natural gas pipelines.

PA § 15.1(b).

As rewritten by Baker Botts, the Call Right called for an

---

[24] JX 975 at 1; JX 1507 at 1-2. At trial, Raju testified that Richards Layton thought the "better argument" was that "a 10 percent or greater adverse effect into perpetuity on the rates metric would constitute an MAE." Raju Tr. 800-01. The contemporaneous documents do not provide that additional color.

opinion that

> a notice of a proposed regulation about whether a regulated interstate natural gas pipeline organized as an MLP can claim an income tax allowance in its cost of service
> the Partnership's status as an association not taxable as a corporation and not otherwise subject to an entity-level tax for federal, state or local income tax purposes has or
>
> will reasonably likelymore likely than not in the future will have a
>
> material10% or more adverse effect on the
>
> maximum applicablehypothetical indicative rates that can be charged to customers by subsidiaries of the Partnership that are regulated interstate **[*202]** natural gas pipelines if each subsidiary faces and loses a rate case in which FERC (i) removes only the income tax allowance from the pipeline's cost of service, (ii) requires amortization of ADIT using the Reverse South Georgia method, (iii) does not conduct the other steps in the ratemaking process, (iv) does not consider rate moratoria, the effects of competition, or other factors that FERC considers when determining rates, and (v) thereby violates the policy against single-issue ratemaking.

Baker Botts chose to give the latter opinion. It could not have given the former opinion.

4. Knowingly Going Where Others Would Not Tread

In addition to counterfactual assumptions, in addition to Rosenwasser's syllogism, and in addition to stretching on a series of issues that amounted to rewriting the Call Right, at least two other dimensions of Baker Botts' conduct support a finding of bad faith. Baker Botts rendered a non-explained opinion on a complex issue of Delaware law that the two Delaware law firms who were consulted would not formally address. And Baker Botts did so in the face of fatal uncertainty that could have been mitigated simply by waiting.

Baker Botts is a sophisticated law firm, **[*203]** but it is not a Delaware law firm. Baker Botts is also a leader in transactions involving MLPs, but it is not in the habit of opining on complex issues of Delaware limited partnership law. Many sophisticated firms render closing opinions on routine issues of Delaware entity law, such as the due formation of an entity or the due authorization of a contract. Baker Botts generally rendered enforceability opinions under the Delaware Revised Uniform Limited Partnership Act, but the firm did not render opinions more broadly on other Delaware issues. *See* JX 878 at 4.

In this case, Baker Botts took on one of the most difficult issues under Delaware law: determining the existence of a material adverse effect. Neither of the Delaware firms in this case would render such an opinion. Skadden has a policy against rendering an opinion on whether an event constitutes a material adverse effect, and Grossman was not willing to give Baker Botts any work product that might be construed as expressing an opinion. *See* JX 771 at 1. Richards Layton gave oral advice about what was the "better argument" and was willing to memorialize its advice in an email, but it would not go further than that and would not **[*204]** let Baker Botts reference its views. *See* JX 975 at 1; *see* Raju Dep. 113-14.

Internally, Baker Botts appropriately questioned its ability to render this opinion under Delaware law. Initially, Baker Botts sought to recast the matter as an issue of federal law. *See* JX 679 at 7. After accepting that it was a Delaware law question, Baker Botts looked to Skadden for help. *See* JX 770 at 1; JX 772. Skadden, however, only provided a summary of the main Delaware authorities and disclaimed any intent to analyze the Call Right. JX 900 at 2. That fell short of what Baker Botts wanted. *See* JX 913 at 1; *see also* JX 936 at 1. Facing a deadline from Loews, Rosenwasser turned to Richards Layton, but in an effort to obtain advice that would reassure his partners, Rosenwasser provided the Richards Layton attorneys with a misleading description of the factual record. *See* Part I.L, *supra*. Rosenwasser's query resulted in Richards Layton's oral advice that the firm would have a "hard time saying [a decline of 12% in perpetuity is] not material." JX 1007 at 2. Richards Layton later stated that subject to assumptions and carveouts, it would regard as the "better argument" the contention that a 12-13% change **[*205]** in rates in perpetuity was sufficiently material and adverse, but Richards Layton would not let Baker Botts reference its advice in the Opinion. JX 975 at 1; *see* Raju Dep. 113-14.

Baker Botts nevertheless rendered a non-explained opinion to the effect that a 10% decline in indicative rates was reasonably likely to constitute a material adverse effect. Baker Botts, a non-Delaware firm that did not regularly render opinions on complex Delaware issues, did not explain how it reached that conclusion. It did not identify any indicators of materiality that would justify that threshold. It did not discuss and distinguish the well-known and (at that point) unbroken line of transactional cases which had failed to find a material adverse effects, such as *In re IBP S'holders Litig. v. Tyson Foods, Inc., 789 A.2d 14 (Del. Ch. 2001)*, *Frontier Oil Corp. v. Holly Corp., 2005 Del. Ch. LEXIS 57, 2005 WL 1039027 (Del. Ch. Apr. 29, 2005)*, *Hexion Specialty Chemicals, Inc. v. Huntsman Corp., 965 A.2d 715 (Del. Ch. 2008)*, or *Mrs. Fields Brand, Inc. v. Interbake Foods LLC, 2017 Del. Ch. LEXIS 113, 2017 WL 2729860 (Del. Ch. June 26, 2017)*. Baker Botts acted as if it was rendering a third-party closing opinion on a routine issue, which it plainly was not. The fact that Baker Botts rendered a non-explained opinion on the existence of a material adverse effect itself suggests that Baker Botts was serving Loews' interests.

The timing of the Opinion points in the same direction. Given the non-final nature of the Revised Policy, the avalanche of comments that FERC received, **[*206]** the direct linkage between the Revised Policy and the ADIT NOI that Boardwalk itself identified, and the uncertainty regarding the treatment of ADIT, Baker Botts could not have believed in good faith that it could render the Opinion before FERC provided further guidance. There were too many known unknowns. And an opportunity for clarity on these unknowns was on the horizon: FERC was likely to provide more guidance at its meeting on July 19, 2018. Baker Botts needed to wait.

Naeve, the Skadden partner and former FERC Commissioner, candidly observed in real time that Baker Botts should have waited. He wrote to a colleague, "If I were Baker Botts I would prefer to wait until FERC acts on the comments." JX 1076 at 1. Among other things, Naeve noted that the Revised Policy was a "blunt instrument that ignore[d]" the fact that some MLPs (including Boardwalk) were "predominately owned by C-corps that pay federal income taxes." *Id.* Naeve described how "the 5 FERC Commissioners testified before a House Subcommittee and were grilled on this issue and others." *Id.* According to Naeve, "at least one Commissioner appeared to be having second thoughts about whether the Commission had fully considered **[*207]** industry input before acting." *Id.*

Yet Baker Botts pushed ahead. In doing so, Baker Botts gave Loews the ability to exercise the Call Right to maximum effect, during a fleeting period of maximum uncertainty before FERC provided additional information on its future decisions. Rather than exercising reasoned judgment, Baker Botts knowingly served Loews' interests.

5. The Human Dynamics

In the course of evaluating whether the Opinion was rendered in good faith, the court has taken account of the professional and personal incentives that Baker Botts faced. Throughout its work on the Opinion, Baker Botts approached the assignment with an advocate's mindset. "Lawyers by nature tend to be loyal to their clients. This is sort of baked into our professional rules." *Williams Cos., 159 A.3d at 280* (Strine, CJ., dissenting). Baker Botts strived to conclude that the General Partner could exercise the Call Right because that is what its client wanted.

Rosenwasser had an additional, personal incentive to push the limits. He drafted the Call Right, and he understandably wanted that provision to accomplish what his client thought it should do.[25] And Loews was a

---

[25] Loews and Baker Botts recognized that Rosenwasser's prior representation of Boardwalk in connection with its IPO and the drafting of the Partnership Agreement created a conflict of interest, and they called it out in Baker Botts' engagement letter. In an effort to neutralize it, they included the following statement: "We [Baker Botts] believe, and you have agreed, that the prior work by [Rosenwasser and other lawyers] while at Vinson & Elkins LLP for Boardwalk, is not substantially related to the Matter." JX 906 at 2.

That was not true. Under any reasonable understanding of the term, the two matters were "substantially related."

> Beyond switching sides in the same matter, the concept of substantial relationship applies to later developments out of the original matter. A matter is substantially related if it involves the work the lawyer performed for the former client. For example, a lawyer may not on behalf of a later client attack the validity of a document that the lawyer drafted if doing so would materially and adversely affect the former client.

Restatement, *supra*, § 132 cmt. d(ii); *see* *J.E. Rhoads & Sons, Inc. v. Wooters, 1996 Del. Ch. LEXIS 4, 1996 WL 41162, at *4 (Del. Ch. Jan. 26, 1996)* (applying rule to disqualify a firm from litigating a case that involved an employment agreement that was part of a transaction that the firm helped negotiate and document).

This court expresses no view regarding Baker Botts' compliance with the ethical rules, both because in most circumstances any resulting conflict can be waived, and because any ethical issue did not affect the fairness of these proceedings. *Cf.* *In re Appeal of Infotechnology, Inc., 582 A.2d* forceful client. Throughout the events giving rise to this litigation, Alpert **[*208]** demonstrated that he knew how to manipulate his outside counsel so that counsel would deliver the answers that he wanted to receive. Sometimes he did so subtly, as when he called for an immediate teleconference after receiving Wagner's email about the March 15 FERC Actions not being final.[26] Sometimes, he was less subtle, as when he "really beat on Skadden" until they "fell in line," but nevertheless decided to impose a consequence on Skadden by "look[ing] to other firms re potential litigation." JX 1136 at 1.

It is also contextually relevant that the Opinion was rendered for an interested transaction involving an MLP. In the MLP ecosystem, interested transactions abound and become routinized. Governance practices are frequently suboptimal, and the Delaware **[*209]** courts have had cause to question opinions rendered to facilitate transactions (albeit by financial advisors rather than lawyers).[27]

The court recognizes that a parade of lawyers testified that they subjectively acted in good faith. Where, as here, witnesses testify about their intent, the trial judge must "make credibility determinations about [each] defendant's subjective beliefs by weighing witness testimony against objective facts." *Allen v. Encore Energy P'rs, L.P., 72 A.3d 93, 106 (Del. 2013)*. The credibility determination turns in part on "the demeanor of the witnesses whose states of mind are at issue." *Johnson v. Shapiro, 2002 Del. Ch. LEXIS 122, 2002 WL 31438477, at *4 (Del. Ch. Oct. 18, 2002)*. A finding that a witness' account is not credible does not mean that the witness lied. Human recall is not like playing a video tape. The act of remembering shapes recollection, as does the context in which the remembering takes place. A wide range of situational and subjective factors prime and shape first-hand accounts. When a witness' conduct is at issue, and as the witness strives to recall what happened in a setting where a particular set of recollections both supports the witness' self-image and generates a favorable outcome in the case, it is understandable that the witness could come to believe in a personally **[*210]** favorable account, while failing to recall or discounting contrary beliefs or disconfirming evidence.

A finding that a party did not act in good faith does not require a confession. It requires that the plaintiff prove by a preponderance of the evidence that the party in question knew it was not acting legitimately when it performed the actions in question. That finding can be made even if the human actors for that party convince themselves after the fact that they acted properly.

6. The Court's Finding

Based on the foregoing confluence of factors, and the more detailed recitation set forth in the Factual Background, the plaintiffs proved the Opinion did not reflect a good faith effort to discern the facts and apply professional judgment. The Opinion therefore failed to satisfy the Opinion Condition.

The analysis of the Opinion is necessarily holistic. Although this decision has discussed various aspects of the Opinion individually, it is the totality of the evidence that results in the finding that the Opinion did not reflect a good faith effort.

If Baker Botts had only stretched once or twice, or made an isolated counterfactual assumption, then it would not be possible to reject the Opinion. **[*211]** Under those circumstances, the court might have disagreed with Baker Botts' assessments, but those disagreements

---

215, 220 (Del. 1990) (holding that a trial court has no authority to rule on ethical issues involving Delaware lawyers, because that subject falls within the exclusive jurisdiction of the Delaware Supreme Court). The point is rather that the issue created by Rosenwasser's former representation was front and center for everyone. A related point is that the General Partner and Baker Botts attempted to deal with the issue by agreeing to something that was untrue.

[26] *See* JX 616 at 1; *e.g.*, Rosenwasser Tr. 183-84 (testifying about obvious pressure from Alpert and Loews to give a "thumbs up"); JX 1225 (obtaining advice from Richards Layton to push back on Skadden without informing Richards Layton that Loews had already consulted the independent directors); JX 1262 at 1 (bringing in Davis Polk to address what Alpert described as "unusual language" in the Opinion).

[27] *See, e.g., Gerber, 67 A.3d at 422* (holding that plaintiffs stated a claim because a fairness opinion "did not fulfill its basic function"); *In re El Paso Pipeline P'rs, L.P. Deriv. Litig., 2015 Del. Ch. LEXIS 116, 2015 WL 1815846, at *21-22 (Del. Ch. Apr. 20, 2015)* ("[The financial advisor's] work product further undermined any possible confidence in the Committee. . . . [the financial advisor's] actions demonstrated that the firm sought to justify Parent's asking price and collect its fee."); *cf. Allen v. El Paso Pipeline GP Co., 113 A.3d 167, 188 (Del. Ch. 2014)* (denying a motion for summary judgment on an implied covenant of good faith and fair dealing claim where a fairness opinion did not take into account the possibility of excessive dilution), *aff'd*, *2015 Del. LEXIS 107, 2015 WL 803053 (Del. Feb. 26, 2015)* (TABLE).

would not have been sufficient to support a lack of good faith. But here, the record as a whole depicts a contrived effort to generate the client's desired result when the real-world facts would not support it. Baker Botts produced a simulacrum of an opinion, and that flawed imitation did not satisfy the Opinion Condition.

C. The Failure To Satisfy The Acceptability Condition

Before the General Partner could exercise the Call Right, the General Partner also had to satisfy the Acceptability Condition. PA §§ 1.1 at 24, 15.1(b)(ii). The Opinion Condition derives directly from Section 15.1. The definition of "Opinion of Counsel" adds the Acceptability Condition. If the Opinion was not acceptable, then the Acceptability Condition could not be met and the General Partner could not exercise the Call Right.

The General Partner purported to satisfy the Acceptability Condition by having Holdings determine in its capacity as Sole Member of the GPGP that the Opinion was acceptable. But the language of the operative agreements is ambiguous as to whether Holdings or the GPGP Board has the **[*212]** authority to make that determination. One reading of the relevant agreements would recognize Holdings as having that authority. That reading rests on textual hooks in the Partnership Agreement and the LLC Agreement, but it renders the Acceptability Condition surplusage. Another reading of the relevant agreements would recognize the GPGP Board as having the authority to make the acceptability determination. That reading has fewer textual supports but meshes better with the overall structure of the agreements. Both readings are reasonable.

As this decision has discussed, the doctrine of *contra proferentem* applies when a partnership agreement governing an MLP is ambiguous. That doctrine calls for the court to apply the reading that is more favorable to the limited partners. The reading that the GPGP Board had authority to make the acceptability determination is more favorable to the limited partners than a reading in which Holdings, an entity where all of the decision-makers were Loews insiders, had authority to make the acceptability determination in its own interests. Under the *contra proferentem* doctrine, the GPGP Board had the authority to make the acceptability determination. Because **[*213]** it did not, the Acceptability Condition was not satisfied.

1. The Contractual Language

The Acceptability Condition exists because the Call Right uses the defined term, "Opinion of Counsel." PA § 15.1(b). The Partnership Agreement defines "Opinion of Counsel" simply as "a written opinion of counsel . . . acceptable to the General Partner." *Id.* § 1.1 at 24. The Partnership Agreement defines "General Partner" to mean "Boardwalk GP, LP . . . except as the context otherwise requires." *Id.* § 1.1 at 18 (punctuation omitted).

The Partnership Agreement does not go further in defining who determines whether an Opinion of Counsel is acceptable. It does not discuss the internal governance structure of the General Partner or identify what organ within the General Partner would make the acceptability determination. Traditionally, a general partner would be a natural person or an entity with a single governing body, such as a corporation with a board of directors. In that scenario, it would be clear who would make the determination. But Loews chose a more complicated structure. When Loews created Boardwalk, it structured the General Partner as another limited partnership, then installed the GPGP as **[*214]** its general partner. The GPGP is a limited liability company with *both* a board of directors (the GPGP Board) *and* a sole member (Holdings). The GPGP Board has general authority to act on behalf of the GPGP. The Sole Member has specific authority to make certain decisions on behalf of the GPGP.

The Partnership Agreement did not attempt to allocate authority for the acceptability determination among the multiple entities and decision-makers that Loews created. The Partnership Agreement only spoke in terms of action by the General Partner. To the extent that the Partnership Agreement considered the internal structure of the General Partner, it contemplated that the General Partner would have a board of directors. *See, e.g.*, PA § 7.9(a). From a structural standpoint, the Partnership Agreement implied that the General Partner would make decisions through a board of directors.

Rather than assigning authority over different decisions to different actors, the Partnership Agreement distinguished between actions that the General Partner took in an individual capacity and actions that the General Partner took in an official capacity. The Partnership Agreement explains "[b]y way of illustration and **[*215]** not of limitation," that if a provision uses "the phrase 'at the option of the General Partner,' or some variation of that phrase," then that language "indicates that the General Partner is acting in its individual capacity." PA § 7.9(c). The Call Right contains that type of signaling language, so the decision whether to exercise the Call Right is a decision that the General Partner makes in its individual capacity. *See id.* § 15.1(b) (stating that General Partner has the "right . . . exercisable at its option . . . to purchase" all the outstanding limited partner interests so long as it satisfies the preconditions). The Opinion of Counsel definition does not have that signaling language. *See id.* § 1.1 at 24.

Notably, whether the General Partner is acting in an individual capacity or an official capacity does not imply that a different decision-maker makes the decision. If the general partner was a natural person or an entity with a single governing body, such as a corporation with a board of directors, then the same decision-maker would make the decision regardless of whether the general partner was acting in an individual capacity or an official capacity. What would change is the contractual **[*216]** standard of review that would apply to the resulting decision.[28] For present purposes, the issue is *not* what standard of review to apply to the General Partner's decision to exercise the Call Right. The issue is whether the proper decision-maker made the decision.

A limited partner thus could not readily determine from the Partnership Agreement who would make the acceptability determination on behalf of the General Partner. The Partnership Agreement is silent and ambiguous.

Lacking guidance, a limited partner might turn to other sources. A logical next step would be to look to the partnership agreement governing the internal affairs of the General Partner, but no one has suggested that any provision in that agreement would be pertinent.

Still lacking guidance, a limited partner might search further. A sophisticated limited partner might realize that the General Partner was itself a limited partnership with the GPGP as its general partner. A diligent limited partner who pressed on might thus end up at a third agreement: the LLC Agreement governing the internal affairs of the GPGP.

The LLC Agreement also does not clearly address what decisionmaker would make the acceptability **[*217]** determination. The LLC Agreement provides generally that, "[e]xcept as otherwise specifically provided in this Agreement, the business and affairs of the Company shall be managed under the direction of the Board." LLCA § 5.2(a). Section 5.6 creates an exception that gives Holdings "exclusive authority over the business and affairs of the Company that do not relate to management and control of the [Partnership]." *Id.* § 5.6. The LLC Agreement adds that Holdings "shall have exclusive authority to cause the Company to exercise the rights of the Company and those of the MLP General Partner . . . provided in . . . Section 15.1." *Id.* § 5.6(xi) (the "Authority Provision").

The LLC Agreement thus divides the world of possible decisions into two categories. Unlike in the Partnership Agreement, those two categories do not depend on whether the General Partner is acting in an individual capacity or an official capacity. Rather, the categories in the LLC Agreement divide the world into decisions relating to "the business and affairs of the Company," where the GPGP Board has authority, and decisions "that do not relate to management and control of the [Partnership]," where Holdings has authority. **[*218]** The LLC Agreement then adds the Authority Provision to confirm that Holdings has authority over the rights provided in Section 15.1 of the Partnership Agreement. That addition suggests that without the Authority Provision it would be unclear whether the decision to exercise the Call Right fell within the purview of the GPGP Board or Holdings. The lack of clarity that would exist without the Authority Provision is also consistent with the fact that whether an action is done in the General Partner's "individual" or "official" capacity only dictates the applicable standard of review, not which decision-maker makes the decision.

The LLC Agreement also contains a definition of "Opinion of Counsel" that expressly refers to the Sole Member. Unlike the definition of "Opinion of Counsel"

[28] *Compare* PA § 7.9(b) (providing the standard of review for a decision made by the General Partner "in its capacity as the general partner of the Partnership as opposed to in its individual capacity"), *with id.* § 7.9(c) (providing the standard of review for a decision made by the General Partner "in its individual capacity as opposed to in its capacity as the general partner of the Partnership"); *see also* JX 1201 at 48 ("Any exercise by our general partner of its call right is permitted to be made in our general partner's individual, rather than representative, capacity; meaning that under the terms of our partnership agreement our general partner is entitled to exercise such right free of any fiduciary duty or obligation to any limited partner and it is not required to act in good faith or pursuant to any other standard imposed by our partnership agreement.").

that appears in the Partnership Agreement, the definition in the LLC Agreement defines the term as "a written opinion of counsel (which may be regular counsel to the Company or the MLP or any of their respective Affiliates) acceptable to the Sole Member." LLCA § 1.1 at 7. But the LLC Agreement never uses the term "Opinion of Counsel" in any substantive provision. It is a stray definition.

As this discussion shows, **[*219]** none of the constitutive agreements gives a clear answer as to which entity makes the acceptability determination. Instead, the agreements divvy up decisions into categories, including (i) the difference between determining the acceptability of the Opinion and exercising the Call Right, (ii) the difference between action in an official capacity and action in an individual capacity, and (iii) the difference between decisions that relate to "the business and affairs of the Company" and those "that do not relate to management and control of the [Partnership]." When mixed and matched, the three pairs could generate eight combinatorial outcomes.

2. The Competing Arguments

One reasonable reading of the provisions is that Holdings makes the acceptability determination. From a textual perspective, that reading treats the phrase "Opinion of Counsel" as the linguistic version of an equivalency formula, like "X = [the definitional text]." Under this reading, the definitional text is substituted algebraically wherever the "X" appears, such that the full language of the "Opinion of Counsel" definition would be substituted wherever the term "Opinion of Counsel" appears in the Partnership Agreement, **[*220]** including in the Call Right in Section 15.1. The Call Right thus would state that if the General Partner held "more than 50% of the total Limited Partner Interests of all classes then Outstanding" and had received "a written opinion of counsel . . . acceptable to the General Partner" then the General Partner could exercise the Call Right, assuming the Opinion of Counsel satisfied the Opinion Condition. *See* PA §§ 1.1, 15.1(b). At that point, the argument goes, the Authority Provision in the LLC Agreement specifies that Holdings makes decisions regarding the General Partner's rights under Section 15.1, so Holdings has the authority to make the decision as the Sole Member. This reading has an added benefit of giving some purpose to the stray definition of "Opinion of Counsel" in the LLC Agreement. Although the definition is never used, it does refer to Holdings making the determination as Sole Member.[29]

The problem with this analysis is that Holdings always and inherently had the right to determine whether the Opinion is acceptable. Holdings possessed that authority as part of its ability to decide whether or not to exercise the Call Right. If Holdings did not think that the Opinion was **[*221]** acceptable, then Holdings could simply decide not to exercise. Because Holdings always had the ability to make a *de facto* acceptability determination, assigning the acceptability determination to Holdings renders the Acceptability Condition surplusage. Under standard principles of contract interpretation, a Delaware court generally eschews an interpretation that would result in surplusage. *See Sunline Com. Carriers, Inc. v. CITGO Petroleum Corp., 206 A.3d 836, 846 (Del. 2019)*.

When viewed as a whole, the language of the Partnership Agreement suggests that rather than serving as a redundant condition for the benefit of Holdings, the Acceptability Condition exists to protect the Partnership. Both the Opinion Condition and the Acceptability Condition ensure that the General Partner cannot exercise the Call Right arbitrarily without satisfying an up-front test. The Opinion Condition establishes the basic hurdle that the General Partner must clear, and the Acceptability Condition ensures that the General Partner cannot obtain a contrived opinion. The Acceptability Condition is thus not a protection for Holdings, which can always protect itself by deciding not to exercise the Call Right. It is instead a protection for the minority partners. In this regard, the Call Right **[*222]** at issue in this case contrasts with a second call right that the General Partner can exercise without satisfying either the Opinion Condition or the Acceptability Condition, as long as the General Partner owns 80% or more of the common units. *See* PA §

[29] Note that the argument in favor of Holdings making the acceptability determination is not advanced by equating (i) the Partnership Agreement's reference to the General Partner taking action in an official capacity with the LLC Agreement's reference to the GPGP Board having authority over decisions that relate to "the business and affairs of the Company," and (ii) the Partnership Agreement's reference to the General Partner taking action in an individual capacity with the LLC Agreement's reference to Holdings having authority over decisions "that do not relate to management and control of the [Partnership]." Aligning the categories in that way leads to the conclusion that Holdings exercises the Call Right, which is consistent with the Authority Provision. But that conclusion does not address whether the acceptability determination is part of the exercise of the Call Right.

15.1(a). The difference between the two call rights indicates that the Opinion Condition and the Acceptability Condition were intended as meaningful limitations on the General Partner's ability to exercise the Call Right at the lower ownership level.

Viewed within this structure, the acceptability determination logically belongs to the GPGP Board. Only the GPGP Board has outside directors, and only the GPGP Board can inject a measure of independence into the determination of acceptability. The need for some measure of independence becomes critical for the Call Right, because otherwise the General Partner can exercise that right in its individual capacity, free of any duty or constraint whatsoever. The defendants' interpretation would make the General Partner the "judge in [its] own cause." *See Dr. Bonham's Case*, 8 Co. Rep. 107a, 114a, 118a, 77 Eng. Rep. 638, 646, 652 (C.P. 1610) ("[O]ne should not be judge in his own cause, indeed it **[*223]** is unjust for one to be a judge of his own matter; and one cannot be Judge and attorney for any of the parties . . . .").

Against this backdrop, the textual arguments for treating the acceptability determination as a decision for Holdings to make as Sole Member are weaker than they initially seem. To reiterate, the distinction between the General Partner acting in an individual capacity as opposed to an official capacity does not shed light on who makes the acceptability determination. That distinction only determines the standard of review that applies to a decision made by the General Partner, not which entity within the General Partner makes the decision. *See* PA § 7.9(b), (c).

The distinction between the two definitions of "Opinion of Counsel," one in the Partnership Agreement and the other in the LLC Agreement, also appears in a different light. The fact that the LLC Agreement contains a reference to the Sole Member confirms the obvious: the drafters could have included a similar reference in the Partnership Agreement. The fact that they did not implies that the Partnership Agreement did not intend to confer the authority to make the acceptability determination on the Sole Member. ***[*224]*** *See* *Int'l Rail P'rs LLC v. Am. Rail P'rs, LLC, 2020 Del. Ch. LEXIS 345, 2020 WL 6882105, at *9 (Del. Ch. Nov. 24, 2020)* (explaining that evidence of specific language in one agreement but not in a distinct yet related agreement "reflects that the drafters knew how to craft" and include the specific language at issue if they so desired).

Finally, the notion that the acceptability determination becomes part of the exercise of the Call Right also becomes suspect. The Call Right is structured as a conditional option. It first identifies conditions that the General Partner must meet, including receiving an Opinion of Counsel that both addresses the substantive issue identified in the Call Right and does so in an acceptable way. PA § 15.1(b)(ii). The second part of the Call Right provides that *if* the General Partner satisfies those conditions, "*then* the General Partner shall *then* have the right . . . exercisable at its option within 90 days of receipt of such opinion to purchase all, but not less than all, of all Limited Partner Interests then Outstanding held by Persons other than the General Partner and its Affiliates." *Id.* (emphasis added). The conditions for exercise must be satisfied *before* the General Partner can determine whether to exercise it.

As noted previously, the reading that gives Holdings **[*225]** authority over the acceptability determination requires replacing "Opinion of Counsel" with the definitional language for that term. That move does not change the structure of the Call Right. It merely introduces the definitional language into the conditions that must be met before the General Partner can decide whether to exercise the Call Right. It does not change the fact that the condition must be met before the General Partner can act, and it does not address who has authority over evaluating the condition.

The term "Opinion of Counsel" was not drafted specifically for the Call Right. The Partnership Agreement uses it in many substantive provisions. *See, e.g.*, PA §§ 4.6(c), 4.8(b), 7.10(b), 11.1(b), 12.1(a), 12.2(iii), 13.1 (f), 13.3(d), 13.11, 14.3(d),(e). It requires consideration of context to determine who would make the resulting determination. For purposes of the Call Right, the Acceptability Condition remains part of the conditions that must be satisfied *before* the General Partner can exercise the Call Right. It is not part of the decision to exercise the Call Right. It follows that the General Partner's authority to exercise the Call Right in its individual capacity does not mean that it can determine acceptability in its individual capacity. **[*226]** For similar reasons, the Authority Provision does not clearly give the Sole Member the ability to make the acceptability determination as part of the "rights . . . of the General Partner . . . provided in . . . Section 15.1." LLCA § 5.6(xi). The Acceptability Condition is not a right of the General Partner; it is a condition that must be satisfied before the General Partner can exercise its rights.

Ultimately, the path to understand who makes the acceptability determination ends in the marshy distinction that the LLC Agreement makes between an issue that relates to the "business and affairs" of the Partnership, which is conferred to the GPGP Board, and an issue that does "not relate to [the] management and control of the [Partnership]," which is left to the Sole Member. LLCA § 5.6. At first blush, that distinction might seem to track the distinction in the Partnership Agreement between official capacity decisions and individual capacity decisions, but the language is different. To the extent the two concepts do align, there are no textual signals relating to the Acceptability Condition that would suggest that the General Partner makes the acceptability determination in an individual **[*227]** capacity, such that the decision would "not relate to [the] management and control of the [Partnership]."

Instead, the concepts of "business and affairs" and "management and control" hearken to Section 141(a) of the Delaware General Corporation Law, which establishes the capacious scope of authority possessed by a board of directors. *See* 8 Del. C. § 141(a). Landmark Delaware Supreme Court cases establish that decisions about whether a public entity's shares are acquired relate to the business and affairs of the enterprise; a purchase of shares is not exclusively an investor-level transaction between a buyer and seller that falls outside the board's purview.[30] Elsewhere in Section 5.6, the LLC Agreement expressly invokes corporate law principles by stating that "[e]xcept as otherwise specifically provided in this Agreement, the authority and functions of the Board, on the one hand, and the Officers, on the other hand, shall be identical to the authority and functions of the board of directors and officers, respectively, of a corporation organized under the General Corporation Law of the State of Delaware." LLCA § 5.6. Under corporate law principles, a decision that would affect the success of a take-private transaction would relate **[*228]** to the business and affairs of the corporation and fall within the authority of the board of directors. Even without the backdrop of Delaware corporate law, the exercise of the Call Right would "relate to" the management of the Partnership. If the Call Right cannot be exercised, then the General Partner will continue to manage the Partnership as an MLP with minority investors, making regular public filings with the SEC, complying with listing requirements, and experiencing all of the other costs and benefits of public status. If the Call Right is exercised, then the Partnership will no longer be an MLP, and the General Partner can manage the Partnership's affairs solely in the interest of Loews and without the accoutrements of public status. Making the acceptability determination therefore "relate[s] to [the] management and control of the [Partnership]."

There is thus a reasonable reading of the pertinent agreements under which the GPGP Board has the authority to make the acceptability determination. Recognizing the potential merit in that argument, Loews initially intended to have the GPGP Board make the acceptability determination. But the outside directors had a "hostile **[*229]** reaction," and they asked "shouldn't we have independent counsel[?]" JX 874 at 5; *see* Layne Dep. 160. The outside directors recognized the importance of the acceptability determination, and they did not want to be treated as a speedbump on Loews' path to the take-private. The outside directors' reaction shows why the Acceptability Condition exists, *viz.*, it could provide an external check.[31]

3. Counsel's Contemporaneous Recognitions Of Ambiguity

Contrary to the defendants' assertions, all of the lawyers acknowledged the ambiguity that Loews created for the acceptability determination by establishing Boardwalk's complex entity structure. Within Skadden, Voss conducted the most thorough and detailed analysis. After reasoning through the various issues, she expressed the view that "the MLP Agreement likely requires that the [GPGP] Board make the determination to accept the Opinion of Counsel. Or, at a minimum, it is ambiguous." JX 747 at 1.

Skadden later prepared a memorandum for Alpert that framed the analysis more conservatively and with

[30] *See, e.g.*, Moran v. Household Int'l, Inc., 500 A.2d 1346, 1353 (Del. 1985) ("[W]e note the inherent powers of the [b]oard conferred by 8 Del. C. § 141(a), concerning the management of the corporation's 'business and affairs' . . . also provides the [b]oard additional authority upon which to enact the [r]ights [p]lan." (emphasis removed) (citing Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 953 (Del. 1985))).

[31] At trial, two defense witnesses disputed whether the outside directors had a "hostile" reaction. McMahon Tr. 535; Siegel Tr. 738. It is not clear why the witnesses quibbled over this point. They agreed that the outside directors were uncomfortable with the determination and did not want to be involved. McMahon Tr. 535; Siegel Tr. 738.

additional caveats and qualifications. The memorandum nevertheless made clear that there were ambiguities surrounding the acceptability determination. ***[*230]*** *See* JX 773 at 1, 3. And when advising Holdings about whether it could accept the Opinion, Skadden would say only that it was reasonable for Holdings to conclude that it had the authority to make the acceptability determination. *See* JX 1508 at 3. Even during his deposition, the farthest that Grossman would go in favor of the defendants' current view is that "the better reading" was for the GPGP Board to make the decision. Grossman Dep. 70-71.

Richards Layton also saw both sides of the interpretive coin. In contrast to Skadden's more detailed analysis, Richards Layton gave advice orally on a twenty-four hour turnaround, and without knowing that Loews had already received advice from Skadden and contacted the members of the GPGP Board about making the acceptability determination. In the initial call with Alpert, Richards Layton went beyond Grossman by an adverb, saying it was the "far better view" that Holdings could make the acceptability determination. Raju Tr. 808, 842. Only after receiving Richards Layton's oral advice did Alpert tell Richards Layton about Skadden's view. No one told Richards Layton about Loews' outreach to the GPGP Board until this litigation.

After receiving Richards **[*231]** Layton's oral advice, Alpert asked the firm to memorialize its advice in an email. JX 1225 at 1. The email backed away from the oral advice by removing the adverb, stating: "While there is some ambiguity and arguments can certainly be made to the contrary, we think that *the better view* is that the [acceptability determination] is within the sole authority of the Sole Member [Holdings] pursuant to Section 5.6 of the LLC Agreement." *Id.* at 2-3 (emphasis added). The email included the following caveat:

> [I]f the Board of Directors is approached and declines to determine that the Opinion of Counsel is acceptable and the Section 15.1(b) call right is exercised by the Sole Member anyway, *that would be a difficult fact to overcome in any future litigation* regarding the exercise of the Section 15.1(b) call right.

Id. at 3 (emphasis added). Richards Layton did not know that the GPGP Board had been approached already about making the decision. *See* Raju Tr. 843. At Alpert's request, Richards Layton later revised its email to restore the adverb, but it kept the caveats. *See* JX 1265 at 4.

Even Baker Botts never opined explicitly that the plain language of the Partnership Agreement and the LLC Agreement made clear that Holdings **[*232]** made the acceptability determination. In its initial advice to Alpert, Baker Botts wrote that "[i]t *seems* that determination of the acceptability of an opinion of counsel in the context of Section 15.1(b) should be made by the Sole Member as opposed to the board of directors of the General Partner." JX 686 at 4 (emphasis added). After obtaining advice from Skadden and Richards Layton, Baker Botts still only would go so far as to describe that as the "better view," while noting that "arguments can be made to the contrary." JX 1508 at 40.

The lawyer who asserted most strongly that the Partnership Agreement gave the General Partner the authority to make the acceptability determination was Layne. He never prepared any written analysis, and he seems originally to have credited the argument that the GPGP Board would determine acceptability.[32] After the outside directors on the GPGP Board expressed their displeasure about being involved in the acceptability determination, Alpert tapped Layne to explain why they no longer had to address the issue. At that point, Layne seems to have lumped together the issue of the authority to exercise the Call Right with the issue of the authority to determine **[*233]** acceptability.[33] The vacillation in Layne's views is also consistent with the ambiguity inherent in the Acceptability Condition.

4. Ambiguity Means The GPGP Board Had To Make The Acceptability Determination.

Because the question of who could make the acceptability determination was ambiguous, well-settled interpretive principles require that the court construe the agreement in favor of the limited partners. *See* *Norton, 67 A.3d at 360*. Under the interpretation that favors the

---

[32] When reviewing a draft of a memorandum from Richards Layton which explained that Section 5.6 "specifies that the Sole Member has exclusive authority to cause GP LLC to exercise the rights of GP LLC," Layne commented, "but not to determine applicability." JX 1810 at 3. Next to another sentence that stated that Holdings decided whether the Opinion of Counsel was acceptable "pursuant to Section 5.6 of the LLC Agreement because the determination to accept the Opinion of Counsel is a part of Section 15.1 of the Partnership Agreement," Layne wrote "not exercise." *Id.*

[33] *See* JX 1325; JX 1331 at 2; JX 1343; JX 1435 at 1, 3; JX 1812.

limited partners, the GPGP Board had the authority to make the acceptability determination. Because the GPGP Board did not make the acceptability determination, the General Partner breached the Partnership Agreement by exercising the Call Right.

D. Contractual Immunity To Damages

The defendants maintain that even if the General Partner breached the Partnership Agreement and otherwise would be responsible for damages, the plaintiffs cannot recover because the defendants immunized themselves contractually against any damages award. There are two relevant provisions in the Partnership Agreement. The first is a true exculpation provision. The second is a provision that establishes a conclusive presumption of good faith if the General Partner **[*234]** or another decision-maker relies on an advisor. The General Partner cannot rely on either of them to escape liability in this case.

1. The Exculpation Provision

Section 17-1101(f) of the Delaware Revised Uniform Limited Partnership Act authorizes a partnership agreement to eliminate "any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a partner or other person to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement," other than "any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing." *6 Del. C. § 17-1101(f)*.

The Partnership Agreement takes full advantage of this statutory authority. Section 7.8(a) states:

> Notwithstanding anything to the contrary set forth in this Agreement, no Indemnitee shall be liable for monetary damages to the Partnership [or] the Limited Partners . . . for losses sustained or liabilities incurred as a result of any act or omission of an Indemnitee unless there has been a final and non-appealable judgment entered by a court of competent jurisdiction determining that, in respect of the matter in question, the **[*235]** Indemnitee acted in bad faith or engaged in fraud, [or] willful misconduct . . . .

PA § 7.8(a). The Partnership Agreement defines "Indemnitee" to include the "General Partner," "any Person who is or was an Affiliate of the General Partner," and "any Person who is or was a member, partner, director, officer, fiduciary or trustee of . . . the General Partner or any Affiliate of . . . the General Partner." *Id.* § 1.1 at 19.

Under this provision, to recover damages from the General Partner, the plaintiff must prove that the General Partner "acted in bad faith or engaged in fraud [or] willful misconduct." *Id.* § 7.8(a). The Partnership Agreement does not define these terms. Under Delaware law, however, all three require a showing of *scienter*.

The exception for willful misconduct best fits the facts of this case. That term requires a showing of "intentional wrongdoing, not mere negligence, gross negligence or recklessness." *Dieckman v. Regency GP LP, 2021 Del. Ch. LEXIS 28, 2021 WL 537325, at *31 (Del. Ch. Feb. 15, 2021)* (quoting *12 Del. C. § 3301(g)*), *aff'd per curiam*, No. 92, 2021, slip op. (Del. Nov. 3, 2021); *see Willful Misconduct*, BLACK'S LAW DICTIONARY (11th ed. 2019) ("Misconduct committed voluntarily and intentionally."). The concept of misconduct involves "unlawful, dishonest, or improper behavior, **[*236]** esp. by someone in a position of authority or trust." *Misconduct*, BLACK'S LAW DICTIONARY (11th ed. 2019).

While serving as a member of this court, Chief Justice Strine described two situations that could support a finding of willful misconduct. *See* *Gotham P'rs, L.P. v. Hallwood Realty P'rs, L.P., 2000 Del. Ch. LEXIS 146, 2000 WL 1476663 (Del. Ch. Sept. 27, 2000)*. A limited partner of an MLP asserted that the general partner "designed" a series of transactions "to entrench its owner [Hallwood Group Incorporated ("HGI")], by placing a large number of [partnership] units in HGI's hands at an unfairly low price." *2000 Del. Ch. LEXIS 146 [WL] at *3*. The limited partner also asserted that the general partner "timed the [t]ransactions so as to enable HGI to grab up a control block at a depressed price." *Id.* Chief Justice Strine held on a motion for summary judgment that the plaintiffs could not prove a claim for fraud, but that the ruling did not eliminate the possibility that the plaintiffs could prove willful misconduct. Possible scenarios included if the general partner or its affiliates

> (i) purposely misled the [independent directors] about (a) the underlying value of the [p]artnership units or (b) the ability of the [p]artnership to get a higher price for the units than HGI was willing to

> pay, (ii) in order to induce the [independent **[*237]** directors] to approve a sale to HGI at an unfair price.

2000 Del. Ch. LEXIS 146, [WL] at *14. Another possible scenario that would provide evidence of willful misconduct involved the general partner having "a secret plan to snatch up a large number of units that could entrench it at a bargain price before an expected up-turn in the market and did not disclose that plan to the [independent directors]." *Id.*

Striving to limit the conceptual space available for a finding of willful misconduct, the defendants argue that the court must (i) focus on the three individuals who comprised the Holdings board (Siegel, Keegan, and Wang), (ii) examine their individual states of mind when deciding to exercise the Call Right, and (iii) deny any recovery to the class unless all three acted with *scienter*. The defendants would have the court ignore all of the other actors in the drama and all of the events leading up to the decision to exercise the Call Right.

If the court were deciding whether to hold Siegel, Keegan, or Wang personally liable for their decision to exercise the Call Right, such as under a tortious interference theory, then that mode of analysis might be warranted. But the plaintiffs are seeking to recover damages from the **[*238]** General Partner, not those three individuals.

"A basic tenet of corporate law, derived from principles of agency law, is that the knowledge and actions of the corporation's officers and directors, acting within the scope of their authority, are imputed to the corporation itself." Stewart v. Wilm. Tr. SP Servs., Inc., 112 A.3d 271, 302-03 (Del. Ch. 2015), *aff'd*, 126 A.3d 1115 (Del. 2015); *see* Teachers' Ret. Sys. of La. v. Aidinoff, 900 A.2d 654, 671 n.23 (Del. Ch. 2006); Restatement (Third) of Agency § 5.03 Westlaw (Am. L. Inst. database updated Oct. 2021). That principle extends to alternative entities like the General Partner. *See* CompoSecure, L.L.C. v. CardUX, LLC, 206 A.3d 807, 823-24 (Del. 2018). "An entity ... can only make decisions or take actions through the individuals who govern or manage it." Dieckman, 2021 Del. Ch. LEXIS 28, 2021 WL 537325, at *36 (quoting Gerber v. EPE Hldgs., LLC, 2013 Del. Ch. LEXIS 8, 2013 WL 209658, at *13 (Del. Ch. Jan. 18, 2013) (omission in original)).

During the relevant period, numerous individuals acted on behalf of the General Partner in a manner sufficient to impute *scienter* to the General Partner. During the relevant period, Alpert, Siegel, McMahon and Johnson were management-level officers and agents of Loews, Holdings, the GPGP, the General Partner, and Boardwalk. Their actions and intent were imputed to the General Partner. Together, those individuals orchestrated the sham Opinion, supported the sham Opinion with the inadequate Rate Model Analysis, and diverted the acceptability determination for the sham Opinion from the GPGP Board to Holdings.

In addition, Baker **[*239]** Botts acted as counsel to the General Partner in rendering the Opinion. A lawyer acts as an agent for its client, and the lawyer's knowledge is imputed to the client for matters within the scope of the lawyer's agency. *Vance v. Irwin, 619 A.2d 1163, 1165 (Del. 1993)*. Ordinarily, an issue would exist about whether to impute an attorney's knowledge to the client when the attorney did not act in good faith. Here, however, the General Partner wanted Baker Botts to render the Opinion and pushed for the outcome that Baker Botts reached. Under the circumstances, Baker Botts' *scienter* in issuing the Opinion can be attributed to the General Partner.

The General Partner engaged in "intentional wrongdoing . . . designed to . . . seek an unconscionable advantage." *Dieckman, 2021 Del. Ch. LEXIS 28, 2021 WL 537325, at *36* (quoting *12 Del. C. § 3301(g)*). The General Partner and Baker Botts pasted together an Opinion intended to achieve the goal of enabling the General Partner to exercise the Call Right. That conduct is sufficient to render the exculpatory provision inapplicable.[34]

2. The Conclusive Presumption

---

[34] The parties have not addressed who has the burden to prove that the exculpatory provision applies. Authorities demonstrate persuasively that the General Partner should bear this burden. In the analogous context of corporate law exculpation, the director defendants must prove that they fall within the exculpatory provision's protections. *See* *Emerald P'rs v. Berlin, 726 A.2d 1215, 1223-24 (Del. 1999)*. For purposes of a breach of contract claim, the exculpatory provision operates as an exception to normal principles of contract liability. As a matter of hornbook law, "[a] party seeking to take advantage of an exception to a contract is charged with the burden of proving facts necessary to come within the exception." *29 Am. Jur. 2d Evidence § 173*, Westlaw (database updated Aug. 2021). This decision has nevertheless analyzed the question of *scienter* as if the plaintiffs bore the burden of proof.

Section 17-407(c) of the Delaware Revised Uniform Limited Partnership Act states that a general partner

> shall be fully protected from liability to the limited partnership, its partners or other persons party to or otherwise bound by the partnership agreement in relying in good **[*240]** faith upon . . . opinions, reports or statements presented . . . by any . . . person as to matters the general partner reasonably believes are within such . . . person's professional or expert competence . . . .

6 Del. C. § 17-407(c).

The Partnership Agreement supercharges this statutory concept by providing as follows:

> The General Partner may consult with legal counsel . . . and any act taken or omitted to be taken in reliance upon the advice or opinion (including an Opinion of Counsel) of such [counsel] . . . shall be conclusively presumed to have been done or omitted in good faith and in accordance with such advice or opinion.

PA § 7.10(b) (the "Reliance Provision").

The General Partner cannot invoke the Reliance Provision when it knows that the opinion in question was contrived to generate a result. Under those circumstances, the General Partner is not relying on the contrived opinion. The opinion is window dressing to enable the General Partner to take action.

That reality prevents the General Partner from relying on the Opinion for purposes of the Reliance Provision. The General Partner not only knew the Opinion was contrived, but the General Partner's representatives participated actively in the manufacturing of **[*241]** the Opinion.

The General Partner also cannot rely on Skadden's advice about the acceptability of the Opinion. As a threshold matter, it is not clear that the Reliance Provision envisions opinions like Matryoshka dolls, in which counsel renders an opinion, then another counsel opines on the opinion, and so on, with the breadth of protection expanding at each level. If anything, the procuring of a second opinion can be a tell, implying inadequacies or taints in the original opinion. Boards often retain a second investment banker when they learn that their chosen banker has a conflict of interest that could render its advice suspect. At least in that setting, the second banker addresses the core issue. Here, Skadden refused as a matter of firm policy to opine on the core issue and instead provided an opinion about an opinion.

Regardless, the Reliance Provision only protects the General Partner when it actually relies on the underlying opinion, not when it manufactures the opinion and then gets another opinion to whitewash the first one. No matter what Skadden said about the Opinion, the General Partner knew how the Opinion came about, including that it addressed hypothetical maximum rates **[*242]** in a setting where the regulatory changes were not yet final and were unlikely to have any meaningful real-world effect. Under those circumstances, the General Partner cannot invoke the Reliance Provision.

Finally, the General Partner cannot invoke the Reliance Provision for purposes of the Acceptability Condition because the wrong decisionmaker considered the issue. The General Partner knew about the ambiguity surrounding the acceptability condition. The General Partner opted for the decisionmaker more favorable to its interests rather than the decisionmaker more favorable to the interests of the limited partners. With the wrong decisionmaker having acted, the General Partner cannot claim to have relied validly on Skadden's advice.

E. Damages

Having found that the General Partner breached the Partnership Agreement, and having concluded that the General Partner can be held liable for damages, the next step is to determine whether the plaintiffs suffered damages, and if so, the amount of a damages award. The plaintiffs proved that by exercising the Call Right in breach of the Partnership Agreement, the General Partner inflicted damages on the class of $689,827,343.38. Plaintiffs are entitled **[*243]** to pre- and post-judgment interest on that amount. As the prevailing party, the plaintiffs are also entitled to an award of fees.

> [T]he standard remedy for breach of contract is based upon the reasonable expectation of the parties *ex ante*. This principle of expectation damages is measured by the amount of money that would put the promisee in the same position as if the promisor had performed the contract. Expectation damages thus require the breaching promisor to compensate the promisee for the promisee's reasonable expectation of the value of the breached contract, and, hence, what the promisee lost.

Duncan v. Theratx, Inc., 775 A.2d 1019, 1022 (Del. 2001).

An injured party "need not establish the amount of damages with precise certainty where the 'wrong has been proven and injury established.'" Siga Techs., Inc. v. PharmAthene, Inc., 132 A.3d 1108, 1131 (Del. 2015) (quoting Del. Express Shuttle, Inc. v. Older, 2002 Del. Ch. LEXIS 124, 2002 WL 31458243, at *15 (Del. Ch. Oct. 23, 2002)). "[D]oubts about the extent of damages are generally resolved against the breaching party." Id. at 1131. "Public policy has led Delaware courts to show a general willingness to make a wrongdoer 'bear the risk of uncertainty of a damages calculation where the calculation cannot be mathematically proven.'" Beard Rsch., Inc. v. Kates, 8 A.3d 573, 613 (Del. Ch. 2010) (quoting Great Am. Opportunities, Inc. v. Cherrydale Fundraising, LLC, 2010 Del. Ch. LEXIS 15, 2010 WL 338219, at *23 (Del. Ch. Jan. 29, 2010) (collecting cases)). That said, expectation damages "should not act as a windfall." Paul v. Deloitte & Touche, LLP, 974 A.2d 140, 146 (Del. 2009).

The plaintiffs proved that the General Partner breached **[*244]** the Partnership Agreement by exercising the Call Right without meeting the necessary conditions. By exercising the Call Right improperly, the General Partner deprived the plaintiffs of the stream of distributions that they otherwise would have received as unitholders. The appropriate measure of damages is therefore the difference between the present value of those future distributions and the transaction price. The transaction price is undisputed. The General Partner paid $12.06 per unit when it exercised the Call Right. Unsurprisingly, the parties dispute the present value of the future distributions, and they presented drastically different estimates to the court.

To make their respective cases, both sides presented damages experts. J.T. Atkins submitted a report and testified on behalf of the plaintiffs. Atkins has been involved in numerous M&A financing and restructuring transactions in the energy and MLP sectors, and has acted as an expert witness in thirteen separate litigations involving energy companies or MLPs. Atkins Tr. 1018. R. Glenn Hubbard submitted a report and testified on behalf of the defendants. Hubbard is a professor at Columbia University's business school and has **[*245]** testified as an expert before this court on matters of valuation on numerous occasions. JX 1745 (Hubbard Report) ¶¶ 2, 5.

Atkins measured damages using a discounted distribution model (a "Distribution Model"). He calculated the fair value of the units to be $17.84 at the low end and $19.30 at the high end, resulting in a range of damages from $720 million to $901.6 million. JX 1761 (Atkins Rebuttal Report) ¶ 2(d).

Hubbard also prepared a Distribution Model, but he discarded it in favor of a valuation based on the market price of Boardwalk's units. Using his market price metric, Hubbard opined that the fair value of the units was $10.74 per unit. Hubbard Report ¶ 9. Because that value was less than the Call Right exercise price, he concluded that the plaintiffs suffered no damages.

Hubbard's approach was not persuasive. This decision uses Atkins' model with one modification.

1. Hubbard's Approach

After considering several valuation indicators, Hubbard opined that the best evidence of the value of the units was their unaffected market price. In reaching this conclusion, Hubbard examined various jurisprudential indicators of market efficiency and concluded that when applied to Boardwalk's **[*246]** units, those indicators were "generally consistent with . . . trading in an efficient market." Hubbard Report ¶ 71.

To derive a measure of damages based on the unaffected market price, Hubbard could not simply use the market price on the date of the Call Right, because the Potential Exercise Disclosures and the self-referential mechanic in the Purchase Price calculation drove the market price downward. To derive an unaffected market price, Hubbard started with the market price on the last trading day before the issuance of the Potential Exercise Disclosures, then used a regression analysis to bring the market price forward to the date on which Loews exercised the Call Right. *See id.* ¶ 89. Based on this analysis, Hubbard concluded that the unaffected market price of the units would have been lower than the Purchase Price. He therefore opined that the limited partners did not suffer any damages. *Id.* ¶ 9.

Hubbard's analysis is not persuasive because he failed to account for the General Partner's control over the Partnership and the resulting valuation overhang. A market for a company's shares "is more likely efficient, or semi-strong efficient, if it has . . . no controlling stockholder." **[*247]** [35] Conversely, a market for a company's shares is less likely to be efficient if it has a controlling stockholder. The presence of a controlling stockholder matters because "participants will perceive the possibility that the controller will act in its own interests and discount the minority shares accordingly." *In re Appraisal of Regal Ent. Gp., 2021 Del. Ch. LEXIS 93, 2021 WL 1916364, at *26 (Del. Ch. May 13, 2021)* (emphasis removed) (declining to rely on unaffected trading price given the presence of a controlling stockholder); *accord* *Glob. GT v. Golden Telecom, Inc., 993 A.2d 497, 503, 508-09 (Del. Ch. 2010)*, *aff'd*, *11 A.3d 214 (Del. 2010)*. It is undisputed that Loews controlled the Partnership through the General Partner. Hubbard's starting point—the supposedly unaffected market price on the last trading date before the issuance of the Potential Exercise Disclosures—was thus not a reliable estimate of fair value.

Hubbard's analysis also failed to account for the fact that the market did not possess material information about the level of distributions that Boardwalk could make in the future. "Under the semi-strong form of the efficient capital markets hypothesis, the unaffected market price is not assumed to factor in nonpublic information." *Verition P'rs Master Fund Ltd. v. Aruba Networks, Inc., 210 A.3d 128, 140 (Del. 2019)*. Consequently, it is inappropriate to rely on the unaffected trading price as a measure of value when there is "material, nonpublic **[*248]** information" which "could not have been baked into the public trading price." *Id. at 139*.

In this case, Loews projected internally that the Partnership's distributions would quadruple in 2023. *See* JX 1529, "Side Model" tab. Because Loews controlled the Partnership, Loews had the ability to make that happen. The market was not aware of Loews' internal projections, and the unaffected trading price of the units could not and did not reflect this information. *See* *Dell, 177 A.3d at 25-26* (explaining that "valuation gaps" can occur when "information fail[s] to flow freely or . . . management purposefully temper[s] investors' expectations for the [c]ompany so that it [can] eventually take over the [c]ompany at a fire-sale price"). By relying on the unaffected trading price, Hubbard's approach failed to take into account this source of value.

Hubbard's analysis of the trading price does not provide a reliable damages estimate. This decision therefore declines to use it.

2. Atkins' Approach

Atkins provided a damages estimate using a Distribution Model. That methodology is a variant of a discounted cash flow analysis, but instead of discounting future cash flows at the entity level, the Distribution Model discounts the value of **[*249]** expected future distributions at the investor level. Because the Distribution Model only looks at returns to the equity, the discount rate is the company's cost of equity capital. Atkins Tr. 1022. As Hubbard acknowledged, a Distribution Model is a "customary" method for valuing units in an MLP.[36]

The principal inputs to a Distribution Model are cash flow projections, the company's cost of equity capital, and a terminal growth rate. Atkins Tr. 1025-26. The defendants do not dispute Atkins' cost of equity capital or his terminal growth rate. In both cases, Atkins used more conservative figures than Hubbard used in his competing Distribution Model. *See* Hubbard Tr. 1195.

The defendants focused their attack on the cash flow projections that Atkins used. Thus, the central question is whether the cash flow projections were sufficiently reliable to use for valuation purposes.

"When evaluating the suitability of projections, Delaware cases express a strong preference for management projections prepared in the ordinary course of business and available as of the date of the [transaction]." *Regal*

[35] *Dell, Inc. v. Magnetar Glob. Event Driven Master Fund Ltd., 177 A.3d 1, 25 (Del. 2017)*; *In re Appraisal of Stillwater Mining Co., 2019 Del. Ch. LEXIS 320, 2019 WL 3943851, at *51 n.22 (Del. Ch. Aug. 21, 2019)* (collecting research supporting the reliability of unaffected trading price in absence of controlling stockholder), *aff'd sub nom.* *Brigade Leveraged Cap. Structures Fund Ltd. v. Stillwater Mining Co., 240 A.3d 3 (Del. 2020)*.

[36] Hubbard Tr. 1194; *see* JX 397 at 15 (industry analyst white paper stating that "[t]he methodology we prefer [for valuing MLPs] is the distribution discount model"); JX 423 at 85 (industry analyst white paper stating that "[o]ur primary tool for valuing MLPs is a three-stage distribution (dividend) discount model"); JX 429 at 3 (analyst report valuing the Partnership using a Distribution Model); JX 431 at 10 (same); JX 523 at 4 (same); JX 1223 at 8 (same); *see also* JX 451 at 29 (analyst white paper using the same methodology but calling it a "Dividend Discount Model"). Hubbard prepared his own Distribution Model to "corroborat[e]" his damages estimate. Hubbard Report ¶¶ 150-51, 155, Ex. 32A.

Ent. Gp., 2021 Del. Ch. LEXIS 93, 2021 WL 1916364, at *21 & n.17 (collecting cases). "[L]itigation-driven projections" are less likely to be reliable and therefore **[*250]** are disfavored. Gray v. Cytokine Pharmasciences, Inc., 2002 Del. Ch. LEXIS 48, 2002 WL 853549, at *8 (Del. Ch. Apr. 25, 2002). Relying on ex post, litigation-driven projections creates an "untenably high" risk of "hindsight bias and other cognitive distortions." Agranoff v. Miller, 791 A.2d 880, 891-92 (Del. Ch. 2000); *accord* Owen v. Cannon, 2015 Del. Ch. LEXIS 165, 2015 WL 3819204, at *22 (Del. Ch. June 17, 2015) (finding that "the after-the-fact projections . . . created for purposes of this litigation are tainted by hindsight bias and are not a reliable source to determine the fair value of [the] shares" (footnotes omitted)).

Both experts relied on a model that the Loews management team prepared (the "Loews Model"). The Loews Model started from a five-year plan that Boardwalk's management team created in the ordinary course of business. Siegel Dep. 115; *see* Siegel Tr. 754-55. The Loews management team then extended the five-year plan to the year 2029. In the course of assisting Loews senior executives in determining whether to exercise the Call Right, the Loews management team modified and refined their model many times. *See, e.g.*, JX 767; JX 881; JX 1485; JX 1529.

Atkins used version ninety-one of the Loews Model. That version was the last one that the Loews management team prepared before the Loews board of directors met on June 29, 2018, and decided to cause the General Partner to exercise the Call Right. *See* JX 1529. Hubbard **[*251]** used version ninety of the Loews Model, which was the immediately preceding version. *See* JX 1485. The two versions are virtually identical, and both project the same amount of distributions. *Compare* JX 1485, "Side model" tab, Row 20, *with* JX 1529, "Side model" tab, Row 20.

Both experts agreed that the Loews Model was an appropriate starting point for a Distribution Model. The court concurs. The Loews Model started from a five-year plan prepared in the ordinary course of business, and the Loews management team refined it so it could be used in real time to make a $1.5 billion dollar investment. The projections were not created for litigation, nor is there any other reason to doubt their accuracy.

Both experts nonetheless made adjustments to the Loews Model. Hubbard made multiple modifications to the cash flow projections. Atkins kept the cash flow projections in the Loews Model, but he eliminated a reduction in EBITDA from the forecast. This decision declines to adopt any of the adjustments and uses the Loews Model in its original form.

a. Hubbard's Adjustments To The Loews Model

For purposes of his Distribution Model, Hubbard arbitrarily removed the projections for 2028 and 2029 from the **[*252]** Loews Model. *See* Hubbard Report Ex. 25. By doing so, Hubbard shortened the projection period and changed the cash flows for the terminal period. *See id.* Ex. 32A. Hubbard did not provide a persuasive explanation for this change. Hubbard was serving as a litigation expert, and he lacked prior experience with MLPs in general and Boardwalk's business in particular. There is no reason to believe that Hubbard had a better understanding of Boardwalk's prospects than the Loews management team.

Hubbard also eliminated the distributions in the out-years of the Loews Model. Hubbard claimed that he reduced the projections "so that the forecasts for the terminal period would reflect a more realistic and sustainable steady state." JX 1759 (Hubbard Rebuttal Report) ¶ 10. That explanation was conclusory and unpersuasive.

In addition, Hubbard progressively increased the projected capital expenditures for the years 2023-2027. *Compare* JX 1529, "Side model" tab, *with* Hubbard Report Ex. 25. Hubbard allocated all capital expenditures to maintenance capital, which reduced the projected distributions during those years. *See* Hubbard Report ¶ 114; Atkins Rebuttal Report ¶ 26. By the year 2027, Hubbard's approach **[*253]** resulted in more than double the expenditures of maintenance capital than the Loews management team had projected. *See* Atkins Rebuttal Report ¶ 26 tbl. 1. That was neither reasonable nor persuasive.

Hubbard's modifications to the Loews Model caused distributions to decline over time. Hubbard Report Ex. 32A. The high point for distributable cash flow in Hubbard's model was 2022, the last year before Hubbard's modifications kicked in. *See id.* After that, the value of the distributions declined steadily. Atkins explained persuasively that such a result was counterintuitive, both in terms of the underlying business and given Loews' decision to exercise the Call Right:

> [I]nstead of having the normal projections where

> you have a slow and steady growth in your distributions, [Hubbard's] assumptions . . . push distributions downward. Why would Loews. . . not just sell the business, get out of this business, if it really believed that [the] distributions would decline as opposed to go up over time?

Atkins Tr. 1057.

Hubbard made these adjustments based on an interview with two Loews executives. Hubbard Report ¶ 106 n.161. Hubbard claimed that the executives told him that, "Loews focused mostly on **[*254]** the period 2018 through 2022 and [that] their assumptions for 2023 through 2029 were vetted less rigorously." Hubbard Report ¶ 106 n.161. The executives' account was self-serving, and the defendants could not produce any documents to support it. *See* JX 1752. The defendants also did not call either executive at trial to support Hubbard's assertion. Instead, they called Siegel, who knew next to nothing about the Loews Model.[37]

This court has rejected expert opinions when the experts downsized management projections for purposes of litigation. While serving as a member of this court, Chief Justice Strine rejected an expert's opinion that was based "on a substantial negative revision of . . . projections that he came up with after discussions with [the company's] managers after the valuation date." *Agranoff, 791 A.2d at 891*. A party seeking to vary from reliable projections must "proffer legitimate reasons to vary from the projections." *Prescott Gp. Small Cap, L.P. v. Coleman Co., Inc., 2004 Del. Ch. LEXIS 131, 2004 WL 2059515, at *21 (Del. Ch. Sept. 8, 2004)* (internal quotation marks omitted). To proffer legitimate reasons, a party must offer more than just "reliance on management's off-the-record denigrations of its own projections." *Id.* "Any other result would condone allowing a company's management or board **[*255]** of directors to disavow their own data in order to justify a lower valuation . . . ." *Gray, 2002 Del. Ch. LEXIS 48, 2002 WL 853549, at *8*. The same reasoning supports rejecting Hubbard's modifications to the Loews Model.

This court likewise has rejected a valuation opinion when the expert increased capital expenditures without good reason, thereby reducing cash flows. *See In re Emerging Commc'ns, Inc. S'holders Litig., 2004 Del. Ch. LEXIS 70, 2004 WL 1305745, at *15 (Del. Ch. May 3, 2004)*. Hubbard did the same thing. As Atkins explained, Hubbard's changes were inconsistent with "Boardwalk's actual operational history." Atkins Rebuttal Report ¶ 27. Maintenance capital expenditures for pipelines are "normally significantly less than depreciation," and Boardwalk's "maintenance capital expenditures were on average 39.3% of depreciation expense." Atkins Rebuttal Report ¶¶ 28-29 (quoting Credit Suisse, *CS MLP Primer — Part Deux* 14 (Nov. 23, 2011)). Hubbard projected that maintenance capital expenditures would increase to 61.7% of depreciation by the terminal year of his Distribution Model. Atkins Rebuttal Report ¶ 29; *see id.* Ex. B. at 46. That percentage exceeded Boardwalk's historical levels and the levels at eleven of twelve comparable MLPs. *Id.* ¶ 29 tbl. 2.

b. Atkins' Adjustment To The Loews Model

Atkins made one modification to the Loews Model. The Loews **[*256]** management team included a "switch" in the Loews Model labeled "FERC Impact," which enabled a user to toggle between three possible scenarios: "Base FERC Impact," "Downside FERC Impact," and "Off," meaning no FERC impact (the "FERC Switch") The first two options—Base FERC

---

[37] *See* Siegel Tr. 755 ("Q: By April 4th your team was up to Version 25 of the model; right? A: I don't know."); *id.* at 756-57 ("Q: By April 9th, your team had built a switch into the model; correct?" A: I don't know. Q: You could toggle the switch from base FERC impact to downside FERC impact or to off; correct? A: Don't know. . . . I never studied the actual model itself and how it was put together, so I can't comment. Q: If the switch was toggled to downside FERC impact, the model would show a hit to EBITDA from the refund to ADIT from the customers; correct? A: I don't know. Q: If the switch was off, the model would show no hit to EBITDA; correct? A: I don't know. Q: On April 9th, your team was at Version 39 of the Loews' [sic] model; correct? A: Don't know."); *id.* at 758 ("Q: By that point, the model was up to Version 43; correct? A: Again, I don't know."); *id.* at 761-62 ("Q: Barclays gave input to Ms. Wang about the model; correct? A: I don't know."); *id.* at 763 ("Q: First of all, [the Loews Model] initially went out ten years; correct? A: I don't know. . . . Q: Version 43 of the model goes out 12 years; isn't that right? A: I have no recollection of seeing that model or many of the models you've referred to."); *id.* at 764 (Q: "Isn't it true that the incentive distribution rights kick in in years 11 and 12 of the Loews' [sic] model? A. I don't know. I'm not sure I've seen the model. Q. That's why the model goes out 12 years; right, Mr. Siegel? A. I don't know."); *id.* at 765 ("Q: Isn't it true that there are 91 versions of this model, Mr. Siegel? A. I have no idea."); *id.* at 766 ("Q: Isn't it true that Version 91 of the model was used to prepare the June 29th Loews' [sic] board deck? A. I don't know. Q. Isn't it true that the inputs or the pages of the Loews' [sic] June 29th board deck come directly from Version 91 of the model? A. I don't know. I'm not sure I've seen Version 91 of the model. Q. Isn't it true that your expert in this case uses Version 90 of the model? A: Again, I don't know.").

Impact and Downside FERC Impact—reflected Loews management's assessment of the potential implications of the March 15 FERC Actions. Johnson Tr. 636. The model built on FERC's proposed Form 501(g), which instructed MLPs to submit cost-of-service information using an indicative ROE of 10.55%. Because FERC had singled out that figure, the Loews management team was concerned that FERC could use it as a trigger for pursuing a rate case.

Even using these assumptions, Gulf South and Gulf Crossing did not face any risk of a rate case. Texas Gas faced some risk. The Loews management team projected that if Texas Gas filed its Form 501(g) and presented its cost-of-service calculations using the indicative ROE, no income tax allowance, and ADIT amortized using the Reverse South Georgia method, then Texas Gas would show an ROE of 24.3%, which was within the range of ROEs that historically had triggered rate cases. *See* JX 1071 at **[*257]** 1, 3; *accord* Wagner Tr. 247. If FERC initiated a rate case and mandated an adjustment in the rates that Texas Gas could charge based on an ROE of 10.55%, then the Loews Model calculated that Texas Gas would face a revenue reduction of $73.9 million per year. *See* Johnson Tr. 636. The "Base FERC Impact" scenario therefore deducted $73.9 million from Boardwalk's EBITDA for every year of the discrete projection period, beginning in 2019. *See* JX 1485, "Side Model" tab, Row 11. Turning the FERC Switch to "Off" removed the negative impact.

Projecting a rate case for Texas Gas based on these assumptions reflected the conservativism that went into the Loews Model. Wagner, the internal FERC expert on the Baker Botts team, believed that there was "a low probability that Texas Gas would face a *section 5* case in the next 1-2 years." JX 1071 at 1. Although an ROE of 24.3% was "the type of return that has caused FERC to initiate a *section 5* case" in the past, Wagner believed that FERC's existing workload, in addition to the influx of Form 501-G filings, made it likely that FERC would "probably be somewhat swamped and not able to begin those investigations." Wagner Tr. 245; *see* JX 1071 at 1. Beyond two years, there **[*258]** were "too many variables to make a prediction with any confidence." JX 1071 at 1. Sullivan, the outside rate expert that Baker Botts hired, thought that it would require an ROE of 20-30% to trigger a rate case for the foreseeable future. *See* JX 1807 at 6; Sullivan Dep. 168. The plaintiffs' rate expert also believed that there was a "low risk of a rate case for Texas Gas." Webb Tr. 1008.

Based on Webb's opinion, Atkins set the FERC Switch to the "Off" position. That was reasonable, and it finds support in the broader record. But it results in an alteration to the Loews Model. The Loews Model adopted a conservative approach on the assumption that the Base FERC Impact scenario would occur. This decision therefore uses the Base FERC Impact scenario.

By using the Base FERC Impact scenario, this decision also adopts a conservative measure of damages compared to the more than $900 million that the court could have awarded under the wrongdoer rule. That rule provides that when the "defendant's wrongful act" causes uncertainty in estimating damages, "justice and sound public policy alike require that he should bear the risk of the uncertainty thus produced." *Story Parchment Co. v. Paterson Parchment Paper Co., 282 U.S. 555, 565, 51 S. Ct. 248, 75 L. Ed. 544 (1931)*. The wrongdoer rule is a "corollary **[*259]** to [the] presumption" that "doubts about the extent of damages are generally resolved against the breaching party." *PharmAthene, 132 A.3d at 1131*. Under the wrongdoer rule, the court "take[s] into account the willfulness of the breach in deciding whether to require a lesser degree of certainty" about the extent of damages.[38]

In this case, the General Partner breached the Partnership Agreement by exercising the Call Right without first meeting the necessary conditions. The General Partner's breach was willful. The uncertainty about the FERC Impact switch only existed because of the timing of the willful breach, which resulted in the take-private transaction being completed just before FERC published its final rule. The publication of the final rule "mitigate[d]" the supposed "adverse effect" of the March 15 FERC Actions that formed the basis for the Opinion. JX 1569. The uncertainty embodied in the Base FERC Impact scenario would not have existed but

---

[38] *See* ***Restatement (Second) of Contracts § 352 cmt. a***, Westlaw (Am. L. Inst. database updated Oct. 2021) ("A party who has, by his breach, forced the injured party to seek compensation in damages should not be allowed to profit from his breach where it is established that a significant loss has occurred. A court may take into account all the circumstances of the breach, including willfulness, in deciding whether to require a lesser degree of certainty, giving greater discretion to the trier of facts."); *see also* *Agilent Techs., Inc. v. Kirkland, 2010 Del. Ch. LEXIS 34, 2010 WL 610725, at *27 (Del. Ch. Feb. 18, 2010)* ("[I]n cases where a specific injury to the plaintiff cannot be established, the defendant's actual gain may be considered.").

for the opportunistic timing of the exercise of the Call Right. Under the wrongdoer rule, that uncertainty should be resolved against the defendants, meaning the proper measure of damages should use the Loews Model with the FERC Switch in the "Off" position. **[*260]**

This decision nonetheless declines to apply the wrongdoer rule. Because Atkins' model with the FERC Switch in the Base FERC Impact position results in a persuasive and reliable measure of damages, the court adopts it.

3. The Finding Regarding Damages

With the FERC Switch set for the Base FERC Impact Scenario, Atkins' Distribution Model results in a valuation of $17.60 per unit. The transaction price was $12.06 per unit. The plaintiffs are entitled to damages of $5.54 per unit.

When the General Partner exercised the Call Right, there were 124,467,395 units outstanding that were not beneficially owned by Loews or its affiliates.[39] Multiplying 124,467,395 by $5.54 yields total damages of $689,827,343.38.

The resulting damages figure is conservative compared to the more than $900 million that the court could have awarded if it had adopted Atkins' opinion in full. It is also conservative relative to Loews' contemporaneous estimate of the $1.557 billion in "Value Creation" that Loews expected to enjoy from exercising the Call Right. JX 1505 at 10.

The plaintiffs are entitled to pre- and post-judgment interest on the damages award from July 18, 2018, until the date of payment. When neither **[*261]** party submits evidence showing the appropriate rate of interest, "the court looks to the legal rate of interest." Taylor v. Am. Specialty Retailing Gp., Inc., 2003 Del. Ch. LEXIS 75, 2003 WL 21753752, at *12 (Del. Ch. July 25, 2003). "The legal rate of interest, as defined by 6 Del. C. § 2301, is 5% over the Federal Reserve discount rate." Doft & Co. v. Travelocity.com Inc., 2004 Del. Ch. LEXIS 75, 2004 WL 1152338, at *12 (Del. Ch. May 20, 2004). When the court "award[s] the legal rate of interest, the appropriate compounding rate is quarterly." *Id.; accord* Taylor, 2003 Del. Ch. LEXIS 75, 2003 WL 21753752, at *13. The plaintiffs therefore are entitled to pre- and post-judgment interest at the legal rate, compounded quarterly, from July 18, 2018, until the date of payment, with the legal rate fluctuating with changes in the underlying reference rate. The plaintiffs are additionally entitled to an award of fees as the prevailing party.

F. The Implied Covenant Of Good Faith And Fair Dealing

As an alternative theory of breach, the plaintiffs contend that the General Partner breached the implied covenant of good faith and fair dealing that inheres in every contract governed by Delaware law. Because the court has held that the General Partner breached the express terms of the Partnership Agreement, there is no need to reach the implied covenant.

The plaintiffs have articulated non-duplicative implied covenant theories about the effect of the Potential Exercise Disclosures and the operation **[*262]** of the Purchase Price formula, but a judgment in the plaintiffs' favor on those questions would result in a lower damages award than the claim for breach of the Call Right. The plaintiffs are only entitled to one recovery. This decision therefore does not wade into the additional implied covenant issues.

G. The Claims Against The Defendants Other Than The General Partner

The plaintiffs have asserted theories that would enable them to recover from the GPGP, Holdings, and Loews. Those affiliates of the General Partner directed its actions and caused it to exercise the Call Right, but the affiliates are not parties to the Partnership Agreement and hence are not liable in contract. The plaintiffs

---

[39] *See* JX 1514 at 3 (June 29, 2018, Schedule 13D filing showing "250,296,782 Common Units Outstanding as of March 31, 2018," of which "124,710,649 Common Units that may be deemed to be beneficially owned by [Loews] based on the right of the General Partner to acquire voting and investment power over such Common Units on July 18, 2018 as a result of the Transaction"); PTO ¶ 388 ("[T]hrough the exercise of the Call Right, Loews . . . acquired all 124,710,469 of the outstanding common units"). Directors and officers of the Partnership disposed of 243,254 units in the Call-Right Exercise. JX 1561 at 1 (Hyland and Hyland's spouse disposed of 29,307 units); JX 1562 at 1 (Rebell, Rebell's spouse, and an affiliated LLC disposed of 60,583 units); JX 1563 at 1 (Shapiro disposed of 33,907 units); JX 1564 at 1 (Tisch disposed of 81,050 units); JX 1565 at 1 (Cordes disposed of 23,407 units); JX 1566 at 1 (Horton's spouse disposed of 15,000 units). Subtracting 243,254 from 124,710,649 yields 124,467,395, the total number of shares held by the class. *See* Atkins Report Ex. C at 7.

maintain that the GPGP, Holdings, and Loews are liable to the class on a claim for tortious interference with contract and under the doctrine of unjust enrichment.

Determining whether the General Partner's affiliates should be liable for tortious interference will require a complex balancing of different factors. *See, e.g.,* NAMA Hldgs., LLC v. Related WMC LLC, 2014 Del. Ch. LEXIS 232, 2014 WL 6436647, at *25-36 (Del. Ch. Nov. 17, 2014). This decision has covered much ground, and it would extend its length significantly to take on the tortious interference claim at this time. Furthermore, as a practical matter, **[*263]** it should be unnecessary to determine whether the General Partner's affiliates tortiously interfered with the Partnership Agreement. As noted, the plaintiffs are only entitled to a single recovery, and if the General Partner pays the damages award, then the class will have no basis to pursue the other defendants.

The facts of this case make it unlikely that pursuing the other defendants will be necessary to ensure the plaintiffs recover their damages. The General Partner acquired 49% of the limited partner interest by exercising the Call Right. It already possessed a 2% general partner interest and all of Boardwalk's incentive distribution rights. The General Partner thus has access to substantial cash flows.

The same is true for the plaintiffs' claim for unjust enrichment, although that claim is comparatively easier to analyze. The General Partner remains the principal wrongdoer. It should satisfy the claim.

Given these dynamics, the court will not adjudicate the claims for tortious interference or unjust enrichment at this time. Those claims are severed and stayed. If the General Partner satisfies the judgment, then those claims will be moot. If the General Partner fails to satisfy **[*264]** the judgment, then the claims can be revived.

III. CONCLUSION

The General Partner is liable to the plaintiff class for damages in the amount of $689,827,343.38, plus pre- and post-judgment interest on that amount through the date of payment. The plaintiffs are also entitled to an award of costs as the prevailing party.

The parties will incorporate the court's rulings into a partial final judgment that has been agreed as to form. The partial final judgment will not extinguish the separate claims for breach of the implied covenant of good faith and fair dealing against the General Partner or for tortious interference and unjust enrichment against the General Partner's affiliates.

If there are other issues that the court needs to address before such an order can be entered, then the parties will prepare a joint letter that identifies the issues and proposes a procedure for resolving them.

Table1 (*Return to related document text*)

Announcement Date	Offering Type	Offer Size	Offer Price
08/16/2005	IPO	$292.5	$19.50
09/21/2006	Primary	$204.6	$29.65
03/19/2007	Primary	$292.0	$36.50
11/02/2007	Primary	$231.8	$30.90
06/09/2008	Primary	$253.0	$25.30
08/10/2009	Primary	$186.4	$23.00
02/17/10	Secondary	$345.2	$30.02
05/26/2011	Primary	$176.0	$29.33
01/19/2012	Primary	$253.5	$27.55
08/01/2012	Primary	$322.5	$27.80
10/03/2012	Primary	$301.9	$26.99
05/29/2013	Primary	$381.0	$30.12
Feb.-Apr. 2015	Primary	-	$16.19
07/18/2018	Call Right	-	$12.06

Table1 (*Return to related document text*)

Table2 (*Return to related document text*)

	35% Tax COS	21% Tax COS	0% Tax COS	35% COS Delta	35% COS % Change	21% COS Delta	21% COS % Change
Texas Gas Pipeline							
2017	$431.09	$406.47	$362.23	$68.86	15.97%	$44.24 **[* 70]**	10.88%
Gulf South Pipeline							
2017	$640.21	$601.93	$534.50	$105.71	16.51%	$67.43	11.20%
Gulf Crossing Pipeline							
2017	$275.50	$259.88	$232.30	$43.20	15.68%	$27.59	10.62%

Table2 (*Return to related document text*)

Table3 (*Return to related document text*)

	35% Tax COS	21% Tax COS	0% Tax COS	35% COS Delta	35% COS % Change	21% COS Delta	21% COS % Change
Texas Gas Pipeline-Overall System							
2017	$424.34	$393.66	$346.57	$77.77	18.33%	$47.09	11.96%
Gulf South Pipeline							
2017	$491.05	$457.04	$403.55	$87.50	17.82%	$53.49	11.70%
Gulf Crossing Pipeline							
2017	$220.29	$198.62	$167.60	$52.70	23.92%	$31.03	15.62%

Table3 (*Return to related document text*)

Table4 (*Return to related document text*)

	35% Tax Indicative Rate	21% Tax Indicative Rate	0% Tax Indicative Rate	35% Rate Delta	35% Rate % Change	21% Rate Delta	21% Rate % Change
Texas Gas Pipeline							
2017	$0.2337	$0.2168	$0.1909	$0.0428	18.33%	$0.0259	11.98%
Gulf South Pipeline **[*73]**							
2017	$0.3698	$0.3442	$0.3040	$0.0658	17.80%	$0.0402	11.68%
Gulf Crossing Pipeline							
2017	$0.3549	$0.3200	$0.2700	$0.0849	23.92%	$0.0500	15.62%

Table4 (*Return to related document text*)

Table5 (*Return to related document text*)

	21% Tax COS	0% Tax COS	21% COS Delta	21% COS % Change
Pipeline				
2017	$406.47	$362.23	$44.24	10.88%
ipeline				
2017	$601.93	$534.50	$67.43	11.20%
g Pipeline				
2017	$259.88	$232.30	$27.59	10.62%

Table5 (*Return to related document text*)

Table6 (*Return to related document text*)

	21% Tax COS	0% Tax COS	21% COS Delta	21% COS % Change
Pipeline-Overall System				
2017	$386.21	$339.12	$47.09	12.19%
ipeline				
2017	$457.04	$403.55	$53.49	11.70%
g Pipeline				
2017	$198.62	$167.60	$31.03	15.62%

Table6 (*Return to related document text*)

Table7 (*Return to related document text*)

	21% Tax Indicative Rate	0% Tax Indicative Rate	21% Rate Delta	21% Rate % Change
Texas Gas Pipeline				
2017	$0.2129	$0.1871	$0.0258	12.12%
Gulf South Pipeline				
2017	$0.3442	$0.3040	$0.0402	11.68%
Gulf Crossing Pipeline				
2017	$0.3200	$0.2700	$0.0500	15.62%

Table7 (*Return to related document text*)

Table8 (Return to related document text)

Subsidiary	Baker Botts Percentage Change	BB % Change with ADIT Adjustment
Texas Gas	12.12%	2.58%
Gulf South	11.68%	1.80%
Gulf Crossing	15.62%	-0.85%

Table8 (Return to related document text)

Table9 (Return to related document text)

Subsidiary	Baker Botts Percentage Change	BB % Change with ADIT Adjustment
Texas Gas	12.12%	7.14%
Gulf South	11.68%	6.91%
Gulf Crossing	15.62%	9.32%

Table9 (Return to related document text)

Table10 (Return to related document text)

Subsidiary	Baker Botts Percentage Change	BB % Change with Both ROE Correction and ADIT Adjustment
Texas Gas	12.12%	-3.33%
Gulf South	11.68%	-3.95%
Gulf Crossing	15.62%	-8.66%

Table10 (Return to related document text)

End of Document

Brookfield Asset Mgmt. v. Rosson

Supreme Court of Delaware

June 30, 2021, Submitted; September 20, 2021, Decided

No. 406, 2020

Reporter

261 A.3d 1251 *; 2021 Del. LEXIS 291 **

BROOKFIELD ASSET MANAGEMENT, INC., ORION US HOLDINGS 1 L.P., BROOKFIELD BRP HOLDINGS (CANADA) INC., BRIAN LAWSON, HARRY GOLDGUT, RICHARD LEGAULT, SACHIN SHAH, and JOHN STINEBAUGH, Defendants-Below, Appellants/Cross-Appellees, v. MARTIN ROSSON and CITY OF DEARBORN POLICE AND FIRE REVISED RETIREMENT SYSTEM (CHAPTER 23), Plaintiffs-Below, Appellees/Cross-Appellants.

Subsequent History: Case Closed October 7, 2021.

Prior History: **[**1]** Court Below: Court of Chancery of the State of Delaware. C.A. No. 2019-0757.

Upon appeal from the Court of Chancery.

In re TerraForm Power, Inc. Stockholders Litig., 2020 Del. Ch. LEXIS 328, 2020 WL 6375859 (Del. Ch., Oct. 30, 2020)

Disposition: REVERSED.

Counsel: Kevin G. Abrams, Esquire, Eric A. Veres, Esquire, Stephen C. Childs, Esquire, Abrams & Bayliss LLP, Wilmington, Delaware. Of Counsel: John A. Neuwirth, Esquire (argued), Stefania D. Venezia, Esquire, Amanda K. Pooler, Esquire, Weil, Gotshal & Manges LLP, New York, New York for Appellants/Cross-Appellees.

Ned Weinberger, Esquire, Derrick Farrell, Esquire, Mark Richardson, Esquire, Labaton Sucharow LLP, Wilmington, Delaware; Peter B. Andrews, Esquire, Craig J. Springer, Esquire, David M. Sborz, Esquire, Andrews & Springer LLC, Wilmington, Delaware. Of Counsel: Steven J. Purcell, Esquire, Douglas E. Julie, Esquire (argued), Robert H. Lefkowitz, Esquire, Kaitlyn T. Devenyns, Esquire, Purcell Julie & Lefkowitz LLP, New York, New York; Jeremy S. Friedman, Esquire, David F.E. Tejtel, Esquire, Friedman Oster & Tejtel PLLC, Bedford Hills, NY for Appellees/Cross-Appellants.

Judges: Before SEITZ, Chief Justice; VALIHURA, VAUGHN, TRAYNOR, and MONTGOMERY-REEVES, Justices, constituting the Court en Banc.

Opinion by: VALIHURA

Opinion

[*1255] **VALIHURA**, Justice:

This is an interlocutory appeal from an Opinion and Order **[**2]** of the Court of Chancery holding that Appellees/Cross-Appellants, former stockholders of TerraForm Power, Inc. ("TerraForm"), have direct standing to challenge TerraForm's 2018 private placement of common stock to Appellant/Cross-Appellees Brookfield Asset Management, Inc. and its affiliates, a controlling stockholder, for allegedly inadequate consideration. The trial court held that Plaintiffs did not state direct claims under *Tooley v. Donaldson, Lufkin & Jennette, Inc.*,[1] but did state direct claims predicated on a factual paradigm "strikingly similar" to that of *Gentile v. Rossette*,[2] and that *Gentile* was controlling here. Appellants contend that *Gentile* is inconsistent with *Tooley* and that this Court's decision in *Gentile* has created confusion in the law and therefore ought to be overruled.

Overruling a precedent of this Court should only occur after a full and fair presentation and searching inquiry has been made of the justifications for such judicial action. Having now engaged in such inquiry after a full and fair presentation of the issues by the parties, and for the reasons set forth herein, we now overrule *Gentile*.

---

[1] *845 A.2d 1031 (Del. 2004)*.

[2] *906 A.2d 91 (Del. 2006)*.

Accordingly, we **REVERSE** the judgment below, not because the Court **[**3]** of Chancery erred, but rather, because the Vice Chancellor correctly applied the law as it existed, recognizing that the claims were exclusively derivative under *Tooley*, and that he was bound by *Gentile*.

I. Relevant Facts and Procedural Background[3]

A. The Parties

Nominal Defendant Below TerraForm Power, Inc. ("TerraForm" or the "Company") was, at the time of the proceedings below, a publicly traded Delaware corporation with its principal place of business in New York City. TerraForm acquired, owned, and operated solar and wind assets in North America and Western Europe.[4] The Company's common stock traded on the NASDAQ Stock Market under the ticker symbol "TERP."

Appellant Brookfield Asset Management, Inc. ("Brookfield") is a Canadian corporation headquartered in Toronto. Brookfield is an alternative asset manager that primarily conducts business through subsidiaries.[5] At the time the Complaint **[*1256]** was filed, Brookfield and its affiliates beneficially owned 61.5 percent of TerraForm.

Appellant Orion US Holdings 1 L.P. ("Orion Holdings") is a Delaware limited partnership and an affiliate of Brookfield through which Brookfield has held beneficial voting and dispositive power over Brookfield's **[**4]** TerraForm shares.

Defendant Below Brookfield BRP Holdings (Canada) Inc. ("BRP Holdings") is a Canadian corporation and an affiliate of Brookfield. BRP Holdings's sole purpose appears to be holding TerraForm stock. In June 2018, in connection with the Private Placement, BRP Holdings along with Orion Holdings, joined a Governance Agreement with TerraForm. The Governance Agreement establishes certain rights and obligations of TerraForm and Brookfield related to the Company's governance.

Appellants Brian Lawson, Harry Goldgut, Richard Legault, and Sachin Shah served as directors of TerraForm. Lawson is a Senior Managing Partner and the Chief Financial Officer ("CFO") of Brookfield. Goldgut is Vice Chair of Brookfield's Renewable Group and Brookfield's Infrastructure Group. Legault is Vice Chairman of Brookfield. Shah is a Managing Partner of Brookfield. He also serves as Chief Executive Officer ("CEO") of Brookfield Renewable Partners and BRP Holdings.

Appellant John Stinebaugh was TerraForm's CEO and was appointed as TerraForm's CEO by Brookfield. He is employed as a Managing Partner of Brookfield and receives no direct compensation from TerraForm for his service as CEO. Instead, he receives **[**5]** his compensation solely from Brookfield.

Appellees Martin Rosson ("Rosson") and City of Dearborn Police and Fire Revised Retirement System (Chapter 23) ("Dearborn," and collectively with Rosson, "Plaintiffs") were holders of TerraForm Class A common stock prior to a merger in July 2020.[6]

B. Brookfield's Investment in Terraform

In October 2017, Brookfield became Terraform's controlling stockholder, owning through Brookfield's affiliates 51 percent of Terraform's outstanding Class A common stock. Brookfield had the power to appoint Terraform's CEO, CFO, and General Counsel pursuant to a Master Services Agreement and governance agreement. Pursuant to TerraForm's certification of incorporation (the "Charter") and its majority holdings, Brookfield had the right to designate four of Terraform's seven directors and used that power to designate four members of Brookfield's senior management, namely, Defendants Lawson, Goldgut, Legault, and Shah, to Terraform's Board.

---

[3] The facts, except as otherwise noted, are taken from the operative Verified Stockholder Derivative and Class Action Complaint, C.A. No. 2020-0050-SG (the "Complaint" or Compl.") and from the Court of Chancery's Opinion below. In this procedural posture, they are presumed to be true.

[4] App. to Op. Br. A86 [hereinafter, "A__"] (Compl. at ¶ 13).

[5] A87 (Compl. at ¶ 15). Hundreds of Brookfield's subsidiaries are incorporated in Delaware or otherwise organized as Delaware entities, including: Brookfield Properties, Inc. (which owns Christiana Mall in Newark, DE), Brookfield Properties Investor LLC, Brookfield Financial Partners, L.P., BOP Management Inc., BOP Properties Holdings LLC, Brookfield Mountain LLC, BOP North Cove Marina LLC, BOP Camarillo LLC, BOP (US) LLC, and BOP One North End LLC.

[6] A86 (Compl. at ¶ 13). TerraForm eliminated its previous share structure and thereafter had only a single class of stock, namely, the Class A, which was entitled to one vote per share.

The Charter required that the TerraForm Board have a Conflicts Committee composed of the three non-Brookfield directors (the "Conflicts Committee").[7] The Conflicts Committee was responsible for reviewing and approving material transactions **[**6]** and matters in which a conflict may exist between TerraForm and Brookfield (and its affiliates). Additionally, TerraForm's Charter contained a supermajority voting provision, requiring an affirmative vote of at least two-thirds of the outstanding shares of common stock to amend certain Charter provisions.

[*1257] *C. Terraform Seeks to Finance a Buyout of Saeta Through an Equity Offering*

Around January 2018, Brookfield approached TerraForm regarding an opportunity to acquire for $1.2 billion Saeta Yield, S.A. ("Saeta"), a publicly-traded Spanish company that owned and operated wind and solar energy assets (the "Saeta Acquisition"). TerraForm had the debt capacity and cash to fund most, if not all, of the Saeta Acquisition. Notwithstanding this debt capacity, Brookfield recognized the substantial upside associated with the Saeta Acquisition and steered TerraForm towards funding it with a backstopped equity offering that, according to Plaintiffs, allowed Brookfield to increase its ownership percentage of TerraForm at a discount to TerraForm's anticipated fair value.

On January 23, 2018, Brookfield and TerraForm informed the Conflicts Committee that, in addition to funding the Saeta Acquisition with **[**7]** debt, TerraForm would raise approximately $600 - $700 million of equity in the public markets. Brookfield indicated that in addition to participating up to its *pro rata* portion of the equity offering (*i.e.*, 51 percent), it was willing to backstop part of the equity offering. At this time, the Conflicts Committee decided not to retain an independent financial advisor and relied on advice from Barclays Capital, Inc. ("Barclays"), which was serving as TerraForm's financial advisor.

The Conflicts Committee met on January 26, 2018 and again on January 29. At the end of the meeting on the 29th, it determined that the proposed backstop was advisable and in TerraForm's best interests. The Conflicts Committee still had not engaged or consulted with a financial advisor. Instead, it relied on the members of TerraForm's management and Brookfield representatives for advice.

On February 6, 2018, without any assistance from an independent financial advisor, the Conflicts Committee approved a support agreement with Brookfield (the "Support Agreement"), pursuant to which Brookfield contracted to backstop up to 100 percent of a $400 million public equity offering (the "Backstop") if the offering price **[**8]** equaled TerraForm's five-day volume weighted average price ending February 6, 2018, which was $10.66 per share.[8]

Brookfield's Backstop obligations were contingent on the successful commencement of a tender offer for Saeta (the "Tender Offer") under applicable Spanish law and on the prior effectiveness of the TerraForm registration statement, if required. TerraForm and Brookfield agreed that the pricing, size, and timing of the Equity offering, including the decision to use the Backstop, would be subject to prior review and approval of the Conflicts Committee, together with any other necessary approvals. It was also agreed in the Support Agreement that TerraForm and the Conflicts Committee would retain an independent financial advisor (meaning independent from Brookfield) to provide advice regarding the Equity Offering. However, the Conflicts Committee waited until late May 2018 to begin consulting with its own financial advisor, Greentech Capital Advisors Securities, LLC ("Greentech").

On February 7, 2018, TerraForm publicly disclosed its intention to acquire all outstanding shares of Saeta via the Tender Offer. TerraForm announced its expectation to fund the $1.2 billion acquisition **[**9]** with **[*1258]** $800 million in available liquidity and the $400 million Equity Offering. On May 3, 2018 TerraForm commenced the Tender Offer, and on May 10, 2018, TerraForm filed its definitive proxy statement with the SEC seeking stockholder approval for the issuance of up to 61 million shares of Class A Common Stock in connection with the planned Equity Offering. TerraForm's stockholders approved the share issuance on May 23, 2018 at TerraForm's annual meeting.

---

[7] A239 (Charter Art. VI, § 7). Since May 23, 2018, Mark McFarland, Christian S. Fong and Carol Burke comprised the Conflicts Committee.

[8] A83-84 (Compl. at ¶ 5); A114-15 (Compl. at ¶¶ 61-63). At the February 6, 2018 meeting, the Conflicts Committee noted that reducing the Equity Offering component of the Saeta Acquisition would be in TerraForm's best interests due, in part, to recent stock market volatility. A114-15 (Compl. n.13). The five-day period included the two lowest closing prices for TerraForm's stock in a nearly two-year period. A129-30 (Compl. at ¶ 103).

D. Brookfield Steers Terraform into the Private Placement, which Increases Brookfield's Economic Interest and Voting Power in Terraform

Minutes after the stockholders approved the Share Issuance at the annual meeting, the full Board met to discuss the Equity Offering and backstop. Stinebaugh proposed to the Board that TerraForm raise $650 million, rather than $400 million, through the sale of equity because "the market expect[ed] a $650 million total equity offering and that the impact to the returns on the Saeta transaction would not be material."[9] Shah indicated that Brookfield would be prepared to increase the size of the backstop from $400 million back up to $650 million. By that point, the Tender Offer to acquire Saeta was scheduled **[**10]** to expire in only a few weeks, and TerraForm had little time to finalize its financing plan. Stinebaugh then proposed that if the Equity Offering presented too much market risk, the full amount be offered to Brookfield through a private placement at $10.66 per share. At the conclusion of the meeting, TerraForm's Board determined that the Conflicts Committee should consider Brookfield's proposal to increase the size of the Backstop to $650 million.

After the full Board meeting on May 23, 2018, the Conflicts Committee met to discuss the information that had just been presented. There was no discussion of the proposed private placement and only a discussion of the proposed increase to the equity offering (to $650 million) and commensurate increase in Brookfield's Backstop.

The Conflicts Committee's first meeting with its financial advisor, Greentech, occurred less than an hour after the May 23, 2018 Board meeting ended. Greentech's written presentation to the Conflicts Committee contemplated that Brookfield would backstop the full $650 million even though, according to meeting minutes, Brookfield first suggested the increased Backstop only a few hours earlier. The Conflicts Committee directed **[**11]** Greentech to coordinate with Barclays. It then met again the following day. At that meeting, Greentech reviewed with the Conflicts Committee the materials provided the previous day. These materials revealed that a $650 million equity offering would "significantly reduce returns" and accretion from the Saeta Acquisition relative to a $400 million offering. Nonetheless, Greentech advised the Conflicts Committee that it would be "difficult to predict the price at which the Equity Offering could be executed (and whether it could be executed at a price above [$10.66])."[10] Greentech also noted that a backstop covering the full amount of the Equity Offering "was very beneficial."[11] The Committee approved increasing the Backstop to $650 million and an amendment to the Support Agreement reflecting such increase. As with the previous day's meeting, there was no discussion of a private placement.

[*1259] During the period after May 24, 2018, the Conflicts Committee received no advice concerning whether a private placement with TerraForm's controller was fair or superior to TerraForm's financing alternatives. Nearly all information provided to the Conflicts Committee in the ensuing two-week period was geared **[**12]** toward convincing it to abandon the Equity Offering in favor of a $650 million private placement exclusively with Brookfield.

On June 4, 2018, after receiving a single slide deck from Greentech, and relying largely on the advice of Brookfield, TerraForm management, and Barclays, the Conflicts Committee approved exercising the $650 million Backstop in lieu of the Equity Offering. TerraForm management recommended doing away with the public offering aspect and instead simply selling the entire amount of the proposed offering directly to Brookfield. Despite the fact that the Conflicts Committee never received advice concerning a private placement with Brookfield, the Conflicts Committee accepted TerraForm management's recommendations and approved full exercise of the Backstop—that is, a private placement of $650 million of TerraForm stock with Brookfield at $10.66 per share.

On June 7, 2018, the Board authorized the sale of 60,975,609 shares of TerraForm common stock to Brookfield for $650 million using the $10.66 per share Backstop price, (*i.e.*, the "Private Placement"). The Private Placement proceeds were used to fund the Tender Offer along with $471 million of TerraForm's available liquidity. **[**13]** The Private Placement increased Brookfield's economic interest in and voting power over TerraForm from 51 percent to 65.3 percent.

With the $650 million received from Brookfield, along with the available liquidity, TerraForm acquired

[9] A84 (Compl. at ¶ 7); A118 (Compl. at ¶ 73).

[10] A122 (Compl. at ¶ 82).

[11] *Id.* (Compl. at ¶ 83).

approximately 95 percent of Saeta's shares for an aggregate of $1.12 billion on June 12, 2018. Following the tender offer, TerraForm completed a squeeze-out under Spanish law for the remaining shares of Saeta that were not tendered.

TerraForm's stock price increased in the aftermath of the Saeta Acquisition and by June 25, 2018, TerraForm's stock was trading at $11.77 per share, 10.4 percent above the $10.66 per share Private Placement price, representing an unrealized profit of $68 million to Brookfield. On January 23, 2020, prior to the Complaint's filing, TerraForm's stock closed at $17.30 a share, representing $400 million in unrealized profit to Brookfield since the Private Placement.

In October 2019, TerraForm conducted a $250 million public offering for 14,907,573 shares of common stock at a price of $16.77 per share, a price 60 percent greater than Brookfield paid in the Private Placement. Concurrently, Brookfield entered into a second private placement **[**14]** purchasing 2,981,514 shares of common stock for $16.77 per share. Brookfield's equity percentage thereby decreased from 65.3 percent to 61.5 percent.

E. Proceedings in the Court of Chancery

On September 19, 2019, Rosson filed a verified derivative and purported class action complaint against Brookfield, Orion, and BRP Holdings for breach of fiduciary duties.[12] On January 11, 2020, after Rosson filed his complaint and Dearborn demanded TerraForm's books and records, Brookfield-affiliate BR Partners proposed to acquire all of TerraForm's public shares.[13] Dearborn then filed a verified derivative and purported class action complaint against all Defendants for breach of fiduciary **[*1260]** duty on January 27, 2020. The trial court consolidated the two actions and designated the Complaint filed by Dearborn as the operative complaint in the consolidated action.[14] The Complaint alleges that Brookfield caused TerraForm to issue its stock in the Private Placement for inadequate value, diluting both the financial and voting interest of the minority stockholders. The Complaint also alleges that the Company was damaged as a result.[15]

Defendants moved to dismiss Plaintiffs' direct claims on the basis that they **[**15]** are entirely derivative. The Motion to Dismiss was argued on July 16, 2020.

On March 16, 2020, BR Partners and BR Corp agreed to acquire all TerraForm stock not held by Brookfield (*i.e.*, the "Merger"). On July 31, 2020, Brookfield affiliates acquired all outstanding TerraForm shares not already owned by Brookfield. In light of the Merger, the trial court granted an order dismissing the derivative counts of the Complaint. Following the Merger, TerraForm's public stockholders ceased to have any interest in TerraForm, and all of TerraForm's assets, liabilities, rights and causes of action became the property of TerraForm's acquirer.[16]

The Court of Chancery issued a thoughtful Opinion denying the Motion to Dismiss on October 30, 2020.[17] In its Opinion, the Court of Chancery rejected Plaintiffs' arguments that they have standing to pursue direct claims against the Defendants under *Tooley v. Donaldson, Lufkin & Jennette, Inc.* The Court of Chancery explained that under *Tooley*, dilution claims are classically derivative, *i.e.*, "the quintessence of a claim belonging to an entity: that fiduciaries, acting in a way that breaches their duties, have caused the entity to

[12] A38-77 (Compl.); A44 (Rosson Compl.).

[13] A329 (Brookfield Form F-1 Registration Statement Amendment dated Apr. 20, 2020).

[14] A145-153 (Order of Consolidation and Appointment of Lead Plaintiffs and Co-Lead Counsel). The Complaint alleges three counts of breach of fiduciary duty. Count I is against Brookfield, Orion Holdings, and BRP Holdings as controlling stockholders. Count II is against Lawson, Goldgut, Legault, and Shah. Count III is against Stinebaugh. All counts were putatively brought both derivatively and directly.

[15] A140 (Compl. at ¶ 135) ("As a direct and proximate result of this misconduct, the Company and the Company's minority stockholders (through a reduction in economic value and voting power) have been damaged."); *see also* A142 (Compl. at ¶ 145) ("As a result of the misconduct described above, Defendants have caused loss and damages to the Company and its minority stockholders."); A149 (Compl. at ¶ 149) ("As a result of the misconduct described above, Stinebaugh has caused loss and damages to the Company and the Class for which Plaintiff seeks appropriate judicial relief.").

[16] *8 Del. C. § 259(a)*; *see also* *Lewis v. Anderson, 477 A.2d 1040, 1044 (Del. 1984)* (holding that the right to bring a derivative action passes via merger to the surviving corporation).

[17] *In re TerraForm Power, Inc. S'holders Litig., 2020 Del. Ch. LEXIS 328, 2020 WL 6375859 (Del. Ch. Oct. 30, 2020)* (hereafter, "*Opinion*").

exchange assets at a **[**16]** loss."[18] The court explained further that the claims are still derivative, and that "[t]his rationale extends even where a controlling stockholder allegedly causes a corporate overpayment in stock and consequent dilution of the minority interest."[19] Thus, it held that "under *Tooley* alone, the Plaintiffs' overpayment claims neatly fall into the derivative category."[20]

Notwithstanding its conclusion that the Plaintiffs had failed to state direct claims under *Tooley*, the court nevertheless found that Plaintiffs had stated direct claims because the claims were predicated on facts similar to those presented in *Gentile v.* ***[*1261]*** *Rossette*.[21] In fact, the Court of Chancery observed that "[t]he facts alleged in the Complaint fit *Gentile's* transactional paradigm to a T."[22] In *Gentile*, this Court determined that "the plaintiffs pled two independent harms arising from the transaction: (1) that the corporation was caused to overpay (in stock) for the debt forgiveness, and (2), the minority stockholders lost a significant portion of the cash value and voting power of the minority interest."[23] Regarding *Gentile*, the Court of Chancery observed that the current law is, as a matter of doctrine, unsatisfying.[24] **[**17]** But it concluded that it was "not free to decide cases in a way that deviates from binding Supreme Court precedent."[25] Accordingly, it held that

> [c]onsistent with *Gentile*, the Plaintiffs have made a sufficient pleading that Brookfield is TerraForm's controller, that Brookfield caused TerraForm to issue excessive shares of its stock in exchange for insufficient consideration, and that the exchange caused an increase in the percentage of the outstanding shares owned by Brookfield, and a corresponding decrease in the share percentage owned by the public (minority) stockholders. Such a pleading is sufficient, under controlling Supreme Court precedent, to withstand the Defendant's Motion to Dismiss the Plaintiffs' direct claims.[26]

Bound by this Court's decision in *Gentile*, the Court of Chancery determined that Plaintiffs had standing to assert direct claims and denied the Defendants' Motion to Dismiss.

Finally, the Court of Chancery held that Plaintiffs' "entrenchment" claims could not withstand dismissal because they did not satisfy the "reasonably conceivable" pleading standard.

On November 9, 2020, Defendants submitted an application to the trial court for certification of an interlocutory appeal of the Court of Chancery's decision denying their motion **[**18]** to dismiss. The trial court granted Defendants' application on November 24, 2020, finding that the appeal could end the litigation and would serve considerations of justice "by clarifying an area of law that appears to be in a state of flux."[27] It held that, "in light of case law questioning the continued vitality of *Gentile* at the trial court level, and in light of criticism at the Supreme Court level," the matter should be available for review by the Supreme Court at this Motion to Dismiss stage in the interests of justice.[28]

Defendants filed a timely Notice of Appeal on November 30, 2020. This Court accepted the interlocutory appeal on December 14, 2020.

F. Contentions on Appeal and Cross Appeal

First, Appellants contend that the Plaintiffs' claims are exclusively derivative under *Tooley* and that the Supreme Court's decision in *Gentile* deviated from, and is doctrinally inconsistent with, the "simple analysis" set forth in *Tooley*. *Second*, Appellants assert that, because *Gentile* contradicts and undermines long-standing case law, complicates real-world commercial transactions, and is superfluous given existing legal remedies, that *stare decisis* is inapplicable, and that *Gentile* should be **[**19]** overruled.

---

[18] *Opinion, 2020 Del. Ch. LEXIS 328, 2020 WL 6375859, at *9*.

[19] *Id.*

[20] *2020 Del. Ch. LEXIS 328, [WL] at *11*.

[21] *906 A.2d 91 (Del. 2006)*.

[22] *Opinion, 2020 Del. Ch. LEXIS 328, 2020 WL 6375859, at *12*.

[23] *Gentile, 906 A.2d at 99*.

[24] *Opinion, 2020 Del. Ch. LEXIS 328, 2020 WL 6375859, at *15*.

[25] *2020 Del. Ch. LEXIS 328, [WL] at *16*.

[26] *Id.*

[27] A488-490 (Letter Op. at 2-4).

[28] A489 (Letter Op. at 3).

[*1262] Appellees contend on cross-appeal that the Court of Chancery erred in holding that they had failed to plead reasonably conceivable direct claims for voting power dilution.

II. Standard of Review

The Delaware Supreme Court exercises *de novo* review when evaluating a trial court's decision to deny a motion to dismiss.[29] Additionally, the Delaware Supreme Court reviews questions relating to standing under the *de novo* standard of review.[30]

III. Analysis

A. Standing is a Threshold Question

In *El Paso*, we explained that "'[t]he concept of standing, in its procedural sense, refers to the right of a party to invoke the jurisdiction of a court to enforce a claim or redress a grievance.'"[31] Thus, "'[a]s a preliminary matter, a party must have standing to sue in order to invoke the jurisdiction of a Delaware court.'"[32] Standing is therefore properly viewed as a threshold issue "to 'ensure that the litigation before the tribunal is a "case or controversy" that is appropriate for the exercise of the court's judicial powers.'"[33]

We explained further in *El Paso* that "[d]erivative standing is a 'creature of equity' that was created to enable a court of equity to exercise jurisdiction over corporate **[**20]** claims asserted by stockholders 'to prevent a complete failure of justice on behalf of the corporation.'"[34] A plaintiff may lose standing in a variety of ways during the progress of litigation. In corporate derivative litigation, for example, a plaintiff's standing is extinguished as a result of loss of plaintiff's status as a stockholder.[35] Once standing is lost, "the court lacks the power to adjudicate the matter, and the action will be dismissed as moot unless an exception applies."[36] Thus, the question of derivative standing is "'properly a threshold question that the [c]ourt may not avoid.'"[37]

B. The Test for Derivative Standing: Tooley and Gentile's Carve-Out

1. First, the Tooley Test for Direct Versus Derivative Standing

A derivative suit enables a stockholder to bring a suit on behalf of the corporation for harm done to the corporation.[38] Because a derivative suit is **[*1263]** brought on behalf of the corporation, any recovery must go to the corporation. However, a stockholder who is directly injured retains the right to bring an individual action for injuries affecting his or her legal rights as a stockholder.[39] "Such a claim is distinct from an injury

[29] *In re Santa Fe Pac. Corp. S'holder Litig., 669 A.2d 59, 70 (Del. 1995)*.

[30] ***El Paso Pipeline GP Co. v. Brinckerhoff, 152 A.3d 1248, 1256 (Del. 2016)***.

[31] ***El Paso, 152 A.3d at 1256*** (citing *Schoon v. Smith, 953 A.2d 196, 200 (Del. 2008)*).

[32] *Id.* (quoting *Ala. By-Prod. Corp. v. Cede & Co., 657 A.2d 254, 264 (Del. 1995)*).

[33] *Id.* (quoting *Dover Historical Soc'y. v. City of Dover Planning Comm'n., 838 A.2d 1103, 1110 (Del. 2003)*).

[34] *Id.* (citing *Schoon, 953 A.2d at 208*).

[35] *Id.* (citing *Lewis, 477 A.2d at 1049 (Del. 1984)*). Frequently, the issue of standing arises in the context of the continuous ownership rule which is reflected in *8 Del. C. § 327* and in *Court of Chancery Rule 23.1*. In *Lewis*, this Court held that "[a] plaintiff who ceases to be a shareholder, whether by reason of a merger or for any other reason, loses standing to continue a derivative suit." *477 A.2d at 1049*.

[36] ***El Paso, 152 A.3d at 1256-57*** (footnotes omitted).

[37] ***Id. at 1257***; *see also* **Morris v. Spectra Energy P'rs (DE) GP, LP, 246 A.3d 121, 129 (Del. 2021)** ("The standing inquiry 'has assumed special significance in the area of corporate law.'").

[38] *Tooley, 845 A.2d at 1036*.

[39] An example of harm unique to the stockholders would be a board failing to disclose all material information when seeking stockholder action. *See, e.g., In re J.P. Morgan Chase & Co. S'holder Litig., 906 A.2d 766, 772 (Del. 2006)* ("This Court has recognized, as did the Court of Chancery, that where it is claimed that a duty of disclosure violation impaired the stockholders' right to cast an informed vote, that claim is direct.").

caused to the corporation **[**21]** alone."[40] In such individual suits, "the recovery or other relief flows directly to the stockholders, not to the corporation."[41] Classification of a particular claim as derivative or direct can be difficult.[42] Further, "[t]he decision whether a suit is direct or derivative may be outcome-determinative."[43] Such is the case here as the central question is whether Plaintiffs have direct standing to pursue their claims or whether their claims are entirely derivative. If the latter, then their claims were extinguished in the Merger, and they lack standing to pursue them.

In *Tooley*, this Court undertook to create a simple test of straightforward application to distinguish direct claims from derivative claims. Under the *Tooley* test, the determination of whether a stockholder's claim is direct or derivative "must turn *solely* on the following questions: (1) who suffered the alleged harm (the corporation or the stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?"[44]

In explaining its test further, the *Tooley* Court cited with approval the analysis **[**22]** set forth by Chancellor Chandler in *Agostino v. Hicks*,[45] and adopted his suggestion that part of the inquiry should be whether the stockholder has demonstrated that he or she has suffered an injury that is not dependent on an injury to the corporation:

> In the context of a claim for breach of fiduciary duty, the Chancellor articulated the inquiry as follows: "[l]ooking at the body of the complaint and considering the nature of the wrong alleged and the relief requested, has the plaintiff demonstrated that he or she can prevail without showing an injury to the corporation?" We believe that this approach is helpful in analyzing the first prong of the analysis: what person or entity has suffered the alleged harm? The second prong of the analysis should logically follow.[46]

[*1264] In announcing this simplified test, this Court retreated from "our confusing jurisprudence on the direct/derivative dichotomy."[47] It concluded that the trial court's analysis had been "hindered . . . because it focused on the confusing concept of 'special injury' as the test for determining whether a claim is derivative or direct."[48] It then unequivocally abandoned the "special injury" concept in stating:

> In our view, the concept **[**23]** of "special injury" that appears in some Supreme Court and Court of

---

[40] *Id.*

[41] *Id.*

[42] *See, e.g.,* Agostino v. Hicks, 845 A.2d 1110, 1117-1118 (Del. Ch. 2004) (noting that "[t]he distinction between direct and derivative claims is frustratingly difficult to describe with precision," and that "[r]eference to Supreme Court opinions, while certainly instructive, does not conclusively resolve how this Court should draw the line between direct and derivative claims."). Other courts applying our law have experienced this difficulty as evidenced by our issuance of several opinions responding to other courts' request to answer certified questions involving distinguishing between a direct and derivative claim. *See, e.g.,* ***Citigroup Inc. v. AHW Investment P'ship, 140 A.3d 1125 (Del. 2016)*** (*en banc*); *NAF Holdings, LLC v. Li & Fung (Trading) Ltd., 118 A.3d 175 (Del. 2015)* (*en banc*); *Culverhouse v. Paulson & Co., 133 A.3d 195 (Del. 2016)* (*en banc*).

[43] *Tooley, 845 A.2d at 1036*. Derivative claims are also subject to higher pleading standards than direct claims.

[44] *Id. at 1033* (emphasis in original).

[45] *845 A.2d 1110 (Del. Ch. 2004)*.

[46] *Tooley, 845 A.2d at 1036*.

[47] *Id. at 1034*.

[48] *Id. at 1035*. In describing the confusing jurisprudence, the *Tooley* Court observed that, "[t]his simple analysis is well embedded in our jurisprudence, but some cases have complicated it by injection of the amorphous and confusing concept of 'special injury.'" *Id.* After observing that the "special injury" concept had been set forth in *Elster v. American Airlines, Inc., 34 Del. Ch. 94, 100 A.2d 219 (Del. Ch. 1953)*, it criticized the application of that concept in ***Bokat v. Getty Oil, 262 A.2d 246 (Del. 1970)*** and in *Lipton v. News Int'l Plc., 514 A.2d 1075 (Del. 1986)* as not setting forth the proper analysis. The *Tooley* Court then noted that "[t]he proper analysis has been and should remain that stated in *Grimes*; *Kramer* and *Parnes*." *Id. at 1039* (citing *Grimes v. Donald, 673 A.2d 1207 (Del. 1996)*; *Kramer v. Western Pac. Indus. Inc., 546 A.2d 348 (Del. 1988)*, and *Parnes v. Bally Enter. Corp., 722 A.2d 1243 (Del. 1999)*). As explained herein, we note that *Gentile* added to the confusion by applying *In re Tri-Star Pictures, Inc. Litig, 634 A.2d 319 (Del. 1993)*. In *Tri-Star*, where stockholder plaintiffs alleged that a controlling stockholder stood on both sides of a dilutive assets-for-stock transaction, this Court employed the special injury test and did not cite to *Kramer*. Instead, the Court in *Tri-Star* referred to the special injury test set forth in *Lipton*.

> Chancery cases is not helpful to a proper analytical distinction between direct and derivative actions. We now disapprove the use of the concept of "special injury" as a tool in that analysis.[49]

It expressly disapproved "both the concept of 'special injury' and the concept that a claim is necessarily derivative if it affects all stockholders equally."[50] Instead, "the tests going forward should rest on those set forth in" its opinion.[51]

2. The Gentile Carve-Out from the Tooley Test

Two years after deciding *Tooley*, this Court decided *Gentile*. *Gentile* involved a controlling stockholder and transactions that resulted in an improper transfer of both economic value and voting power from the minority stockholders to the controlling stockholder. There, a corporation's CEO and controlling stockholder forgave a portion of the company's $3 million debt to him in exchange for additional equity. The applicable contractual conversion rate was $0.50 of debt per share, but the CEO and the company's board of directors (which included himself and one other person) agreed **[**24]** to $0.05 of debt per share. Without disclosing the underlying transaction, the board secured a stockholder vote authorizing the shares needed to issue the additional equity.

The share issuance increased the CEO's equity position from 61.19 percent to 93.49 percent. The minority stockholders suffered a corresponding decrease in their interest from 38.81 percent to 6.51 percent. When the CEO later negotiated a merger between the corporation and its only competitor, the CEO received a generous put agreement that was not disclosed to the other stockholders. The trial court dismissed the ensuing stockholders litigation after concluding that the claims were exclusively derivative and that the plaintiff **[*1265]** stockholders' standing had been extinguished following the merger.

This Court reversed and allowed the plaintiffs to proceed with direct claims. The Court reasoned that there were two independent aspects of the plaintiffs' claims, namely, the overpayment claim and the minority's significant loss of cash value and voting power. These claims constituted "a species of corporate overpayment claim" that was "both derivative and direct in character."[52] Accordingly, this Court held that "[u]nlike the **[**25]** typical overpayment transaction,"[53] a dual-natured claim arises where:

> (1) a stockholder having a majority or effective control causes the corporation to issue "excessive" shares of its stock in exchange for assets of the controlling stockholder that have a lesser value; and (2) the exchange causes an increase in the percentage of the outstanding shares owned by the controlling shareholder, and a corresponding decrease in the share percentage owned by the public (minority) shareholders.[54]

The Court in *Gentile* clearly recognized that allowing direct standing to assert a corporate dilution/overpayment claim was a deviation from the norm:

> Normally, claims of corporate overpayment are treated as causing harm solely to the corporation and, thus, are regarded as derivative. The reason (expressed in *Tooley* terms) is that the corporation is both the party that suffers the injury (a reduction in its assets or their value) as well as the party to whom the remedy (a restoration of the improperly reduced value) would flow. In the typical corporate overpayment case, a claim against the corporation's fiduciaries for redress is regarded as exclusively derivative, irrespective of whether the currency or **[**26]** form of overpayment is cash or the corporation's stock. Such claims are not normally regarded as direct, because any dilution in value of the corporation's stock is merely the unavoidable result (from an accounting standpoint) of the reduction in the value of the entire corporate entity, of which each share of equity represents an equal fraction. In the eyes of the law, such equal "injury" to the shares resulting from a corporate overpayment is not viewed as, or equated with, harm to specific shareholders individually.[55]

The *Gentile* panel addressed the tension with *Tooley* by

---

[49] *Tooley, 845 A.2d at 1035*.

[50] *Id. at 1039*.

[51] *Id.*

[52] *Gentile, 906 A.2d at 99*.

[53] *Id. at 100 n.21*.

[54] *Id. at 100*.

[55] *Id. at 99*.

acknowledging that "[a]lthough the corporation suffered harm (in the form of a diminution of its net worth), the minority shareholders also suffered a harm that was unique to them and independent of any injury to the corporation."[56] Focusing on the identity of the alleged wrongdoer, the Court stated that, the harm to the minority plaintiffs "resulted from a breach of a fiduciary duty owed to them by the controlling shareholder, namely, not to cause the corporation to effect a transaction that would benefit the fiduciary at the expense of the minority shareholders."[57] Thus, in *Gentile* the Court held that the value represented **[**27]** by the corporate overpayment is "an entitlement that may be claimed by the public shareholders directly and without regard to any claim the corporation may have."[58]

[*1266] *3. Plaintiffs Have Standing Under Gentile but Not Tooley*

In this case, the Vice Chancellor determined that Plaintiffs' Complaint "does not state direct claims without *Gentile*, but that it does state direct claims under *Gentile's* rationale."[59] In other words, that the Complaint does not state direct claims under "a classic *Tooley* analysis,"[60] but that it does under *Gentile*. We agree.

As noted above, to plead a direct claim under *Tooley*, a "stockholder must demonstrate that the duty breached was owed to the stockholder and that he or she can prevail without showing an injury to the corporation."[61] We do not think Plaintiffs can prevail without showing an injury to the corporation. The claim is derivative because they allege an overpayment (or over-issuance) of shares to the controlling stockholder constituting harm to the corporation for which it has a claim to compel the restoration of the value of the overpayment. Clearly, the gravamen of the Complaint is that the Private Placement was unfair and that TerraForm suffered harm. **[**28]** [62] Further, they seek rescissory damages on behalf of TerraForm.[63]

If the Private Placement was for inadequate consideration, the worth of the stockholder's interest is reduced to the extent TerraForm was harmed -- as the Vice Chancellor put it, "a classic derivative claim." The alleged economic dilution in the value of the corporation's stock is the unavoidable result of the reduction in the value of the entire corporate entity, of which each share of equity represents an equal fraction. Dilution is a typical result of a corporation's raising funds through the issuance of additional new shares. As the Court in *Gentile* recognized, normally such equal "injury" to the shares resulting from a corporate overpayment is not equated to specific, individual harm to stockholders. Here, the economic and voting power dilution that allegedly harmed the stockholders flowed indirectly to them in proportion to, and via, their shares in TerraForm, and thus any remedy should flow to them the same way, derivatively via the corporation.[64]

That is why in *El Paso* we suggested that *Gentile* "can be read as undercutting the traditional rule that dilution claims are classically derivative."[65] We think that when a **[**29]** corporation exchanges equity for assets of a stockholder who is already a controlling stockholder for allegedly inadequate consideration, the dilution/overpayment claim is exclusively derivative. Carving out an exception to the *Tooley* test and allowing for a separate, direct claim in such circumstance presents both practical and doctrinal difficulties as we discuss herein. To the extent the corporation's issuance of equity does not result in a shift in control from a diversified group of public equity holders to a controlling interest, (a circumstance where our law, *e.g., Revlon*,[66]

---

[56] *Id. at 103* (citing *Tooley, 845 A.2d at 1039*).

[57] *Id.*

[58] *Id. at 100*.

[59] *Opinion, 2020 Del. Ch. LEXIS 328, 2020 WL 6375859, at *9*.

[60] *Id.*

[61] *Tooley, 845 A.2d at 1039*.

[62] *See* A140 (Compl. at ¶ 135) (alleging damage to "the Company" and to its minority stockholders only "through a reduction in economic value and voting power").

[63] A82, A141 (Compl. at ¶¶ 1, 140).

[64] In such cases, the remedy could be cancelling the shares and allowing the corporation to sell them for fair value or requiring the acquirer to pay fair value for the shares.

[65] ***152 A.3d at 1251***.

[66] *Revlon, Inc. v. MacAndrews & Forbes Hldgs., Inc., 506 A.2d 173, 182 (Del. 1986)* (finding that once a corporate board decides to effectuate the sale of the company, its duty changes "from the preservation of [the company] as a corporate entity to the maximization of the company's value at

already provides for a **[*1267]** direct claim), holding Plaintiffs' claims to be exclusively derivative under *Tooley* is logical and re-establishes a consistent rule that equity overpayment/dilution claims, absent more, are exclusively derivative.[67] Because we agree with the Vice Chancellor that Plaintiffs' claims do fit precisely into the Gentile paradigm, we now explain why Gentile should be overruled.

C. Gentile Should be Overruled

1. Gentile's Tension with Tooley

Appellants persuasively argue that, "[g]iven the clear conflict between Gentile and *Tooley* ***[**30]*** , the confusion Gentile imposes on *Tooley's* straightforward and easy-to-apply analysis, and the policy reasons for removing the exception . . ., this Court should exercise its discretion to overrule Gentile.[68] After careful consideration of the relevant doctrinal, practical, and policy considerations, we agree and address these points in turn. We first focus on *Gentile's* analytical tension with *Tooley*.

In Gentile, this Court stated that its holding "fits comfortably within the analytical framework mandated by *Tooley*."[69] Based upon that comment, the Vice Chancellor stated that, "to the extent that Gentile can be said to rely on *Tri-Star*, the Gentile decision itself forecloses any argument that Gentile's citation of *Tri-Star* renders Gentile irreconcilable with *Tooley*."[70] But our critical self-assessment of Gentile, coupled with subsequent decisions at the trial court level, lead us now to the conclusion that the "fit" is not so "comfortable."

Instead, we agree with Appellants that certain aspects of Gentile are in tension with *Tooley*.[71] One aspect is Gentile's conclusion that the economic and voting dilution was an injury to stockholders *independent* of any injury **[**31]** to the corporation. A **[*1268]** second is *Gentile's* reliance on *Tri-Star*, which itself was criticized in *Tooley*. A third is Gentile*'s* focus on the alleged wrongdoer, here the controller, and the devising of a special rule or *Tooley* "carve-out" for cases involving controlling stockholders.

As to the first point, in *Tooley*, this Court stated that "[t]he stockholder's claimed direct injury must be *independent* of any alleged injury to the corporation."[72] In Gentile, this Court acknowledged that the corporation was injured also, but nevertheless, found the plaintiffs' claims to be *both* derivative and direct:

---

a sale for the stockholders' benefit"). As we explained in *Paramount Communications, Inc. v. QVC Network Inc.*, "[i]n the absence of devices protecting the minority stockholders, stockholder votes are likely to become mere formalities where there is a majority stockholder . . . [t]he acquisition of majority status and the consequent privilege of exerting the powers of majority ownership come at a price," and that price "is usually a control premium which recognizes not only the value of a control block of shares, but also compensates the minority stockholders for their resulting loss of voting power." 637 A.2d 34, 42-43 (Del. 1994).

[67] *See, e.g.*, *Oliver v. Bos. Univ., 2006 Del. Ch. LEXIS 75, 2006 WL 1064169, at *17 (Del. Ch. Apr. 14, 2006)* ("Under *Tooley*, the harm alleged by the Plaintiffs was suffered by the corporation because it was the corporation in the Plaintiffs' scenario that issued its stock too cheaply."); Green v. LocatePlus Holdings Corp., 2009 Del. Ch. LEXIS 85, 2009 WL 1478553, at *2 (Del. Ch. May 15, 2009) ("Classically, Delaware law has viewed as derivative claims by shareholders alleging that they have been wrongly diluted by a corporation's overpayment of shares."); *Feldman v. Cutaia, 951 A.2d 727, 732-33 (Del. 2008)*.

[68] Op. Br. at 26.

[69] *Gentile, 906 A.2d at 102*. We note that *Tooley* was decided by an *en banc* panel of five Justices. *Gentile* was decided by a panel of three Justices, all of whom were part of the *Tooley en banc* panel.

[70] *Opinion, 2020 Del. Ch. LEXIS 328, 2020 WL 6375859, at *13*.

[71] We intend no disrespect to any prior panel of this Court. Rather, we recognize that the law must evolve as a result trial and error, through the tests of time and practical application. The Court at the time perceived Gentile as being harmonious with the *Tooley* test. The parties in Gentile did not appear to have perceived the case as a departure either as they did not move for rehearing *en banc* as only an *en banc* panel may modify or overrule a prior decision of this Court. *Supr. Ct. R. 4(f)*. Cases should not be overruled because the composition of the Court changes and members of the Court may have different views, and mere difference of opinion should not -- and does not today -- cause a departure from precedent. Rather, with the benefit of hindsight and the added perspective of fifteen years of development in Delaware corporate law which our predecessors did not enjoy, we find compelling reasons to revisit Gentile.

[72] *Tooley, 845 A.2d at 1039* (emphasis added).

> Because the means used to achieve that result is an overpayment (or "over-issuance") of shares to the controlling stockholder, the corporation is harmed and has a claim to compel the restoration of the value of the overpayment. That claim, by definition, is derivative.[73]

It went on to find a "separate, and direct, claim arising out of that same transaction."[74] The direct claim was "an improper transfer—or expropriation—of economic value and voting power from the public shareholders to the majority or controlling stockholder."[75]

The gravamen of Plaintiffs' Complaint is that the Private Placement allegedly harmed the Company by issuing shares to Brookfield for an unfairly low price and harmed the stockholders indirectly through economic and voting power dilution proportional to their shareholdings. Thus, the harm to the stockholders was not *independent* of the harm to the Company, but rather flowed indirectly to them in proportion to, and via their shares in, TerraForm. We agree with the Vice Chancellor that under *Tooley*, this alleged corporate overpayment in stock and consequent dilution of minority interest falls "neatly" into *Tooley's* derivative category.

Gentile's second **[**33]** point of tension with *Tooley* is its reliance upon *Tri-Star*. In *Gentile*, the plaintiffs argued that their case was "functionally indistinguishable from, and thus [was] controlled by *Tri-Star*."[76] In *Gentile*, this Court summarized their argument:

> Their argument runs as follows: even if the SinglePoint shares had value, the debt conversion was a self-dealing corporate transaction with a significant stockholder, that increased the voting and economic value of that significant stockholder's interest in SinglePoint, at the expense and to the corresponding detriment of the minority shareholders. The plaintiffs claim that the Court of Chancery erred by reading into *Tri-Star* a requirement that for such a transaction to give rise to a direct claim, the loss of voting power must be 'material,' **[*1269]** *i.e.*, that it must reduce the public stockholders' voting power from majority to minority status.[77]

This Court then "conclude[d] that the plaintiffs are correct and that *Tooley* and *Tri-Star*, properly applied, compel the conclusion that the debt conversion claim was both derivative and direct."[78] In fact, it held that "[t]his case is . . . functionally indistinguishable from *Tri-Star*, and *Tri-Star's* governing rule **[**34]** should control."[79]

Plaintiffs argue on appeal that "*Tooley* noted that *Tri-Star* addressed the special injury concept that was being discarded but did not discuss or overrule *Tri-Star's* result."[80] They argue further that *Gentile* did not specifically discuss the "special injury" test, and that its reference to *Tri-Star* "merely recognizes that the special injury analysis partially concerns the same issue as *Tooley's* first prong -- *i.e.*, whether stockholders were directly harmed."[81] They also point out that *Gentile* cites to *Kramer* which *Tooley* had cited with approval.

Some historical perspective may be useful in explaining the confusion that *Tooley* sought to eliminate, and why there is support for the view that *Gentile* is doctrinally in tension with *Tooley*. The phrase "special injury" was first used by the Court of Chancery in *Elster v. Am. Airlines,*

---

[73] *Gentile, 906 A.2d at 100*.

[74] *Id.*

[75] *Id.* This Court in *Gentile* chose not to use the word "dilution" and instead used "extraction or expropriation:"

> In *Tri-Star*, this Court **[**32]** articulated the harm to the minority in terms of a "dilution" of the economic value and voting power of the stock held by the minority. In this case, we adopt a more blunt characterization -- extraction or expropriation --because that terminology describes more accurately the real-world impact of the transaction upon the shareholder value and voting power embedded in the (pre-transaction) minority interest, and the uniqueness of the resulting harm to the minority shareholders individually, than does a description framed in terms of "dilution."

906 A.2d at 102 n.26. But the presence of a controlling stockholder does not negate the fact that the minority stockholders were diluted in proportion to their stockholdings in TerraForm.

[76] *Id. at 101*.

[77] *Id. at 99*.

[78] *Id.*

[79] *Id. at 101*.

[80] Ans. Br. at 27.

[81] *Id.*

Inc.[82] There, the plaintiff asserted a direct claim for dilution, alleging that a stock issuance to senior management was for inadequate consideration. The court rejected plaintiff's claim, in part, because

> [a]ny injury which plaintiff may receive by reason of the dilution of his stock would be equally applicable to all the stockholders of defendant, **[**35]** since plaintiff holds such a small amount of stock in proportion to the amount of stock outstanding that the control or management of defendant would not be affected by the granting of these options, and, further, since there is no averment that the pre-emptive rights of plaintiff as a stockholder are affected by their issuance.[83]

The Court of Chancery, in setting forth the "special injury" test, identified three categories of direct injury. It also recognized that stockholders could be harmed *indirectly* as a result of harm to the corporation and that such claims would be derivative:

> There are cases . . . in which there is injury to the corporation and also special injury to the individual stockholder. In such case a stockholder . . . may proceed on his claim for the protection of his individual rights rather than in the right of the corporation. The action would then not constitute a derivative action . . . Here the wrong of which plaintiff complains is not a wrong inflicted upon him alone or a wrong affecting any particular right which he is asserting,—such as his pre-emptive rights as a stockholder, rights involving control of the corporation, or a wrong affecting the stockholders and **[**36]** not the corporation,—*but is an indirect injury as a result of the wrong done to the corporation*.[84]

But later decisions in this class of cases omitted *Elster's* reference to "indirect injury" in describing derivative claims. In *Bokat v. Getty Oil Co.*,[85] a stockholder **[*1270]** sought "money damages for improper management of [the corporation]."[86] Thus, the *Bokat* Court classified the claims as belonging to the corporation and not its stockholders. But it reached that result by reasoning that, "[w]hen an injury to corporate stock falls equally upon all stockholders, then an individual stockholder may not recover for the injury to his stock alone, but must seek recovery derivatively on behalf of the corporation."[87]

Similarly, in *Moran v. Household Int'l. Inc.*,[88] the Court of Chancery inquired whether the plaintiffs had suffered an "injury distinct from that suffered by other shareholders."[89] There the Court of Chancery held that the adoption of a shareholder rights plan was not subject to an individual challenge unless shareholders were actively engaged in a proxy fight that the rights plan would thwart. It reasoned that the claims were derivative, "[b]ecause the plaintiffs are not engaged in **[**37]** a proxy battle, they suffer no injury distinct from that suffered by other shareholders as a result of this alleged restraint on the ability to gain control of [the company] through a proxy contest."[90] *Moran* cited *Elster* but did not refer to the "special injury" concept. Instead, *Moran* set forth the following test for ascertaining the nature of the claim:

> To set out an individual action, the plaintiff must allege either an injury which is separate and distinct from that suffered by other shareholders, or a wrong involving a contractual right of a shareholder, such as the right to vote, or to assert majority control, which exists independently of the corporation.[91]

This Court affirmed the decision but did not specifically address the Court of Chancery's holding that the claims were derivative.[92]

---

[82] *34 Del. Ch. 94, 100 A.2d 219, 222 (Del. Ch. 1953)*.

[83] *Id. at 222*.

[84] *Id.* (emphasis added).

[85] ***262 A.2d 246 (Del. 1970)***.

[86] ***Id. at 249***.

[87] *Id.* (citing 13 Fletcher, *Corporations* (Perm. Ed.) § 5913).

[88] *490 A.2d 1059, 1069-70 (Del. Ch. 1985)*, *aff'd*, *500 A.2d 1346 (Del. 1985)*.

[89] *Id. at 1069-70*.

[90] *Id. at 1070-1071*. In addition, the Court found that, although the plaintiff corporation was the defendant corporation's largest stockholder (holding approximately five percent of the defendant corporation's stock), it did not suffer any unique harm merely by virtue of its holdings because it had no alleged intent to use its block position to gain control of the defendant corporation.

[91] *Id. at 1070* (internal quotations and citations omitted).

[92] *Moran v. Household Int'l Inc., 500 A.2d 1346 (Del. 1985)*.

The following year, this Court addressed the direct/derivative distinction in *Lipton v. News Int'l, Plc*.[93] In its analysis, *Lipton* compared the passages from both *Moran* and *Elster* quoted above. But in doing so, *Lipton* failed to mention the third situation in *Elster* giving rise to "special injury," namely, when "a wrong affected the stockholders and not the corporation:"

> In comparing the two-pronged **[**38]** test of *Moran* with the definition of "special injury" in *Elster*, it appears that the term encompasses both prongs of the *Moran* test. That is, a plaintiff alleges a special injury and may maintain an individual action if he complains of an injury distinct from that suffered by other shareholders or a wrong involving one of his contractual rights as a shareholder. Moreover, while *Moran* serves as a useful guide, the case should not be construed as establishing the only test for determining whether a claim is derivative or individual in nature. Rather, as was established in *Elster*, we must look **[*1271]** ultimately to whether the plaintiff has alleged "special" injury, in whatever form.[94]

In 1988, this Court again addressed the direct/derivative distinction in *Kramer v. Western Pacific Industries, Inc.*[95] Surprisingly, *Kramer* did not rely on *Lipton*, although it cited it. Nor did it refer to "special injury." There plaintiffs challenged certain corporate insiders' receipt of stock options and golden parachutes in a merger transaction. In determining that the claims amounted only to "waste" and were derivative, the Court articulated **[**39]** the direct/derivative test as:

> [T]o have standing to sue individually, rather than derivatively on behalf of the corporation, the plaintiff must allege more than an injury resulting from a wrong to the corporation. . . . "[T]o set out an individual action, the plaintiff must allege either 'an injury which is separate and distinct from that suffered by other shareholders,' or a wrong involving a contractual right of a shareholder . . . which exists independently of any right of the corporation." For a plaintiff to have standing to bring an individual action, he must be injured *directly* or *independently* of the corporation.[96]

In 1993, this Court next addressed the direct/derivative analysis in *Tri-Star*. There we relied on *Lipton* and the "special injury" test without ever citing to the more recent decision in *Kramer*. *Tri-Star* stated the "special injury" test as follows:

> It is well settled that the test used to distinguish between derivative and individual harm is whether the plaintiff suffered 'special injury.' A special injury is established where there was a wrong suffered by the plaintiff that was not suffered by all the stockholders generally or where the wrong involves a contractual right **[**40]** of the stockholders, such as the right to vote.[97]

Like *Lipton, Tri-Star* omits *Elster's* third category of special injury "when the wrong affects the stockholders and not the corporation."

But then three years later, in *Grimes v. Donald*,[98] this Court, in distinguishing between direct and derivative claims, relied almost exclusively on *Kramer* and *Moran* but did not mention either *Lipton* or *Tri-Star*. Nor did it mention the "special injury" concept:

> "Although tests have been articulated many times, it is often difficult to distinguish between a derivative and an individual action." . . . The distinction depends upon "'the nature of the wrong alleged' and the relief, if any, which could result if plaintiff were to prevail." . . . To pursue a direct action, the stockholder-plaintiff "must allege more than an injury resulting from a wrong to the corporation." . . . The plaintiff must state a claim for "'an injury which is separate and distinct from that suffered by other shareholders,' . . . or a wrong involving a contractual right of a shareholder . . . which exists independently of any right of the corporation."[99]

---

[93] 514 A.2d 1075 (Del. 1986).

[94] Id. at 1078; *see also* Kurt M. Heyman & Patricia L. Enerio, *The Disappearing Distinction between Derivative and Direct Actions*, 4 DEL. L. REV. 155 (2001).

[95] 546 A.2d 348 (Del. 1988).

[96] Id. at 351 (quoting Moran, 490 A.2d at 1070 and citing ***Bokat, 262 A.2d at 249***) (emphasis in original).

[97] Tri-Star, 634 A.2d at 330 (finding that plaintiffs stated individual claims for cash-value and voting power dilution and separately, that the controlling stockholder's alleged breach of the duty of disclosure, if true, is a unique special harm to each uninformed stockholder for which the wrongdoer is answerable in damages.).

[98] 673 A.2d 1207 (Del. 1996).

[99] Id. at 1213 (citing Kramer, 546 A.3d at 352 and Moran, 490

[*1272] Then came our decision in *Parnes v. Bally Entertainment Corp.*,[100] where the plaintiff alleged **[**41]** that the Chairman and CEO of Bally wrongfully required that corporate assets be transferred to him in order to obtain his consent in proceeding with a merger. This Court concluded that such allegations directly challenged the fairness of the process and the price in the merger.[101] Citing only to *Kramer* and avoiding the term "special injury," it stated simply that "[a] derivative claim is one that is brought by a stockholder, on behalf of the corporation, to recover for harms done to the corporation."[102] By contrast, "[s]tockholders may sue on their own behalf (and, in appropriate circumstances, as representatives of a class of stockholders) to seek relief for direct injuries that are independent of any injury to the corporation."[103]

In 2004, this Court in *Tooley* sought to bring clarity to this confusing area of the law by discarding the "special injury" test and announcing a simple test that would be easier to apply. It is important to identify precisely which part of *Tri-Star's* analysis was discarded by *Tooley*. The answer lies in the refocused *Tooley* test itself and in *Tooley's* statement that

> two confusing propositions have encumbered our caselaw governing the direct/derivative distinction. **[**42]** The "special injury" concept, applied in cases such as *Lipton*, can be confusing in identifying the nature of the action. The same is true of the proposition that stems from *Bokat* -- that an action cannot be direct if all stockholders are equally affected or unless the stockholder's injury is separate and distinct from that suffered by other stockholders.[104]

The problem with *Lipton*, according to *Tooley*, was that the trial court had found a "special injury" because the board's manipulation of certain transactions "worked an injury upon the plaintiff-stockholders unlike the injury suffered by other stockholders."[105] That was because the plaintiff-stockholder was actively seeking to gain control of the defendant corporation. According to *Tooley*, the court could have reached the same correct result by simply concluding that the manipulation directly and individually harmed the stockholders, without injuring the corporation.

The problem with this Court's decision in *Bokat*, according to *Tooley*, was different. Though the *Tooley* Court agreed that the *Bokat* matter was derivative, it explained that *Bokat*'s concept that a suit "must be maintained derivatively if the injury falls equally upon all stockholders" **[**43]** was both "confusing" and "inaccurate."[106] It was inaccurate because "a direct, individual claim of stockholders that does not depend on harm to the corporation can also fall on all stockholders equally, without the claim thereby becoming a derivative claim."[107] It was "confusing" because **[*1273]** the "equal injury" concept appeared to be intended to address the fact that an indirect stockholder injury flowing derivatively through the corporation diminishes

---

A.2d at 1070).

[100] 722 A.2d 1243 (Del. 1999).

[101] *Id. at 1245*.

[102] *Id.*

[103] *Id.* (citing Kramer, 546 A.3d at 352). This Court further stated that, "[a] stockholder who directly attacks the fairness or validity of a merger alleges an injury to the stockholders, not the corporation, and may pursue such a claim even after the merger has been consummated." *Id.*

[104] Tooley, 845 A.2d at 1038-39.

[105] *Id. at 1037*.

[106] *Id.*

[107] Tooley, 845 A.2d at 1037. The Court of Chancery recognized this weakness in the "special injury" rule in *In re Gaylord Container Corp. S'holder Litig.*, when it allowed a class of all non-defendant stockholders to pursue a direct claim against controlling shareholders who were also board members and who had taken entrenchment actions which included anti-takeover provisions ten days before a post-bankruptcy restructuring terminated their shares' super-voting privileges and ended their control of the shareholder vote. 747 A.2d 71, at 73. Reviewing *Moran*, the Court of Chancery in *Gaylord* wondered why the special injury cases would classify the case as direct or derivative based on whether the entrenching board were also shareholders themselves. *Id. at 80*. "The mere fact that such an injury is to the economic property rights of all the stockholders rather than to their voting rights does not make the injury suffered any less 'special' and non-corporate." *Id.* It then cited to commentators who had criticized *Moran's* focus "on the similarity of treatment" as missing "the central point that fundamental shareholder rights (*e.g.*, voting and alienability) can be infringed by a variety of board actions that treat existing shareholders alike." *Id. at 81* (citing *2 Principles of Corporate Governance: Analysis & Recommendations* § 7.01 n.3 at 30 (1994)).

each share of stock equally.[108] But the relevant factor was not that all stockholders could equally assert the claim -- it was that the claim "does not arise out of any independent or direct harm to the stockholders, individually."[109]

The *Tooley* Court then noted that "[t]he proper analysis has been and should remain that stated in *Grimes, Kramer*, and *Parnes*. That is, a court should look to the nature of the wrong and to whom the relief should go."[110]

Further, *Gentile*, by focusing on whether one group of stockholders (a controller) was impacted differently from another group (the public or minority holders), arguably **[**44]** relied on one aspect of *Tri-Star's* special injury concept, *i.e.*, focusing on whether a wrong suffered by plaintiff was not suffered by all stockholders generally.[111] We note that, if this were the proper focus and requirement for finding a direct injury as opposed to whether a stockholder suffered an injury independent of any injury suffered by the corporation, then that would seem to preclude a class of all stockholders asserting a direct claim. *Tooley's* first prong instead properly focuses on who suffered the alleged harm and requires that the stockholder demonstrate that he or she has suffered an injury that is not dependent on an injury to the corporation.

In sum, *Gentile's* statements that *Tri-Star* "created the analytical framework for this issue," that *Gentile* "was functionally indistinguishable from *Tri-Star*," and that it **[**45]** applied *Tri-Star* and *Tooley* in determining the debt conversion claim was both derivative and direct,[112] detracts from *Tooley's* stated goal of adding clarity to a difficult and important area of our law. Although *Gentile* does not expressly discuss the "special injury" test, it creates confusion by heavily relying on *Tri-Star's* analysis,[113] which in turn relies on *Lipton* **[*1274]** and the "special injury test" that *Tooley* rejected. By expressly stating that it had "applied" *Tooley* and *Tri-Star, Gentile* blurred *Tooley*'s clear rejection of the "special injury" test.[114]

The third area of tension is *Gentile's* focus on the wrongdoer. *Gentile* is premised on the presence of a controlling stockholder that allegedly used its control to "expropriate" and extract value and voting power from the minority stockholders. Controlling stockholders owe fiduciary duties to the minority stockholders, but they also owe fiduciary duties to the corporation.[115] The focus on the alleged wrongdoer deviates from *Tooley's* determination, which turns *solely* on two central inquiries of who suffered the harm and who would receive the benefit of any recovery. That shift has led to doctrinal **[**46]** confusion in our law. The presence of a controller, absent more, should not alter the fact that such equity overpayment/dilution claims are normally exclusively derivative because the *Tooley* test does not turn on the identity of the alleged wrongdoer.[116]

---

[108] *Tooley, 845 A.2d at 1037*.

[109] *Id.*

[110] *Id. at 1039*.

[111] *See Tri-Star, 634 A.2d at 330* ("A special injury is established where there is a wrong suffered by plaintiff that was not suffered by all stockholders generally or when the wrong involves a contractual right of stockholders, such as the right to vote."). But *Tri-Star* recognized two different types of direct injury to shareholder voting rights:

> "Voting power dilution is a harm distinct and separate from that suffered by the minority shareholders due to the alleged nondisclosures made by the defendants in their proxy materials. The harm from voting power dilution goes to the impact of an individual stockholder's vote, the latter harm goes to a stockholder's right to cast an *informed* vote."

Id. at n.12 (emphasis in original).

[112] *Gentile, 906 A.2d at 99, 101*.

[113] We note in this regard that *Gentile* states that "*Tri-Star's* governing rule should control." *Id. at 101*.

[114] *Tri-Star* also did not cite to *Kramer* which, by contrast, had been cited with approval in *Tooley*. *Gentile*, however, does cite *Kramer*, but for the proposition that equity dilution is normally a derivative harm, not a direct harm. *Gentile, 906 A.2d at 99*.

[115] *Carr v. New Enter. Assocs., Inc., 2018 Del. Ch. LEXIS 100, 2018 WL 1472336, at * 22 (Del. Ch. 2018)* ("A controlling stockholder owes fiduciary duties to the corporation and its minority stockholders, and it is 'prohibited from *exercising corporate power* (either formally as directors or officers or informally through control over officers and directors) so as to advantage [itself] while disadvantaging the corporation.'") (citation omitted).

[116] *See, e.g., Agostino, 845 A.2d at 1126 n.84* ("The identity of the culpable parties does not speak to whether the conduct of those parties injured the corporation, rather than its stockholders.").

Because of this shift in focus, the Vice Chancellor aptly observed that "[p]ost-Gentile, Delaware courts have struggled to define the boundaries of dual-natured claims."[117] Understandably, cases decided soon after Gentile assumed that direct standing was only available in circumstances involving a controlling stockholder or, by implication, a functionally equivalent control group.[118]

Thereafter, however, courts construed Gentile more expansively to logically extend to non-controller issuances involving participating insiders. In *Carsanaro v. Bloodhound Tech, Inc.*,[119] for example, the Court of Chancery held that Gentile also applied to self-interested stock issuances effectuated by a board lacking a disinterested and independent majority. The Court of Chancery reasoned that "the core insight of dual injury applies to non-controller issuances in which insiders participate."[120]

[*1275] Similarly, in *In **[**47]** re Nine Sys. Corp. S'holders. Litig.*,[121] the Court of Chancery found direct standing with respect to a dilutive recapitalization transaction in which the directors and their affiliated funds participated. The court commented that "it makes little sense to hold a controlling stockholder to account to the minority for improper expropriation after a merger but to deny standing for stockholders to challenge a similar expropriation by a board of directors after a merger."[122] The court asked why Delaware law should hold controlling stockholders to a higher standard than the board of directors when, after all, the board has exclusive authority to manage the business and affairs of the corporation, which includes the power to issue stock.[123] We agree that there is no principled reason to allow dilution/overpayment claims to proceed directly against controllers when the law rightly refuses to permit such claims to proceed directly in non-controller dilution cases.

This expanded application of Gentile was subsequently curtailed by this Court's opinion reversing the Court of Chancery in *El Paso*.[124] The challenged transaction in *El Paso* did not fall squarely under the Gentile paradigm as the **[**48]** entity involved was a limited partnership and the alleged harm involved economic dilution where the limited partner conceded that he had proved only expropriation of economic value, and not any dilution of voting rights. Understandably, the defendants in *El Paso* did not argue on appeal that Gentile should be overruled. Thus, this Court was not asked -- and did not reconsider --Gentile at that time. However, in *El Paso* we expressly "decline[d] the invitation to further expand the universe of claims that can be asserted 'dually' to hold here that the extraction of solely economic value from the minority by a controlling stockholder constitutes direct injury."[125] Thus, we made clear that Gentile should be read narrowly because any other interpretation would swallow the general rule that equity dilution claims are solely derivative and cast doubt on the *Tooley* framework.[126]

---

[117] *Opinion, 2020 Del. Ch. LEXIS 328, 2020 WL 6375859, at *13* (citing Sciabacucchi v. Liberty Broadband Corp., 2018 Del. Ch. LEXIS 252, 2018 WL 3599997, at *7 (Del. Ch. July 26, 2018)).

[118] *Feldman, 956 A.2d at 657 (Del. Ch. 2007)* ("Indeed, any other interpretation would swallow the general rule that equity dilution claims are solely derivative, and would cast great doubt on the continuing vitality of the *Tooley* framework."), *aff'd*, *951 A.2d 727 (Del. 2008)*. Under *Feldman*, a dual-natured claim arises only where "a controlling stockholder, with sufficient power to manipulate the corporate processes, engineers a dilutive transaction whereby that stockholder receives an exclusive benefit of increased equity ownership and voting power for inadequate consideration." *Id. at 657*.

[119] *65 A.3d 618 (Del. Ch. 2013)*.

[120] *Id. at 658*. The Court of Chancery stated further that "[t]he expropriation principle operates only when defendant fiduciaries (i) had the ability to use the levers of corporate control to benefit themselves and (ii) took advantage of the opportunity." *Id. at 659*.

[121] *2014 Del. Ch. LEXIS 171, 2014 WL 4383127, at *26 (Del. Ch. Sept. 4, 2014)*, *aff'd sub nom.* ***Fuchs v. Wren Holdgs., LLC, 129 A.3d 882 (Del. 2015)*** (TABLE).

[122] *2014 Del. Ch. LEXIS 171, [WL] at *28*.

[123] *Id.*

[124] *See, e.g., Carr*, 2018 Del. Ch. LEXIS 100, 2018 WL 1472336, at *9 ("to invoke the dual dynamic recognized in Gentile, a controlling stockholder must exist *before* the challenged transaction.") (emphasis in original); *Cirillo Family Trust v. Moezinia, 2018 Del. Ch. LEXIS 230, 2018 WL 3388398, *16 (Del. Ch. 2018)* ("the Gentile paradigm only applies when a stockholder *already possessing majority or effective control* causes the corporation to issue more shares to it for inadequate consideration.") (emphasis in original).

[125] ***152 A.3d at 1264***.

[126] *Id.*; *see also W&M Helenthal Holdg. LLC v. Schmitt*, C.A. No. 2018-0505-AB (Del. Ch. June 3, 2019) (TRANSCRIPT) at

The Court of Chancery in *Sciabacucchi* observed our guidance that "the reasoning of *El Paso*, applied here, means that *Gentile* must be limited to **[**49]** its facts, which involved a dilutive stock issuance to a **[*1276]** controlling stockholder."[127] However, it noted that limiting *Gentile* to controller situations rather than expanding it to non-controller dilution cases, or overruling it entirely is, as a matter of doctrine, unsatisfying, because there is no reason to permit direct dilution claims against controllers while prohibiting direct claims in other contexts.[128]

Chief Justice Strine's concurrence in *El Paso* agreed that the facts presented did "not require us to consider *Gentile's* ongoing viability in the corporate law context," and that it was "[s]ufficient for today" that "we refuse to extend *Gentile* further, to a situation where a limited partnership was already firmly under the control of a general partner and where the transaction under attack had no effect whatsoever on limited partner voting rights."[129] But he more directly questioned *Gentile's* continued viability as sound law, writing that *Gentile* "is a confusing decision, which muddies the clarity of our law in an important context,"[130] and that it "cannot be reconciled with the strong weight of our precedent."[131]

It was not until this case that the **[**50]** issue of *Gentile's* continued viability was squarely presented to this Court.[132] The Vice Chancellor appropriately observed that changing settled law by the Supreme Court requires reasoned analysis by this Court. The difficulty courts have had in applying *Gentile* in a logically consistent way, along with *Gentile's* erosion of *Tooley's* simple analysis convinces us that *Gentile* should be overruled.

2. The Gentile "Carve-Out" is Superfluous

Aside from the doctrinal difficulties discussed above, we see no practical need for the "*Gentile* carve-out." Other legal theories, *e.g., Revlon*, provide a basis for a direct claim for stockholders to address fiduciary duty violations in a change of control context.[133] And as we observed in *El Paso*, "equity holders confronted by a merger in which derivative claims will pass to the buyer have the right to challenge **[*1277]** the merger itself as a breach of the duties they are owed."[134] Such

---

51:11-115 ("In its 2016 *El Paso* decision, our Supreme Court made clear that the *Gentile* doctrine is to be construed narrowly and that the sort of dual claims described in that case only apply in the unique circumstances of that case."); *Sciabacucchi v. Liberty Broadband Corp., 2018 Del. Ch. LEXIS 252, 2018 WL 3599997, at * 10 (Del. Ch. Jul. 26, 2018)* ("*El Paso* thus implicitly rejected the reasoning of decisions such as *Carsanaro* and *Nine Systems*, which had extended *Gentile* to any dilutive issuance approved by a conflicted board."); *In re: Zohar III, Corp., 631 B.R. 133, 2021 Bankr. LEXIS 1622, 2021 WL 2495146, at *39 (Bankr. D. Del. June 18, 2021)* ("While the continued application and viability of the holdings in *Gentile* have been questioned, they have not been overruled. Regardless, they should be applied cautiously and narrowly.").

[127] *Sciabacucchi, 2018 Del. Ch. LEXIS 252, 2018 WL 3599997, at *10*. In *Reith v. Lichtenstein, 2019 Del. Ch. LEXIS 244, 2019 WL 2714065 (Del. Ch. June 28, 2019)*, the Court of Chancery determined that even an issuance of preferred stock to a controller for allegedly unfair consideration which resulted in a dilution of the minority stockholders' voting power, was derivative because stockholders retained the same percentage of the Company's shares of common stock after the Preferred Stock was issued as they had before. *See also* *Klein v. H.I.G. Capital, L.L.C., 2018 Del. Ch. LEXIS 577, 2018 WL 6719717, at *7 (Del. Ch. Dec. 19, 2018)* (noting "this court has exercised caution in applying the *Gentile* framework"); *Almond v. Glenhill Advisors LLC, 2018 Del. Ch. LEXIS 280, 2018 WL 3954733, at *24 (Del. Ch. Aug. 17, 2018)* (the Supreme Court in *El Paso* "recently construed the [*Gentile*] doctrine narrowly" and "[i]n the wake of *El Paso*, this court has exercised caution in applying the *Gentile* framework"). We agree with Appellants that the different treatment of common and preferred stock in these cases makes little sense.

[128] *2018 Del. Ch. LEXIS 252, [WL] at *10, n.147*

[129] ***El Paso, 152 A.3d at 1266*** (Strine, C.J., concurring).

[130] ***Id. at 1265-66***.

[131] ***Id. at 1266***.

[132] In *Sheldon v. Pinto Technology Ventures, L.P.*, for example, this Court did not address the continued vitality of *Gentile* because the sole issue presented was whether the plaintiff had adequately alleged the existence of a control group. ***220 A.3d 245, 250 n.15 (Del. 2019)***.

[133] ***El Paso, 152 A.3d at 1266*** (Strine, C.J., concurring) (noting that even in a change of control situation, "there is no gap in our law for *Gentile* to fill" since "*Revlon* already accords a direct claim to stockholders when a transaction shifts control of a company for a diversified investor base to a single controlling stockholder.").

[134] ***El Paso, 152 A.3d at 1252*** (citing *Parnes v. Bally Entm't Corp., 722 A.2d 1243, 1245 (Del. 1999)* ("In order to state a direct claim with respect to a merger, a stockholder must

stockholders might claim that the seller's board failed to obtain sufficient value for the derivative claims.[135]

In addition, *Gentile* creates the potential practical problem of allowing two separate claimants **[**51]** to pursue the same recovery.[136] The double recovery rule prohibits a plaintiff from recovering twice for the same injury from the same tortfeasor.[137] In a corporate-overpayment-to-a-controlling shareholder claim, the amount of the overpayment deprives the corporation of assets to which minority shareholders have only a *pro rata* claim as residual claimants on the corporation's assets. If the corporation recovers the overpaid funds, then the minority shareholders are beneficiaries of that recovery on that same *pro rata* basis.

As Appellees concede, the double recovery rule does not permit both the direct and derivative claimants to recover for that single injury. Rather, they propose that the Court of Chancery devise a mechanism to "proportion" the recovery for the overpaid funds between the plaintiffs if both derivative and direct shareholders claim it.[138] Permitting such "dual" claims unnecessarily complicates fashioning a remedy for such claims. *Tooley* appropriately sought to simplify the law, not complicate it.

For the foregoing reasons, like the Court of Chancery, we think that the corporation overpayment/dilution *Gentile* claims, like those present here, are exclusively derivative under *Tooley* and that *Gentile*, for all of the reasons identified above, should be overruled. We now explain **[*1278]** why *stare decisis* does not compel our adherence to *Gentile*.

3. Stare Decisis Presents No Obstacle Here

Plaintiffs argue that "*stare decisis*" compels this Court to uphold *Gentile*. No doubt, the development of and adherence to precedent **[**53]** is an essential feature of common law systems,[139] and as such, precedent should not be lightly cast aside. The United States Supreme Court has explained that "*[s]tare decisis* 'promotes the evenhanded, predictable, and consistent development of legal principles, fosters reliance on judicial decisions, and contributes to the actual and

challenge the validity of the merger itself, usually by charging the directors with breaches of fiduciary duty resulting in unfair dealing and/or unfair price.") (additional citations omitted).

[135] *See, e.g.,* ***Morris, 246 A.3d at 132*** ("After *Parnes*, 'to state a direct claim with respect to a merger, a stockholder must challenge the validity of the merger itself, usually by charging the directors with breaches of fiduciary duty resulting in unfair dealing and/or unfair price.'"); ***id. at 136*** ("When the court is faced with a post-merger claim challenging the fairness of a merger based on the defendant's failure to secure value for derivative claims, we think the *Primedia* framework provides a reasonable basis to conduct a pleadings-based analysis to evaluate standing on a motion to dismiss.").

[136] We note that following the acquisition in *Gentile* (when the corporation was acquired by a third party and plaintiffs lost derivative standing), the acquiring company was liquidated and the stockholders of the acquired company were left as the only parties who could recover for a dilution claim.

[137] As this Court observed in *J.P. Morgan Chase & Co. S'holder Litig.*, "if the plaintiffs' damages theory is valid, the directors of an acquiring corporation would be liable to pay both the corporation and its shareholders the same compensatory damages for the same injury. That simply cannot be." *906 A.2d at 773*.

[138]

> COUNSEL: I think I was perhaps unclear then. I don't think there would be a double recovery, I think that in the end, there would only be **[**52]** one recovery and the court may have to determine as it would on any case, whether its direct and derivative claims permitted, how to proportion the damages. I think one solution might be to really allow the direct claim to go forward because ultimately those shareholders can receive the full remedy. But I don't at all think if the shares were underpriced by $3, that the corporation would get a $3 damages award and the shareholders would also get a $3 damages award, plus something else for derivative, for voting dilution damages, because then the shareholders would be double recovering. I don't know if that was a satisfactory answer, but I don't think there would be a double recovery.

Oral Argument at 23:00-25:44, https://livestream.com/delawaresupremecourt/events/9697327/videos/222905751.

[139] *See* 1 Blackstone, Commentaries, *68-70 (conceiving of the common law as having its "maxims" known and "their validity determined" by "the judges in the several courts of justice," and that they are subject to "an established rule to abide by former precedents."); *see also* *Patterson v. McLean Credit Union, 491 U.S. 164, 172, 109 S. Ct. 2363, 105 L. Ed. 2d 132 (1989)* (observing that "*stare decisis* is a basic self-governing principle within the Judicial Branch, which is entrusted with the sensitive and difficult task of fashioning and preserving a jurisprudential system that is not based upon 'arbitrary discretion.'") (quoting the Federalist, No. 78, p. 490 (H. Lodge ed. 1888) (A. Hamilton)).

perceived integrity of the judicial process.'"[140] That principle, embodied in the Latin term, "*stare decisis*,"[141] is an important feature of Delaware law and of judicial restraint. As this Court stated in *Seinfeld v. Verizon Comm'n, Inc.*, "[u]nder the doctrine of *stare decisis*, settled law is overruled only 'for urgent reasons and upon clear manifestation of error.'"[142]

When re-examining a question of law in a prior case, the essential danger is that parties have acted in reliance on the answer that this Court previously gave.[143] There is no hard and fast rule for when a decision is or is not immutable, because the nature of reliance interests at play and the importance of improving doctrinal law are highly context-specific inquiries. Thus, the formulation we gave in *Seinfeld*, (quoting *Oscar George v. Potts*) though longstanding, **[**54]** is necessarily vague.

Nevertheless, decisions by Delaware and federal courts offer some guideposts by which to measure and weigh these reliance interests. One consideration is the nature of any reliance interests in the decision. Reliance interests flow from a number of sources.[144] Because parties have a right to have confidence that long-established **[*1279]** rules will be retained, the "antiquity" of the precedent is accorded importance,[145] with due consideration for whether the challenged precedent was itself a departure.[146] The area of law the precedent addresses is likewise a consideration, since some subjects are more apt to induce reliance than others.[147]

Clarity and administrability also relate to reliance interests, since reliance can only be created by a ruling which is amenable to consistent, stable, and thus predictable application.[148] Thus, a "traditional justification for overruling a prior case is that a precedent may be a positive detriment to coherence and consistency in the law, either because of inherent confusion created by an unworkable decision, or

---

[140] Gamble v. United States, 139 S.Ct. 1960, 1969, 204 L. Ed. 2d 322 (2019) (citation omitted).

[141] Literally "to stand by things decided." *Stare Decisis*, Black's Law Dictionary (11th ed. 2019).

[142] 909 A.2d 117, 124 (Del. 2006) (citing Oscar George, Inc. v. Potts, 49 Del. 295, 10 Terry 295, 115 A.2d 479, 481 (Del. 1955)). We have quoted that language verbatim on many occasions. *See, e.g.,* Shuba v. United Servs. Auto. Ass'n, 77 A.3d 945, 949 (Del. 2013); White v. Liberty Ins. Corp., 975 A.2d 786, 790-91 (Del. 2009); Account v. Hilton Hotels Corp., 780 A.2d 245, 248 (Del. 2001).

[143] *See* State v. Barnes, 116 A.3d 883, 891 (Del. 2015) ("The doctrine of *stare decisis* exists to protect the settled expectations of citizens because, 'elementary considerations of fairness dictate that individuals should have an opportunity to know what the law is and to conform their conduct accordingly.'") (alteration omitted) (quoting Landgraf v. USI Film Prods., 511 U.S. 244, 265, 114 S. Ct. 1483, 128 L. Ed. 2d 229 (1994)).

[144] For example, the General Assembly, in its lawmaking capacity, necessarily relies upon this Court's pronouncements of what the law already is. Thus, "prior statute-interpreting rulings gain approving harmony from ensuing legislative silence." *See* Nationwide Prop & Cas. Ins. Co. v. Irizarry, 2020 Del. Super. LEXIS 62, 2020 WL 525667, at *4 (Del. Super. Jan. 31, 2020) ("Any concerted judicial misconstruction of a statute is subject to corrective tuning by the legislature, and thus prior statute-interpreting rulings gain approving harmony from ensuing legislative silence."), *aff'd*, ***238 A.3d 191, 2020 Del. LEXIS 286, 2020 WL 5031953 (Del. 2020)*** (affirming the Superior Court on the basis of its opinion).

[145] Gamble, 139 S.Ct. at 1969 ("the strength of the case for adhering to such decisions grows in proportion to their 'antiquity'") (quoting Montejo v. Louisiana, 556 U.S. 778, 792, 129 S. Ct. 2079, 173 L. Ed. 2d 955 (2009)).

[146] *See* Adarand Constructors, Inc. v. Peña, 515 U.S. 200, 231, 115 S. Ct. 2097, 132 L. Ed. 2d 158 (1995) (if the precedent under consideration itself departed from the Court's jurisprudence, returning to the "intrinsically sounder" doctrine established in prior cases may "better serv[e] the values of *stare decisis* than would following the more recently decided cases inconsistent with the decisions that came before it").

[147] *See* Kimble v. Marvel Entertainment, LLC, 576 U.S. 446, 457, 135 S. Ct. 2401, 192 L. Ed. 2d 463 (2015) ("Considerations favoring *stare decisis* are at their acme" in "cases involving property and contract rights" because "parties are especially likely to rely on such precedents when ordering their affairs."). In criminal matters, reliance interests are so strong that "under the doctrine of *stare decisis*, we must take seriously the longstanding interpretation of a statute held by our Superior Court, especially when it has been relied upon by the key actors in our criminal justice system." Barnes, 116 A.3d at 890-91.

[148] *See* Itel Containers Int'l Corp. v. Huddleston, 507 U.S. 60, 79-80, 113 S. Ct. 1095, 122 L. Ed. 2d 421 (1993) (Scalia, J., concurring) ("Like almost all their predecessors, these latest tests are so uncertain in their application (and in their anticipated life span) that they can hardly be said to foster stability or to engender reliance deserving of *stare decisis* protection.").

because the decision poses a direct obstacle to the realization of **[**55]** important objectives embodied in other laws."[149]

Bounded up with reliance interests are institutional considerations of the Court. Precedent should not be overturned by narrow majorities[150] and very recent precedent should not lightly be overturned when the only change is the composition of the court,[151] because society **[*1280]** must be able to "presume that bedrock principles are founded in the law rather than in the proclivities of individuals."[152] "Overruling precedent is never a small matter."[153] Mere disagreement with the reasoning and outcome of a prior case, even *strong* disagreement, cannot be adequate justification for departing from precedent or *stare decisis* would have no meaning.[154]

This Court decided Gentile fifteen years ago. This is old enough, we think, that we can properly say that the practical and analytical difficulties courts have encountered in applying it reflect fundamental unworkability and not growing pains, but not so old as to carry the weight of "antiquity." Moreover, that gap in time has given us the perspective to see that Gentile is more of a departure from the then-recent *Tooley* than the continuation we **[**56]** perceived it to be at the time.[155] Any reliance is further muted by *El Paso*, from which parties could rightly anticipate that Gentile's continued viability was in doubt. Finally, in overturning it today we speak unanimously, with the concomitant aid to certainty that provides. Having given all due consideration to the weight of precedent, the circumstances persuade us that we should overrule the Gentile exception to our *Tooley* test for derivative and direct standing. Accordingly, Gentile should be, and hereby is, overruled.

D. Appellees Cross-Appeal Contention that They Have Direct Standing Regardless of Gentile is Meritless

Appellees also separately argue on cross-appeal that they have direct standing to proceed without Gentile because the transaction consolidated Brookfield's control of the corporate levers of power, and so the Board violated its fiduciary duties by approving the transaction without compensating the minority shareholders for the further diminution of their voting power. Appellees argue that because entrenchment works a disenfranchisement felt by the minority stockholders as voters, they have direct standing apart from Gentile.

At the outset, it is not clear **[**57]** that the cross-appeal is procedurally proper. Unlike Brookfield, Appellees did not present their application for interlocutory appeal to the Court of Chancery,[156] and Plaintiffs opposed the defendants' application. Our rules instruct us not to take interlocutory cross-appeals that fail to adhere to procedural requirements.[157] But for the sake of

[149] Patterson, 491 U.S. at 173; *see also* Urdan v. WR Cap. P'rs, LLC, 244 A.3d 668, 678 (Del. 2020) (overturning, in part, Schultz v. Ginsburg, 965 A.2d 661 (Del. 2009) which has "caused some confusion in later cases"); ***Brinckerhoff v. Enbridge Energy Co., Inc., 159 A.3d 242, 252 (Del. 2017)*** (reversing one of this Court's prior rulings because it had departed from a common definition of bad faith used elsewhere in Delaware entity law and resulted in "confusing precedent").

[150] Supreme Court Rule 4(d) likewise informs this view, requiring a panel of this Court to seek rehearing *en banc* if a decision has a "reasonable likelihood" to modify or overrule a prior decision, even if the panel is unanimous.

[151] *See* June Med. Servs. L. L. C. v. Russo, 140 S.Ct. 2103, 2134, 207 L. Ed. 2d 566 (2020) ("I joined the dissent in Whole Woman's Health [v. Hellerstedt, 136 S.Ct. 2292, 195 L. Ed. 2d 665 (2016)] and continue to believe that the case was wrongly decided," but concurring in the same outcome four years later because "[t]he legal doctrine of *stare decisis* requires us, absent special circumstances, to treat like cases alike.") (Roberts, C.J., concurring in the judgment). *But see* id. at 2151 ("[w]hen our prior decisions clearly conflict with the text of the Constitution we are required to 'privilege [the] text over our own precedents.'") (Thomas, J., dissenting.).

[152] Vasquez v. Hillery, 474 U.S. 254, 265-66, 106 S. Ct. 617, 88 L. Ed. 2d 598 (1986).

[153] *See* Kimble, 576 U.S. at 455.

[154] *Id.* ("Respecting *stare decisis* means sticking to some wrong decisions.").

[155] *See, e.g.,* Adarand Constructors, Inc., 515 U.S. at 234 (noting that "reliance on a case that has recently departed from precedent is likely to be minimal.").

[156] *See* Del. Supr. Ct. R. 42(c) ("An application for certification of an interlocutory appeal shall be made in the first instance to the trial court.").

[157] *See* Del. Supr. Ct. R. 42(d)(ii) ("No interlocutory order shall be reviewed by this Court unless the appeal therefrom has been accepted by this Court in accordance with the following

efficiency, we address the issue presented.

Appellees' direct disenfranchisement argument is twofold. First, Plaintiffs contend that the Private Placement allowed Brookfield to expand their majority voting control enough that a subsequent sale would not eliminate their majority status (the **[*1281]** "Entrenchment Claim").[158] Second, the Private Placement brought Brookfield near to *super*majority voting control, a threshold that, if they crossed it, would permit them to unilaterally alter certain provisions of the corporate charter without Appellees' consent (the "Supermajority Claim").[159] Appellees emphasize that theirs was a *substantial* loss of voting power.[160]

The Entrenchment Claim fails because Plaintiffs fail to allege any facts supporting a reasonably conceivable inference that Brookfield, absent the Private Placement, **[**58]** would have permitted a dilution of their equity stake sufficient to relinquish their majority control. Brookfield's stake in TerraForm declined slightly in the 2019 equity issuance because, concurrently with the $250 million October 2019 public offering of close to fifteen million shares at $16.77 per share, Brookfield made a further investment in a private placement (of close to three million shares) at the same price.[161] Plaintiffs' theory is that Brookfield entrenched itself in 2018 in anticipation of failing to purchase sufficient stock to maintain control in 2019. In other words, had it not increased its majority interest in 2018 from 51 percent to 65.3 percent, and if it had acted in that hypothetical situation as it did in fact—not participating *pro rata* in the 2019 offering—Brookfield would have allowed TerraForm to issue stock and decrease its holdings below a majority level without compensation.

We agree that it is not reasonably conceivable that these allegations state a claim. As the Vice Chancellor points out, Plaintiffs fail to allege that anyone knew in June 2018 that TerraForm would conduct an offering in October 2019. Moreover, it would have to be reasonably conceivable **[**59]** that even had the Private Placement not occurred, Brookfield would not have participated on a *pro rata* basis in the 2019 offering, thereby choosing to forego its majority stake. Because a control premium has value, we agree it is not reasonably conceivable that Brookfield would have declined to participate in the 2019 offering if that would translate into Brookfield forfeiting majority control for no premium.

Nor does the Supermajority Claim hit the mark, again for the reasons the Court of Chancery explained. To overcome the supermajority threshold, Brookfield needed to expand its equity stake to exceed two-thirds of the Company's voting shares. The Private Placement raised Brookfield's share to 65.3 percent only. As the Vice Chancellor found, Brookfield never achieved the level of control necessary to unilaterally remove the supermajority voting rights, and Brookfield never attempted to abrogate the rights through the 2019 offering. For the reasons stated by the Vice Chancellor, we agree that Plaintiffs' entrenchment claims fail.

IV. Conclusion

For the foregoing reasons, this Court overrules *Gentile* and **REVERSES** the Court of Chancery's denial of Defendant's Motion to Dismiss for lack **[**60]** of standing.

End of Document

procedure: . . . (ii) *Form of Filing*. The notice of appeal **and any cross-appeal** shall comply with this rule, *Rules 6* and *7* of this Court and with such version of Official Form M as shall be applicable to the situation") (emphasis added) (italics in original).

[158] A131-32 (Compl. at ¶¶ 105-06).

[159] A135 (Compl. at ¶¶ 113-14).

[160] Ans. Br. at 44. Appellees also argue in their Reply Brief on Cross Appeal that "[b]ecause entire fairness review applies, the trial court erred in conducting an entrenchment analysis." Appellees' Reply Br. on Cross Appeal at 4. But this was not a theory that was fairly presented below. *See* https://livestream.com/delawaresupremecourt/events/9697327/videos/222905751, 40:46-42:06 (Oral Argument held June 30, 2021).

[161] A131-32 (Compl. at ¶¶ 105-06, nn.18-19).

Constr. Indus. Laborers Pension Fund v. Bingle

Court of Chancery of Delaware

May 13, 2022, Submitted; September 6, 2022, Decided

C.A. No. 2021-0940-SG

Reporter

2022 Del. Ch. LEXIS 223 *; 2022 WL 4102492

CONSTRUCTION INDUSTRY LABORERS PENSION FUND, CENTRAL LABORERS' PENSION FUND, LAWRENCE MILES, and BRIAN SEAVITT, derivatively on behalf of SOLARWINDS CORPORATION, Plaintiffs, v. MIKE BINGLE, WILLIAM BOCK, SETH BORO, PAUL J. CORMIER, KENNETH Y. HAO, MICHAEL HOFFMANN, DENNIS HOWARD, CATHERINE R. KINNEY, JAMES LINES, EASWARAN SUNDARAM, KEVIN B. THOMPSON, JASON WHITE, MICHAEL WIDMANN, Defendants, and SOLARWINDS CORPORATION, Nominal Defendant

Notice: THIS OPINION HAS NOT BEEN RELEASED FOR PUBLICATION. UNTIL RELEASED, IT IS SUBJECT TO REVISION OR WITHDRAWAL.

Counsel: **[*1]** Michael J. Barry and Vivek Upadhya, of GRANT & EISENHOFER, P.A., Wilmington, Delaware; Thomas Curry and Tayler D. Bolton, of SAXENA WHITE P.A., Wilmington, Delaware; OF COUNSEL: Chad Johnson, Noam Mandel, Desiree Cummings, Jonathan Zweig, and Sarah Delaney, of ROBBINS GELLER RUDMAN & DOWD LLP, New York, New York; Jeremy S. Friedman and David Tejtel, of FRIEDMAN OSTER & TEJTEL PLLC, Bedford Hills, New York; D. Seamus Kaskela, of KASKELA LAW LLC, Newton Square, Pennsylvania; Julia Goldsmith Reiser, of COHEN MILSTEIN SELLERS & TOLL PLLC, Washington, DC; Richard A. Speirs and Amy Miller, of COHEN MILSTEIN SELLERS & TOLL PLLC, New York, New York, Attorneys for Plaintiffs.

Raymond J. DiCamillo, Kevin M. Gallagher, and Alexander M. Krischik, of RICHARDS, LAYTON & FINGER, P.A., Wilmington, Delaware; OF COUNSEL: Sandra C. Goldstein, Stefan Atkinson, and Byron Pacheco, of KIRKLAND & ELLIS LLP, New York, New York, Attorneys for Defendants William Bock, Seth Boto, Paul Cormier, Michael Hoffman, Dennis Howard, Catherine Kinney, James Lines, and Easwaran Sundaram.

William M. Lafferty, Ryan D. Stottmann, and Alexandra M. Cumings, of MORRIS NICHOLS ARSHT & TUNNELL LLP, Wilmington, Delaware; OF COUNSEL: **[*2]** Sameer Advani, Wesley R. Powell, and Patricia O. Haynes, of WILLKIE FARR & GALLAGHER LLP, New York, New York, Attorneys for Defendants Mike Bingle, Kenneth Hao, Jason White, and Michael Widmann.

A. Thompson Bayliss and Stephen C. Childs, of ABRAMS & BAYLISS LLP, Wilmington, Delaware; OF COUNSEL: Peter L. Welsh, C. Thomas Brown, and Patrick T. Roath, of ROPES & GRAY LLP, Boston, Massachusetts; Edward R. McNicholas, of ROPES & GRAY LLP, Washington, D.C., Attorneys for Defendant Kevin Thompson.

John L. Reed, Ronald N. Brown, Peter H. Kyle, and Kelly L. Freund, of DLA PIPER LLP, Wilmington, Delaware; OF COUNSEL: Paul R. Bessette, Michael J. Biles, and Daniel M. Wodnicki of KING & SPALDING LLP, Austin, Texas; Benjamin Lee and Benjamin B. Watson, of KING & SPALDING LLP, Atlanta, Georgia, Attorneys for Nominal Defendant SolarWinds Corporation.

Judges: GLASSCOCK, Vice Chancellor.

Opinion by: GLASSCOCK

Opinion

GLASSCOCK, Vice Chancellor

Nominal Defendant SolarWinds Corporation (the "Company") was in the business of providing management software to its customers. Sometime in 2020, SolarWinds became the victim of a major crime. Per the complaint, Russian hackers were able to penetrate SolarWinds systems and insert malware, to **[*3]** the detriment of SolarWinds customers, ultimately damaging the value of the company itself. The Plaintiffs here, SolarWinds stockholders at the time of the trauma, allege that the Defendant corporate directors, a majority of whom were on the board at all times pertinent, failed to adequately oversee the risk to cybersecurity of criminal attack. They seek to hold the Defendants liable in damages.

Derivative claims against corporate directors for failure to oversee operations—so-called *Caremark* claims, once relative rarities—have in recent years bloomed like dandelions after a warm spring rain, largely following the Delaware Supreme Court's opinion in *Marchand v. Barnhill*.[1] The cases, superficially at least, seem easy to conjure up: find a corporate trauma; allege the truism that the board of directors failed to avert that trauma; and *hey, presto*! an oversight liability claim is born. They remain, however, one of the most difficult claims to cause to clear a motion to dismiss. That is also easy to understand. Directors are not liable under our corporate law for the most likely cause of operational loss, simple negligence. Nor, given the ubiquity of exculpation clauses, are the directors **[*4]** even liable for gross negligence in violation of their duty of care. And, of course, most corporate trauma, to the extent it represents a breach of duty at the board level, implicates the exculpated duty of care. To plead potential liability sufficient to cause directors to be unable to consider a demand and thus justify a derivative claim under [Rule 23.1](), therefore, the lack of oversight pled must be so extreme that it represents a breach of the duty of loyalty. This in turn requires a pleading of scienter, demonstrating bad faith—in then-Chief Justice Strine's piquant formulation, a failure to fulfill the duty of care *in good faith*.[2] In other words, an oversight claim is a flavor of breach of the duty of loyalty, which itself requires an action (or omission) that a director knows is contrary to the corporate weal.[3] Historically, only utter failures by directors to impose a system for reporting risk, or failure to act in the face of "red flags" disclosed to them so vibrant that lack of action implicates bad faith, *in connection with the corporation's violation of positive law*, have led to viable claims under Caremark.

This matter is before me on the Defendants' Motions to Dismiss. Here, there **[*5]** is no credible allegation that the Company violated positive law. Instead, the Directors are accused of failing to monitor corporate effort in way that prevented cybercrime. Of course, absent statutory or regulatory obligations, how much effort to expend to prevent criminal activities by third parties against the corporate interest requires an evaluation of business risk, the quintessential board function. Judicial post-hoc intrusion into the appropriate consideration of business risk, pre-trauma, is problematic, particularly where the demand is for damages and the directors are exculpated for gross negligence. Accordingly, this should be an easy action to resolve in favor of the Defendants. Many corporate decisions have implications for customers, no doubt. Nonetheless, I note that before me is a peculiar kind of business risk. Online software companies are dependent on their customers sharing access to the customer's information. The resulting relationship is essential to the business of these companies. In light of the ubiquity of attempts by evildoers to breach the security of tech companies and their customers, disclosure obligations have been imposed by the SEC regarding board **[*6]** efforts to oversee cybersecurity, and at least one major stock exchange has promulgated cybersecurity guidelines. To use the shibboleth arising from *Marchand*, cybersecurity, for online service providers, is mission critical.

To what extent are the decisions or omissions of Directors reviewable under Caremark in such a scenario? I need not address that issue here, because, as pled, the director defendants here (1) are not credibly alleged to have allowed the company itself to violate law, (2) did ensure that the company had at least a minimal reporting system about corporate risk, including cybersecurity, and (3) are not alleged to have ignored sufficient "red flags" of cyber threats to imply a conscious disregard of a known duty, indicative of scienter.[4] In other words, the directors failed to prevent a large corporate trauma, but the Plaintiffs have failed to plead specific facts from which I may infer bad faith liability on the part of a majority of the directors regarding that trauma. The defendants have moved to dismiss, and I conclude [Rule 23.1]() is unsatisfied. The motions to dismiss must be granted accordingly.

My reasoning follows.

---

[1] ***212 A.3d 805, 822 (Del. 2019)***.

[2] ***Id. at 824***.

[3] Or self-dealing, which is not typically implicated in allegations of oversight liability.

[4] I discuss supposed "red flags," *infra*.

I. BACKGROUND

Before me are three motions to dismiss **[*7]** the sole count in this action, a derivative claim brought against all defendants for a breach of the "Fiduciary Duties of Loyalty and Care through a Bad Faith Failure to Oversee SolarWinds's Cybersecurity."[5] SolarWinds Corporation, the nominal defendant in this action ("SolarWinds" or the "Company"), suffered a major cyberattack in December 2020.[6] That cyberattack is referred to herein as the "Sunburst Attack." The purported breaches of fiduciary duty relate to the Sunburst Attack.

A. Factual Background[7]

1. The Parties

Per the complaint (the "Complaint"), the Plaintiffs are current SolarWinds stockholders who "purchased SolarWinds shares during the relevant period" and have held shares since.[8]

Nominal Defendant SolarWinds, a Delaware corporation, provides information technology infrastructure management software.[9] Its software is used by a proliferation of clients ranging from the Fortune 500 to United States government agencies, and the Company's revenue is entirely dependent on the sale of its software.[10] The Company's main product, Orion Platform ("Orion"), is the software that was targeted in the Sunburst Attack.[11] Use of Orion requires the software to have access to clients' **[*8]** information technology systems.[12]

SolarWinds was a private company prior to October 2018,[13] when it went public via an initial public offering ("IPO").[14] The Plaintiffs refer throughout the Complaint to the time period between the IPO and the Sunburst Attack in a manner that suggests they view this time period as the relevant one for purposes of their claim here.[15] I assume this is the case due to the timing of the various Plaintiffs' stock purchases in SolarWinds, though that information has not been provided in the Complaint.[16]

SolarWinds's charter contains a provision reflective of *Delaware General Corporation Law Section 102(b)(7)*, exculpating its directors from liability for duty of care violations commensurate with the statute.[17]

The named Defendants in this action are Mike Bingle, William Bock, Seth Boro, Paul Cormier, Kenneth Hao, Michael Hoffmann, Dennis Howard, Catherine Kinney, James Lines, Easwaran Sundaram, Kevin Thompson, Jason White, and Michael Widmann, each of whom

---

[5] *See* Verified Stockholder Derivative Compl. 70, Dkt. No. 1 [hereinafter "Compl."].

[6] *See id.* ¶ 4. To be more precise, the Complaint pleads that SolarWinds learned of the cyberattack in December 2020. *Id.* Based on the pleadings, it is not clear that the Sunburst Attack can be tied to a singular date of occurrence.

[7] Unless otherwise specified, the facts in this section are drawn from the Complaint. *See* Compl. This section is reflective of the Complaint, and I consider the facts to be true as pled in the Complaint, in accordance with the applicable standard on a motion to dismiss. This section therefore does not constitute formal findings of fact.

[8] *Id.* ¶ 18. It is unclear that this statement is sufficient to confer standing to bring a derivative claim on behalf of the Company, given its lack of anchor in time. No party has disputed the Plaintiffs' standing to date, so I do not address the question further here.

[9] *Id.* ¶ 2.

[10] *Id.* ¶¶ 2, 33.

[11] *Id.* ¶¶ 4, 34.

[12] *Id.* ¶¶ 3, 34-35.

[13] More precisely, SolarWinds was founded in 1999, went public in 2009, and was taken private in 2016, prior to its second "initial" public offering. *See id.* ¶ 36. The take-private transaction in 2016 was undertaken by two private equity firms named Silver Lake and Thoma Bravo. *Id.* A number of directors on the SolarWinds board of directors have connections to Thoma Bravo and Silver Lake. *See id.* ¶ 37.

[14] *Id.* ¶ 36.

[15] *See, e.g., id.* ¶¶ 8, 71, 78, 80.

[16] I am assuming that events to which liability may attach here are limited to post-IPO. Nothing in the Complaint indicates that the Plaintiffs were stockholders prior to the take-private transaction in 2016, and in any event, laches issues would likely inhere in any attempt to raise events from that time period now.

[17] Transmittal Decl. of John L. Reed, Esq., Supp. Nominal Def. SolarWinds Corporation's Mot. to Dismiss Pls.' Derivative Compl., Ex. 11, Art. VII [hereinafter "Reed Decl."].

currently serves or previously served as a director on SolarWinds's board of directors (the "Board").[18] The current Board is composed of eleven directors.[19] The Complaint alleges that a majority of the current (demand) directors **[*9]** were in service during/prior to the Sunburst Attack.[20]

Kevin Thompson stands in a somewhat different factual posture than the remainder of the Defendants, so additional facts are helpful. Thompson was, prior to his resignation in December 2020, both a director and the Chief Executive Officer ("CEO") of SolarWinds.[21] Following the Sunburst Attack, the Company rehired Thompson in a role as a consultant under a Transition Agreement.[22] Thompson's compensation for five months of transition services exceeds $300,000 under the Transition Agreement.[23] The Transition Agreement also provided him with a release related to any of his actions or omissions during his service as the CEO and a director of SolarWinds.[24]

2. <u>SolarWinds's Board and Cybersecurity at the Relevant Time</u>[25]

The Company created at least two Board subcommittees following its IPO: an Audit Committee and a Nominating and Corporate Governance Committee (the "NCG Committee"). Throughout this Memorandum Opinion, the two subcommittees are occasionally referred to as the "Committees."

At the time of the Company's IPO, the NCG Committee was charged with general oversight responsibility as pertained **[*10]** to corporate governance risks, though responsibility for cybersecurity was not specifically mandated.[26] In April 2019, the NCG Committee's charter was amended to require members to discuss SolarWinds's major risk exposures, explicitly including cyber and data security, with management.[27]

The Complaint indicates that "[f]ollowing the Company's IPO," the Board delegated cybersecurity oversight to the Audit Committee.[28] It is otherwise unclear when this delegation occurred relative to other pertinent facts. The Audit Committee charter states that members must discuss major financial risk exposures, such as cyber and data security, with members of management.[29]

In February 2019—before its charter was amended to specifically reference cybersecurity—the NCG Committee heard a briefing on the subject of cybersecurity, presented by the Company's executives (the "Cybersecurity Briefing").[30] That presentation emphasized the seriousness of cybersecurity risks for SolarWinds given its wide customer base and access to client software, but confirmed that the Company had only been a "target of opportunity" to date.[31] The presentation also specified that SolarWinds's "[i]ncident response process" was **[*11]** employed 94 times in 2018—indicating 94 issues had been detected and "tested" the process.[32] The minutes from the meeting indicate the NCG Committee held a discussion on the

---

[18] *See* Compl. ¶¶ 20-32.

[19] *See id.* ¶ 113.

[20] *Id.*

[21] *Id.* ¶ 30.

[22] *Id.* ¶¶ 30, 111.

[23] *Id.* ¶ 111.

[24] *Id.* ¶ 30.

[25] The Plaintiffs, having seemingly narrowed the pertinent timeframe to post-October 2018, also reference multiple events that took place at least in part in 2017. Most prominently, they point to an elementary-level password, 'solarwinds123,' that was used at the Company as early as 2017. *See, e.g., id.* ¶ 82. This password was discovered by an outside party, who informed SolarWinds's information technology team of the issue in November 2019. *See id.* The Plaintiffs also reference a presentation describing perceived cybersecurity failures that a former employee, previously the Global Cybersecurity Strategist, had given to management in April 2017, to bolster their position that SolarWinds's approach to cybersecurity was lackadaisical. *See id.* ¶ 97. That same officer later left the Company in 2017 via resignation email to the Chief Marketing Officer. *Id.*

[26] *Id.* ¶ 10. The Complaint does not specify what document supports this assertion, though context suggests it may be the NCG Committee charter.

[27] *Id.* ¶ 75.

[28] *Id.* ¶ 72.

[29] *Id.*

[30] *Id.* ¶ 39. The Complaint pleads that the Cybersecurity Briefing was heard by defendant directors Kinney, Bingle, Bock, and Widmann. *Id.*

[31] *See, e.g., id.* ¶¶ 39-40.

[32] *Id.* ¶¶ 41-42.

topic of cybersecurity following management's presentation.[33]

The Cybersecurity Briefing slides also contained a reference to the NCG Committee's upcoming events, including a listing for "January"—presumably January 2020—that read: "Discussion of risk management topic (e.g. cybersecurity)[.]"[34] No such meeting was ever scheduled.[35]

Besides the Cybersecurity Briefing in February 2019, the Committees did not receive any further presentations from management regarding SolarWinds's cybersecurity in the time period between the 2018 IPO and the Sunburst Attack in 2020.[36]

The full Board did not conduct any meetings or hold any discussions concerning cybersecurity at the Company from October 2018 until the Sunburst Attack occurred in December 2020.[37] Neither the NCG Committee nor the Audit Committee made any presentation to the full Board regarding cybersecurity during this time period, either.[38]

The Complaint contains a plethora of background facts about the increasing need for technology companies, **[*12]** in general, to address cybersecurity, including agency and private sector reports.[39] The most salient facts are those pertaining to certain guidance issued by the Securities and Exchange Commission (the "SEC") in 2018.[40] The guidance states in part: "This interpretive release outlines the Commission's views with respect to cybersecurity disclosure requirements under the federal securities laws as they apply to public operating companies."[41] The guidance reflects the SEC's belief that "the development of effective disclosure controls and procedures is best achieved" when directors are informed about cybersecurity risks and incidents pertaining to their company.[42]

The New York Stock Exchange ("NYSE"), where SolarWinds trades, also provides cybersecurity guidelines for directors and officers.[43]

3. <u>The 2020 Sunburst Attack</u>

The Sunburst Attack was discovered in December 2020.[44] The Complaint describes the attack as follows: "Russian hackers used SolarWinds' software as a 'Trojan Horse' to attack the Company's clients by hiding malicious code in SolarWinds' Orion software and exploiting its trusted access to gain entry to the Company's clients' systems."[45] The Plaintiffs allege that as early **[*13]** as January 2019, the hackers were able to infect the Orion "software build environment,"[46] theoretically through password deficiencies exploited by the hackers.[47] Once the hackers had accessed that software build environment, they inserted malicious code into Orion's software updates.[48] When SolarWinds's clients engaged in routine software updates, the malicious code was downloaded along with the Orion software.[49] The Complaint describes the hackers as accessing and stealing "extensive proprietary information, confidential emails, and intellectual property" from both private sector and government clients.[50]

Per SolarWinds, the Sunburst Attack affected up to 18,000 of its clients, both in the private and governmental sectors.[51] Upon public disclosure of the

[33] Reed Decl., Ex. 12, at SW_SEAVITT 220_000000806.

[34] Compl. ¶ 74.

[35] *Id.*

[36] *Id.* ¶¶ 8-10; *id.* ¶ 75.

[37] *Id.* ¶ 8.

[38] *Id.* ¶ 9; *id.* ¶ 75.

[39] *Id.* ¶¶ 44-56.

[40] *Id.* ¶ 59.

[41] *Id.*

[42] *Id.*

[43] *Id.* ¶ 64.

[44] *Id.* ¶ 4.

[45] *Id.*

[46] *Id.* ¶ 100.

[47] *Id.* ¶¶ 100-02.

[48] *Id.* ¶ 103.

[49] *Id.*

[50] *Id.* ¶ 104. Among the affected government entities were the Department of Homeland Security, the Pentagon, and numerous U.S. Attorney's Offices. *Id.* ¶ 105.

[51] *Id.* ¶ 4.

Sunburst Attack, SolarWinds's stock suffered significant losses, with its value ultimately discounted by almost 40%.[52] The stock continued to trade at a more than 30% discount to its pre-attack value as of the filing of the Complaint.[53] License revenues and other financial metrics were likewise negatively affected at least in part due to the Sunburst Attack.[54]

Following the attack, multiple class action lawsuits were **[*14]** filed, and investigations were opened by "numerous domestic and foreign law enforcement agencies."[55]

B. Procedural History

The Complaint in this action was filed on November 1, 2021,[56] and three motions to dismiss followed soon after in January 2022.[57] Oral argument followed briefing on the motions to dismiss, and I took the matter under advisement in May 2022.[58]

II. ANALYSIS[59]

Litigation assets, like other corporate assets, are under the control of the board of directors. Only when a majority of directors are disabled from bringing their business judgment to bear regarding a litigation asset may a stockholder proceed to exploit it derivatively on behalf of the corporation. Accordingly, *Court of Chancery Rule 23.1* requires that stockholders seeking exploitation of a corporate litigation asset make a demand for directors to so act; where, as here, no demand was made, demand is excused only where the putative derivative plaintiff pleads with specificity facts from which a court may infer that a demand would be futile. Otherwise, the derivative action will be dismissed.[60]

The Complaint in this action pleads that demand is futile solely on the basis that SolarWinds's Board could not impartially evaluate a **[*15]** demand for suit because eight of the eleven Board members face a substantial likelihood of liability in the action.[61] The Plaintiffs' primary theory alleging liability is founded in *Caremark* and its progeny.[62] The Plaintiffs must demonstrate that at least half of the members of the demand Board are substantially likely to be liable under their *Caremark* theory (or some other theory) to have satisfied demand futility.[63] The motions to dismiss seek dismissal under *Rule 23.1* for failure to allege with particularity that demand is in fact futile due to a substantial likelihood of *Caremark* liability.[64]

The standard of review applicable to assess demand futility under *Rule 23.1* is more demanding than the standard of review applicable to a motion to dismiss

---

[52] *Id.* ¶ 107.

[53] *Id.*

[54] *Id.* ¶ 108.

[55] *Id.* ¶ 109.

[56] *See generally* Compl.

[57] Nominal Def., SolarWinds Corporation's Mot. to Dismiss Pls.' Derivative Compl., Dkt. No.18; Def. Kevin B. Thompson's Mot. to Dismiss Pls.' Verified Shareholder Derivative Compl., Dkt. No. 19; Director Defs.' Mot. to Dismiss Pls.' Derivative Compl., Dkt. No. 20.

[58] *See* Tr. of 5-13-22 Oral Arg. on Defs.' Mots. to Dismiss, Dkt. No. 53 [hereinafter "Oral Arg."].

[59] As a preliminary matter, though the Complaint's count indicates that the claim includes a breach of the fiduciary duty of care (among others), I do not address duty of care here because SolarWinds's charter contains an exculpatory provision insulating directors from liability for duty of care breaches. It is the directors whose business judgment must be discredited here for the matter to proceed derivatively, obviously.

[60] *See* ***United Food & Comm. Workers Union v. Zuckerberg, 262 A.3d 1034, 1058 (Del. 2021)***.

[61] Compl. ¶ 113; *see also* ***Zuckerberg, 262 A.3d at 1058***.

[62] Compl. ¶ 113 ("[A majority of the Demand Board] could not impartially evaluate a demand because they face a substantial likelihood of personal liability for utterly failing to implement or oversee any reasonable system of monitoring over mission critical aspects of SolarWinds' business during the relevant time.").

[63] *See* *Firemen's Ret. Sys. of St. Louis ex rel. Marriott Int'l, Inc. v. Sorenson, 2021 Del. Ch. LEXIS 234, 2021 WL 4593777, at *7 (Del. Ch. Oct. 5, 2021)* (citation omitted).

[64] *See, e.g.*, Opening Br. of Nominal Def., SolarWinds Corporation Supp. Its Mot. to Dismiss Pls.' Derivative Compl. 16, Dkt. No. 18. Though there are three motions pending, I need only treat the nominal defendant's motion under *Rule 23.1* to dispose of the action. The other two motions also reference a failure to state a claim under *Rule 12(b)(6)* as a separate argument in favor of dismissal.

brought under *Rule 12(b)(6)*. In short, the reason for this higher standard is that by bringing suit on behalf of a corporation without first making a demand upon the board of directors, a plaintiff supplants the board of directors' decision-making role with respect to whether to bring said suit.[65] Given this subversion of default roles, *Court of Chancery Rule 23.1* requires derivative complaints to allege demand futility with particularity, which "differ[s] substantially" from notice **[*16]** pleading.[66]

Despite the requirement that the Plaintiffs plead their case with particularity, they are still entitled to the benefit of all reasonable inferences and the Court must accept as true all particularized and well-pled allegations contained in the Complaint.[67] The reasonable inferences "must logically flow from particularized facts alleged by the plaintiff."[68]

A. Assessing the Caremark Theory of Demand Futility

The Plaintiffs have argued that a substantial likelihood of liability attaches to a majority of the demand Board based on either or both of what are colloquially referred to as prongs one and two of *Caremark*.[69] That is, the Plaintiffs allege both that a majority of the demand Board utterly failed "to implement and monitor a system of corporate controls and reporting mechanisms" regarding cybersecurity,[70] and that even if a monitoring system was in place, the directors failed to "oversee" such system of oversight in breach of their fiduciary duties because they overlooked "red flags" signaling corporate risk.[71]

Plaintiffs in *Caremark* cases must "plead with particularity 'a sufficient connection between the corporate trauma and the [actions or inactions **[*17]** of] the board.'"[72] "A stockholder cannot displace the board's authority simply by describing the calamity and alleging that it occurred on the directors' watch."[73] The requirement of a connection between the Board and the corporate trauma at issue is at least one plausible reason that *Caremark* cases are generally brought in the context of violations of applicable *laws*.[74] For example, in *Marchand v. Barnhill*, the corporate trauma suffered as a result of a listeria outbreak was—at least theoretically—within the company's (and the directors') control. That is, the board's failure to institute a reporting and monitoring system allowing it to oversee the company's compliance with positive-law regulation of food safety led to a pleading-stage inference of bad faith.[75] Similarly, in *Boeing*, the Boeing board of directors, in their duties as overseers of corporate performance, failed to monitor compliance with airplane safety regulations at the board level, even after two fatal crashes.[76]

The Plaintiffs plead that despite this juridical history of applying *Caremark* primarily to cases involving violations of positive law, oversight liability may be established even in the **[*18]** absence of such a violation.[77] Here, the Plaintiffs ask me to find that

---

[65] *See, e.g.*, *United Food & Comm. Workers Union v. Zuckerberg, 250 A.3d 862, 875-77 (Del. Ch. 2020)*, *aff'd*, ***262 A.3d 1034***.

[66] ***Zuckerberg, 262 A.3d at 1048*** (internal quotations omitted) (quoting *Brehm v. Eisner, 746 A.2d 244, 254 (Del. 2000)*).

[67] ***Id. at 1048***.

[68] *Wood v. Baum, 953 A.2d 136, 140 (Del. 2008)*.

[69] *See, e.g.*, Compl. ¶ 113; Pls.' Omnibus Answering Br. Opp'n Defs.' Mots. to Dismiss 33-52, Dkt. No. 28 [hereinafter "AB"].

[70] Compl. ¶ 121.

[71] *Id.* ¶ 118. The "prong two" argument that directors of SolarWinds ignored red flags was made without enthusiasm in the complaint, but advanced more strongly in the answering brief. *See* AB 44-52.

[72] *In re Boeing Co. Deriv. Litig., 2021 Del. Ch. LEXIS 197, 2021 WL 4059934, at *24 (Del. Ch. Sept. 7, 2021)* (citing *La. Mun. Police Emps.' Ret. Sys. v. Pyott, 46 A.3d 313, 340 (Del. Ch. 2012)*, *rev'd on other grounds*, *74 A.3d 612 (Del. 2013)*).

[73] *Pyott, 46 A.3d at 340*.

[74] *Cf.* *id., 46 A.3d at 340-41* (citations omitted) ("To plead a sufficient connection between the corporate trauma and the board, the plaintiff's first and most direct option is to allege with particularity actual board involvement in a decision that violated positive law . . . . [T]he next alternative is to plead that the board consciously failed to act after learning about evidence of illegality—the proverbial 'red flag.'"); *see* *Sorenson, 2021 Del. Ch. LEXIS 234, 2021 WL 4593777, at *11-12*.

[75] ***Marchand, 212 A.3d at 822***.

[76] *Boeing, 2021 Del. Ch. LEXIS 197, 2021 WL 4059934, at *25-33*.

[77] *See* Oral Arg. 59:5-62:3; *see also* *Sorenson, 2021 Del. Ch. LEXIS 234, 2021 WL 4593777, at *11-12*.

oversight liability may attach to the Company's alleged failure to sufficiently oversee risks related to efforts to avoid cybercrime by third parties—that is, business risk. Many Delaware cases have cautioned that whether *Caremark* should be applied to business risk remains an open question.[78]

The Plaintiffs cite *Firemen's Retirement System of St. Louis on behalf of Marriott International, Inc. v. Sorenson* in support of their argument. *Sorenson* is a recent Court of Chancery case that found *Caremark* to apply, at least hypothetically, to failure to monitor cybersecurity risks, reasoning that "corporate governance must evolve" as "legal and regulatory frameworks" do.[79] But *Sorenson* did not address the question of whether an appropriate nexus existed between the corporate trauma—a cybersecurity breach—and the Board. And *Sorenson* specifically found that there was

> no known illegal conduct, lawbreaking, or violation[] of a regulatory mandate alleged in the Complaint that could support a finding that the [] Board faces a substantial likelihood of liability **[*19]** for failed oversight . . . . The plaintiff in this action has not pleaded particularized facts that the [] Board knowingly permitted Marriott to violate the law.[80]

Thus, despite the *Sorenson* court's discussion of the increasing importance of cybersecurity, echoed in this decision, *supra., Sorenson* expressly looked to affirmative corporate illegality in assessing the substance of the *Caremark* claims. *Sorenson* ultimately suggests that even if lack of cybersecurity oversight might be an appropriate subject for a *Caremark* claim, a violation of law or regulation is still likely a necessary underpinning to a successful pleading. Unable to find one applicable to its facts, the court dismissed the complaint.

While no case in this jurisdiction has imposed oversight liability based solely on failure to monitor business risk, it is possible, I think, to envision an extreme hypothetical involving liability for bad faith actions of directors leading to such liability.[81] What is not wholly clear to me is that cybersecurity incidents of the type suffered by SolarWinds and in *Sorenson*—involving crimes by malicious third parties—present a sufficient nexus between the corporate trauma suffered and the Board for liability to attach. **[*20]** Oversight liability caselaw focusing on the "connection" element is comparatively thin, with virtually all of the discussion centered around illegal acts by the company stemming from company (board or management) action or inaction.[82] As the court in *Sorenson* aptly noted at the end of its analysis, the corporate trauma "that came to fruition was at the hands of a hacker. Marriott was the victim of an illegal act rather than the perpetrator."[83] So too with SolarWinds here. The pertinent question is not whether the Board was able to prevent a corporate trauma, here a third-party criminal attack. Instead, the question is whether the Board undertook its monitoring duties (to the extent applicable) *in bad faith*.

I need not resolve these open questions in order to address the pending motions, which can be adequately

---

[78] *See In re Facebook, Inc. Section 220 Deriv. Litig., 2019 Del. Ch. LEXIS 197, 2019 WL 2320842, at *14 n.150 (Del. Ch. May 30, 2019)* (collecting cites); *see also In re Clovis Oncology, Inc. Deriv. Litig., 2019 Del. Ch. LEXIS 1293, 2019 WL 4850188, at *12 (Del. Ch. Oct. 1, 2019)* ("[A]s relates to *Caremark* liability, it is appropriate to distinguish the board's oversight of the company's *management of business risk* that is inherent in its business plan from the board's oversight of the company's *compliance with positive law*—including regulatory mandates."); *In re Goldman Sachs Grp., Inc. S'holder Litig., 2011 Del. Ch. LEXIS 151, 2011 WL 4826104, at *21 (Del. Ch. Oct. 12, 2011)* ("As a preliminary matter, this Court has not definitively stated whether a board's *Caremark* duties include a duty to monitor business risk.").

[79] *Sorenson, 2021 Del. Ch. LEXIS 234, 2021 WL 4593777, at *11-12*.

[80] *2021 Del. Ch. LEXIS 234, [WL] at *15*.

[81] *But see* ***In re Citigroup Inc. S'holder Deriv. Litig., 964 A.2d 106, 126 (Del. Ch. 2009)*** ("To the extent the Court allows shareholder plaintiffs to succeed on a theory that a director is liable for a failure to monitor business risk, the Court risks undermining the well settled policy of Delaware law by inviting Courts to perform a hindsight evaluation of the reasonableness or prudence of directors' business decisions.").

[82] *See, e.g., South v. Baker, 62 A.3d 1, 14-15 (Del. Ch. 2012)*; *Pyott, 46 A.3d at 340-41*; *Okla. Firefighters Pension & Ret. Sys. v. Corbat, 2017 Del. Ch. LEXIS 848, 2017 WL 6452240, at *15 (Del. Ch. Dec. 18, 2017)*; *Horman v. Abney, 2017 Del. Ch. LEXIS 13, 2017 WL 242571, at *7 (Del. Ch. Jan. 19, 2017)*; *Reiter ex rel. Cap. One Fin. Corp. v. Fairbank, 2016 Del. Ch. LEXIS 158, 2016 WL 6081823, at *8 (Del. Ch. Oct. 18, 2016)*; *Pettry ex rel. FedEx Corp. v. Smith, 2021 Del. Ch. LEXIS 134, 2021 WL 2644475, at *7 (Del. Ch. June 28, 2021)*.

[83] *Sorenson, 2021 Del. Ch. LEXIS 234, 2021 WL 4593777, at *18*.

resolved via a traditional "two prong" *Caremark* analysis, in any event. I turn now to that analysis.

1. Caremark's Doctrinal Underpinnings

At bottom, a meritorious *Caremark* claim demonstrates a breach of the duty of loyalty, by way of a failure by the directors to act in good faith. As Chancellor Allen wrote in *Caremark* itself,[84] and as has been reaffirmed by our Supreme Court **[*21]** in *Stone v. Ritter* and *Marchand v. Barnhill*, a lack of good faith is a "necessary condition" to a finding of nonexculpated oversight liability.[85] In *Stone*, the Delaware Supreme Court indicated that imposing oversight liability "requires a showing that the directors knew that they were not discharging their fiduciary obligations."[86]

Shortly thereafter, in *Desimone v. Barrows*, the Court of Chancery commented upon *Stone*, reading *Stone* to "ensure[] that the protections that exculpatory charter provisions afford to independent directors against damage claims would not be eroded" by expansion of the *Caremark* doctrine.[87] Stated differently, *Stone* stood for the proposition that despite the potential for oversight liability to attach to director judgments under *Caremark*, exculpatory charter provisions preventing a director from being held liable for a breach of the *duty of care* were to continue in force. Directors of a corporation with exculpatory charter provisions could continue to wield their business judgment—including "evaluation of risk"—under the umbrella protection of exculpation clauses, despite the *Caremark* specter.[88] In *Citigroup*, another *Caremark* case, the Court noted that "[i]t is almost impossible for a court, in hindsight, to determine whether the directors **[*22]** of a company properly evaluated risk and thus made the 'right' business decision."[89]

This state's courts, then, have acknowledged the importance of retaining the statutory safe harbor that *Delaware General Corporation Law Section 102(b)(7)* provides for director conduct that might otherwise give rise to a reasonably conceivable claim of a breach of the duty of care.[90] In other words, director gross negligence with respect to a corporate trauma is insufficient to establish director liability; such liability may only attach where a director acts in bad faith.

Marchand v. Barnhill is the latest word in Delaware Supreme Court cases that substantively treat the *Caremark* doctrine.[91] *Marchand* emphasizes again the requirement that directors act in a manner lacking good faith before a *Caremark* claim can be considered viable.[92] That opinion notes that "[b]ad faith is established, under *Caremark*," by way of either prong one, "when the directors completely fail to implement any reporting or information system or controls," or via prong two, when directors, "having implemented such a system or controls, consciously fail to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."[93] Per the Supreme Court **[*23]** in *Marchand*, "[u]nder *Caremark*, a director may be held liable if she acts in bad faith in the sense that she made no good faith effort to ensure that the company had in place any 'system of controls.'"[94] As I understand *Marchand*, the lack of a system of controls with respect to a *particular* incarnation of risk does not itself demonstrate bad faith; the lack of such system must be the result of action or inaction taken in bad faith. This distinction is heightened, I believe, in consideration of risk outside the realm of positive law.

Marchand does not undertake an analysis of bad faith

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

[85] *Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, at 370-71 (Del. 2006)*; ***Marchand, 212 A.3d at 820-21*** (quoting *Desimone v. Barrows, 924 A.2d 908, 935 (Del. Ch. 2007)*) ("In other words, for a plaintiff to prevail on a *Caremark* claim, the plaintiff must show that a fiduciary acted in bad faith—'the state of mind traditionally used to define the mindset of a disloyal director.'").

[86] *Stone, 911 A.2d at 370*.

[87] *Desimone, 924 A.2d at 935*.

[88] *Corbat, 2017 Del. Ch. LEXIS 848, 2017 WL 6452240, at *18* (citations omitted).

[89] ***Citigroup, 964 A.2d at 126*** (citation omitted).

[90] *8 Del. C. § 102(b)(7)*. *Section 102(b)(7)* also indicates that charters cannot eliminate or limit director liability for breaches of the duty of loyalty or "for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law." *See id.*

[91] ***Marchand, 212 A.3d 805***.

[92] ***Id. at 820-24***.

[93] ***Id. at 821*** (cleaned up and emphasis added).

[94] ***Marchand, 212 A.3d at 821*** (citations omitted).

under *Disney* or its progeny,[95] despite the concept's prominence in the opinion. As I read *Marchand*, directors must make a good faith effort to satisfy prongs one and two of *Caremark*. This interpretation is, I believe, bolstered by the opinion's further statement that "[i]f *Caremark* means anything, it is that a corporate board must make a good faith effort to exercise its duty of care."[96] That is, directors cannot intentionally disregard their duties to be "informed of risks or problems requiring their attention,"[97] because such intentional disregard would constitute bad faith supporting a *Caremark* claim.

Marchand and the other caselaw **[*24]** discussed above thus demonstrate that it is necessary to assess a director's good or bad faith in connection with a plaintiff's allegations before an oversight liability claim can be deemed viable.

2. Considering the SolarWinds's Directors Bad Faith

Disney remains the preeminent word on good faith in Delaware caselaw.[98] In *Disney*, the Delaware Supreme Court adopted the following definitions of bad faith:

> [(i) w]here the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, [(ii)] where the fiduciary acts with the intent to violate applicable positive law, or [(iii)] where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.[99]

Notably common among all three formulations here is an element of *intent*. That is, to act in bad faith, the directors must have acted with scienter, in that the directors had "actual or constructive knowledge that their conduct was legally improper."[100] And, as mentioned above, showing scienter in the context of a *Rule 23.1* motion to dismiss requires a plaintiff to plead supporting facts with particularity, from which a plaintiff-friendly inference **[*25]** of bad faith may arise.[101]

The Plaintiffs allege that the directors behaved in a manner contrary to positive law,[102] but this is not supported by the Complaint. The Complaint cites a number of "warnings" by government agencies[103] and private companies.[104] Its strongest fact is that the SEC in 2018 issued "new interpretive guidance" about disclosures around cybersecurity risks, including a statement that "[c]ompanies are required to establish and maintain appropriate and effective disclosure controls and procedures[,] including those related to cybersecurity[.]"[105] While this guidance is certainly indicative of requirements regarding public company disclosures, it does not establish positive law with respect to required cybersecurity *procedures* or how to manage cybersecurity risks. NYSE—the stock exchange upon which SolarWinds is listed—has also promulgated a "guide" to cybersecurity, which the Complaint references, but this guide is also not positive law.[106] The Plaintiffs did not plead that this guide was binding. In other words, the Plaintiffs have not alleged that "legal and regulatory frameworks" have "evolve[d]" with respect to cybersecurity, such that SolarWinds's corporate **[*26]** governance practices must have followed.[107]

The Complaint also does not plead with particularity that the SolarWinds directors intentionally acted with a purpose inimical to the corporation's best interests and, so far as I can tell, the Plaintiffs do not attempt to put that argument forward here.

The last, best argument available to the Plaintiffs in this action is that the directors demonstrated a conscious disregard for their duties by intentionally failing to act in

---

[95] *See generally* In re Walt Disney Co. Deriv. Litig., 906 A.2d 27 (Del. 2006).

[96] ***Id. at 824***.

[97] ***Id. at 821***.

[98] 906 A.2d 27.

[99] *Id. at 67*.

[100] ***City of Birmingham Ret. & Relief Sys. v. Good, 177 A.3d 47, 55 (Del. 2017)***; *see also* Boeing, 2021 Del. Ch. LEXIS 197, 2021 WL 4059934, at *24-25 (quoting Stone, 911 A.2d at 370)).

[101] *See, e.g.,* Wood, 953 A.2d at 141.

[102] Compl. ¶ 118.

[103] *Id.* ¶¶ 6, 44-56.

[104] *Id.* ¶¶ 7, 44-56.

[105] *Id.* ¶ 59.

[106] *Id.* ¶¶ 64-67.

[107] Sorenson, 2021 Del. Ch. LEXIS 234, 2021 WL 4593777, at *12.

the face of a known duty to act,[108] either by ignoring red flags so vibrant that scienter is implied, or by utterly failing to put into place a mechanism for monitoring or reporting risk. The Complaint discusses in considerable detail the actions and inactions of the SolarWinds Board and various Board committees with respect to cybersecurity, and I take all of the allegations in the Complaint as true, given the procedural posture here. Again, the Plaintiffs are also entitled to the benefits of all reasonable inferences at this stage.

But even with this plaintiff-friendly tailwind, the Complaint does not clear the high hurdle of pleading scienter with particularity. To establish that the directors acted in bad faith, **[*27]** a predicate to oversight liability, the Plaintiffs must make out a particularized allegation of facts from which I may infer scienter on the part of the directors.[109] To the extent the Plaintiffs argue that I should infer scienter exists due to 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,"[110] or lack of action in the face of "red flags" manifesting a duty to act, I find that such an inference would not be reasonable here.

I first address the red flags, indifference to which, per Plaintiffs, implies bad faith. The positive facts pled that support the Plaintiffs' position are: a reference in the Complaint to the Company's NCG Committee "effectively ignor[ing]" cybersecurity warnings it received at a presentation in 2019;[111] a description of a *2017* cybersecurity presentation given to management by the Company's former Global Cybersecurity Strategist and a later resignation email complaining that changes he requested prior to his departure were not implemented;[112] and a vestigial and patently insecure password used by the Company that was created in 2017 but survived **[*28]** at least until November 2019.[113]

Taking these in turn: the NCG Committee's receipt of the Cybersecurity Briefing, itself, is not a red flag or a fact supportive of bad faith or scienter. It was, in fact, an instance of oversight. As presented in the Complaint, the Cybersecurity Briefing was not indicative of an imminent corporate trauma. It reflected the concept that the Company *might become* the subject of a cyberattack and described the manner in which the Company was successful in preventing any such trauma. The pleading that the NCG Committee effectively ignored the presentation is conclusory. It is not pled that the presentation made action by the Board necessary.

The facts regarding the Company's Global Cybersecurity Strategist are outside the relevant time period, and further, there is no pleading that the Board was aware of either the presentation he gave before departure or the complaints he made in his resignation email. The Complaint instead indicates that the Global Cybersecurity Strategist's presentation was made to "technology and marketing executives" in the non-public company, pre-IPO, and that he resigned in an email **[*29]** to the Chief Marketing Officer.[114] Given its lack of knowledge, the Board cannot have acted in bad faith in response (or a lack of response) thereto.

Finally, and most seriously, the Complaint pleads a failure of cybersecurity in that the Company had a jejune, even farcical, password—'solarwinds123'—in place in a manner that could have compromised Company security from as early as 2017 until November 2019.[115] In November 2019, an unaffiliated third party

---

[108] Assuming, without finding, that directors have a "known duty" to act with respect to cybersecurity.

[109] *See, e.g.*, *Boeing, 2021 Del. Ch. LEXIS 197, 2021 WL 4059934, at *25*.

[110] *South, 62 A.3d at 15-16* (quoting *Caremark, 698 A.2d at 970*)).

[111] Compl. ¶ 78.

[112] *Id.* ¶ 97.

[113] *Id.* ¶¶ 81-84. The Complaint also pleads a number of business practices, described as "gross deficiencies," seemingly in support of a red-flags type argument. These include the allegations that SolarWinds did not properly "segment" its information technology networks, that it directed clients to disable antivirus scanning and firewall protection in order to use Orion, that it cut investments in cybersecurity, and that it listed high-value clients on their website. *See id.* ¶ 80. These decisions are business decisions rather than particularized incidents giving rise to red flags. The answering brief also alleges that generalized industry warnings constituted red flags. *See* AB 52-53. Failing to take industry warnings into account, I may presume, is bad *practice*, but is insufficient to plead bad faith failure *to oversee SolarWinds particularly*, as was the fiduciary duty of the Board.

[114] Compl. ¶ 97.

[115] *Id.* ¶ 81-82.

sent an email to SolarWinds's information technology team informing them of this security deficiency.[116] But again, it is not pled that the Committees were ever told that this incident had occurred. There is no indication that management knew of the solarwinds123 password being in place when the Cybersecurity Briefing was given in February 2019, and there is no indication that either the Committees or the full Board were ever apprised of the password deficiency. Without such knowledge, the Board again cannot have acted in bad faith relating to this incident.

The stronger argument is that the facts above are not themselves "red flags" but instead indicate the lack of an effective reporting system. The Plaintiffs note that the Board as a **[*30]** whole received no briefing about cybersecurity risk—indeed, the Plaintiffs plead that the "Board did not conduct a single meeting or have a single discussion about the Company's mission critical cybersecurity risks"[117] in its two-year pre-attack existence.

The Complaint notes that "[f]ollowing the Company's IPO," the Board had delegated cybersecurity oversight to the Audit Committee,[118] but also that the Audit Committee "never reported to the Board about cybersecurity risks."[119] The Audit Committee charter, per the Complaint, instructs the Audit Committee to discuss "with *management* the Company's major financial risk exposures, including . . . cyber and data security."[120]

The Complaint also acknowledges that the NCG Committee had oversight responsibility for cybersecurity, as the NCG Committee was responsible for "oversight responsibility for corporate governance risks" as of the time SolarWinds completed its IPO in October 2018.[121] The Company identified the NCG Committee in multiple proxy statements as "monitor[ing] and assess[ing] the effectiveness of our corporate governance guidelines *and our policies, plans and programs relating to cyber and data security*."[122] That is, the NCG Committee **[*31]** was to oversee business risk. And the NCG Committee received a presentation in February 2019 entitled "Risk Management Topic: Cybersecurity Briefing."[123] The minutes from that NCG Committee meeting indicate that Joe Kim, Rani Johnson, and Tim Brown, each a member of Company management, presented on "the Company's risk management and mitigation policies and initiatives related to cybersecurity," and that a "discussion ensued."[124]

Two months later, in April 2019, the NCG Committee amended its charter to specify "cyber and data security" as a major risk exposure within the Committee's risk management.[125] Like the Audit Committee, the NCG Committee's charter specifically stated the Committee would "[d]iscuss with management the Company's major risk exposures, including [among other topics] cyber and data security."[126]

The Complaint also notes that the NCG Committee "apparently attempted to schedule a subsequent meeting to discuss the Company's cybersecurity" in January 2020, but that this meeting never occurred.[127] The Sunburst Attack occurred late that same year.

---

[116] *Id.* ¶ 81-84.

[117] *Id.* ¶ 71.

[118] This was apparently in addition to the NCG Committee, which retained general risk management oversight, although the documents supporting the delegation of authority are not available to me at this stage. The Complaint does not plead that the Audit Committee's receipt of oversight authority divested the NCG Committee of oversight authority, and as I understand the pleadings, the Committees' roles were essentially duplicative in this area.

[119] *Id.* ¶ 72. The Complaint also asserts that the Audit Committee never held any discussion regarding the Company's cybersecurity or risks. This the Defendants contest, pointing to a document not produced until after the filing of the Complaint; the document should have been included in the *Section 220* production associated with this action, but was not. The challenged document is a set of Audit Committee meeting minutes indicating a discussion about cybersecurity risk did indeed take place in April 2020. I need not determine whether the minutes can be considered at this stage, given their exceedingly late production, because I find their consideration would not change the outcome here.

[120] *Id.* (emphasis added).

[121] *Id.* ¶ 10.

[122] *Id.* ¶ 63.

[123] *Id.* ¶ 39.

[124] Reed Decl., Ex. 12, at SW_SEAVITT 220_000000805-06.

[125] Compl. ¶ 10.

[126] *Id.* ¶ 75.

[127] *Id.* ¶ 74.

I read the Complaint as indicating that both of the Committees were charged with oversight responsibility for cybersecurity. The **[*32]** next question is whether I can infer that the Committees' failure to report to the Board regarding cybersecurity risk over a period of 26 months (from latest IPO to the Sunburst Attack) was reflective of bad faith, on the part of a majority of directors.

This inference I find unwarranted. To be sure, nominal acts of delegation, such as delegating oversight responsibility to a Board subcommittee that failed to meet, or that failed to investigate serious misconduct after being put on notice, are not preclusive of an oversight claim.[128] But the Complaint does not allege that the Audit Committee failed to meet; it alleges that the Audit Committee "did not hold one meeting or discussion concerning any aspect of the Company's cybersecurity" within a period of 26 months.[129] There is no indication in the complaint that the Audit Committee was simply a nominal, sham committee, and it would not be reasonable to infer such.

In the case of the NCG Committee, there are affirmative facts pled in the Complaint indicating that the committee not only met, but that it *met and discussed the pertinent issue*, cybersecurity, both via receipt of a management presentation and then again in discussion **[*33]** following the presentation.[130] Following the Cybersecurity Briefing, the NCG Committee in April 2019 amended its charter to expressly address cybersecurity,[131] indicating that the topic had arisen at a subsequent meeting. The Plaintiffs also point out that the NCG Committee had at least referenced a follow-up discussion about cybersecurity—possibly to take place in January 2020—though they note that no follow-up occurred.[132] The Plaintiffs' argument remains true, however, that there is nothing in the pleadings showing the NCG Committee ever spoke to the *Board as a whole* regarding cybersecurity concerns. The Complaint is silent as to what management told the NCG Committee that is sufficient to imply bad faith in the failure to communicate such information to the Board; what actions should have been recommended, if any; or what could have been done to prevent the Sunburst Attack.

In fact, as I understand the Plaintiffs' argument, they urge me to infer bad faith on the part of the Committees' members solely based on the fact that in the two years following the delegation of responsibility regarding cybersecurity, the Committees failed to report to the full Board on the subject. Without a **[*34]** pleading about the Committees' awareness of a particular threat, or understanding of actions the Board should take, the passage of time alone under these particular facts does not implicate bad faith.[133] Board committees, as delegees of Board authority, must exercise their members' business judgment in determining what items are on the agenda for any given meeting.[134] They must also exercise business judgment in determining what issues should be brought from the subcommittee to the full Board. Such exercises of business judgment are protected by exculpatory clauses such as the one SolarWinds had in place here. To hold members of Board committees liable for failure to discuss one particular business risk with the full Board over a period of 26 months—while contending with the transition to life as a public company and the novel coronavirus pandemic—and without a pleading of what information Committee members possessed which raised a good-faith duty to report, is simply unwarranted.

Certainly, the actions (or omissions) of the Committees in carrying out their oversight duties here appear in

---

[128] *See, e.g.*, *David B. Shaev Profit Sharing Acct. v. Armstrong, 2006 Del. Ch. LEXIS 33, 2006 WL 391931, at *5 (Del. Ch. Feb. 13, 2006)*, *aff'd*, ***911 A.2d 802 (Del. 2006)***; *Rich ex rel. Fuqi Int'l, Inc. v. Chong, 66 A.3d 963, 980 (Del. Ch. 2013)* (quoting *Stone, 911 A.2d at 370*) ("Examples of directors' 'disabling themselves from being informed' include a corporation's lacking an audit committee, or a corporation's not utilizing its audit committee.").

[129] Compl. ¶ 72. The Plaintiffs' counsel, at oral argument, appeared to concede that the Audit Committee did in fact meet. *See* Oral Arg. 56:1-58:4. I do not rely on this concession, in any event.

[130] *See* Reed Decl., Ex. 1. Management's presentation identified cybercriminal activity as a ubiquitous threat, but there is no allegation that recommendations for corporate action were communicated to the Committees or the Board, let alone ignored thereby.

[131] Compl. ¶ 10.

[132] *Id.* ¶ 74.

[133] *Cf. Chong, 66 A.3d at 980* ("I am conscious of the need to prevent hindsight from dictating the result of a *Caremark* action; a bad outcome, without more, does not equate to bad faith.").

[134] *South, 62 A.3d at 18-19* (citation omitted) ("Directors who try to 'get this balance right[]' are protected by the business judgment rule, even if they fall short in the attempt.").

hindsight far from ideal. I agree fully with the [Sorenson] court that good corporate practice requires director **[*35]** consideration of potential risks to customers; particularly so, perhaps, regarding cybersecurity. That does not mean the actions of the Committees, as pled, imply scienter supporting bad faith. Even if the acts of the Committees did implicate bad faith, those actions would not necessarily implicate the directors not serving therein. Having delegated oversight of risk to two non-sham, functioning Committees, the failure of those Committees to make a Board presentation on a particular risk in a particular year, without more, does not to my mind give rise to an inference that the *Board* intentionally disregarded its oversight duties in bad faith.[135] The fact that the Board did not receive reports from the Committees with respect to cybersecurity over a 26-month period, I may infer, should have been, to a prudent director, of concern, but failure to demand a presentation, without facts pled implying that the directors were aware of a failure of Committee duties, does not implicate bad faith—instead, it goes to the duty of care, not loyalty.[136] It is not indicative of an utter failure of reporting and control for the Board to delegate risk assessment to the Committees, and then fail to demand **[*36]** an accounting of a particular business risk. As this Court noted in [Boeing], the "'intentional dereliction of duty' or 'conscious disregard for one's responsibilities' . . . 'is more culpable than simple inattention or failure to be informed of all facts material to the decision,'" instead requiring that "directors have acted in bad faith and cannot avail themselves of defenses grounded in a presumption of good faith"[137] to raise the inference of liability. Here, inferences cannot take the Plaintiffs from inattention to intentional dereliction.

To recapitulate, a subpar reporting system between a Board subcommittee and the fuller Board is not equivalent to an "utter failure to attempt to assure" that a reporting system exists.[138] The short time period here between the IPO and the trauma suffered, together with the fact that the Board apparently did not request a report on cybersecurity in that period, is not sufficient for me to infer an *intentional* "sustained or systematic failure" of oversight,[139] particularly given directors are *presumed* to act in good faith.[140] And again, the Complaint is silent as to what the Committees should in good faith have reported, **[*37]** and how it could have mitigated corporate trauma.

Carelessness absent scienter is not bad faith. In sum, the Complaint has not pled sufficient particularized facts to support a reasonable inference of scienter and therefore actions taken in bad faith by the Board. Without a satisfactorily particularized pleading allowing reasonably conceivable inference of scienter, a bad faith claim cannot survive a motion to dismiss. Because the [Caremark] claim is not viable, there is no substantial likelihood of liability attaching to a majority of the directors on the demand Board. Therefore, demand on the Board would not have been futile.

---

[135] *But see* [Hughes v. Hu, 2020 Del. Ch. LEXIS 162, 2020 WL 1987029, at *15 (Del. Ch. Apr. 27, 2020)] (emphasis added) ("These chronic deficiencies support a reasonable inference that the Company's board of directors, *acting through its Audit Committee*, failed to provide meaningful oversight over the Company's financial statements and system of financial controls.").

[136] The Complaint also alleges that the Company created a Technology and Cybersecurity Committee "at a special meeting of the board in early January 2021," and tasked it with helping the Board to fulfill its oversight responsibilities, including oversight of the Company's IT systems and cybersecurity generally. Compl. ¶ 76. Although the Plaintiffs frame the creation of this new committee as an admission that the Board had failed in its oversight responsibilities prior to the Sunburst Attack, "[t]hese actions do not bespeak faithless or imprudent fiduciaries." [Ash v. McCall, 2000 Del. Ch. LEXIS 144, 2000 WL 1370341, at *15 (Del. Ch. Sept. 15, 2000)] (discussing defendant directors' "immediately" taking "decisive steps to disclose and cure" corporate trauma leading to a [Caremark] claim).

[137] [Boeing, 2021 Del. Ch. LEXIS 197, 2021 WL 4059934, at *25] (citing [Disney, 906 A.2d at 66]; then citing ***Citigroup, 964 A.2d at 125***).

[138] *See* [South, 62 A.3d at 18] (citing [Caremark, 698 A.2d at 971]) ("These pled facts do not support an inference of an 'utter failure to attempt to assure a reasonable information and reporting system exists,' but rather the opposite: an evident effort to establish a reasonable system.").

[139] No facts are pled regarding the frequency of Board subcommittee meetings.

[140] *Cf.* ***Citigroup, 964 A.2d at 125*** ("The presumption of the business judgment rule, the protection of an exculpatory [Section 102(b)(7)] provision, and the difficulty of proving a [Caremark] claim together function to place an extremely high burden on a plaintiff to state a claim for personal director liability for a failure to see the extent of a company's business risk."); *see* ***id. at 136*** (internal quotations omitted) ("[T]he plaintiff must overcome the general presumption of good faith . . . .").

B. The Plaintiffs' Second Theory of Demand Futility

The Plaintiffs make another argument as to a majority of the demand Board. They argue that the demand Board is incapable of impartially evaluating a demand because that majority granted Defendant Thompson a release for any actions taken as Company CEO or director.[141] The legal theory they seek to advance is, to me, unclear, and the release theory is not discussed in the single count of the Complaint. This demand futility argument fails for want of particularized pleading, as well.

The Defendants' motions to dismiss **[*38]** must therefore be granted for failure to establish demand futility under any theory. Accordingly, I need not examine the Defendants' motions to dismiss under *Rule 12(b)(6)*.

III. CONCLUSION

For the foregoing reasons, Defendants' motions to dismiss under *Rule 23.1* are GRANTED. The parties should submit a form of order consistent with this Memorandum Opinion.

End of Document

[141] Compl. ¶ 116.

Diep v. Trimaran Pollo Partners, L.L.C.

Supreme Court of Delaware

March 30, 2022, Submitted; June 28, 2022, Decided

No. 313, 2021

Reporter
280 A.3d 133 *; 2022 Del. LEXIS 192 **

KEVIN DIEP, derivatively on behalf of EL POLLO LOCO HOLDINGS, INC., Plaintiff Below, Appellant, v. TRIMARAN POLLO PARTNERS, L.L.C., Defendant Below, Appellee, and EL POLLO LOCO HOLDINGS, INC., Nominal Defendant Below, Appellee.

Subsequent History: Case Closed July 14, 2022.

Prior History: [1]** Court Below: Court of Chancery of the State of Delaware. C.A. No. 12760.

Disposition: AFFIRMED.

Counsel: Ralph N. Sianni, Esquire, ANDERSEN SLEATER SIANNI LLC, Wilmington, Delaware, Hung G. Ta, Esquire (argued), JooYun Kim, Esquire, Natalia D. Williams, Esquire, HGT LAW, New York, New York, and Peter Safirstein, Esquire, SAFIRSTEIN METCALF LLP, New York, New York, for Plaintiff Below, Appellant Kevin Diep, derivatively on behalf of El Pollo Loco Holdings, Inc.

Kurt M. Heyman, Esquire, Jamie L. Brown, Esquire, HEYMAN ENERIO GATTUSO & HIRZEL LLP, Wilmington, Delaware, Adam H. Offenhartz, Esquire (argued), GIBSON, DUNN & CRUTCHER LLP, New York, New York, and Tyler H. Amass, Esquire, GIBSON, DUNN & CRUTCHER LLP, Denver, Colorado, for Defendant Below, Appellee Trimaran Pollo Partners, L.L.C., and Nominal Defendant Below, Appellee El Pollo Loco Holdings, Inc.

Judges: Before SEITZ, Chief Justice; VALIHURA, VAUGHN, TRAYNOR, and MONTGOMERY-REEVES, Justices, constituting the Court en Banc. VALIHURA, J., dissenting.

Opinion by: SEITZ

Opinion

[*136] SEITZ, Chief Justice, for the Majority:

El Pollo Loco is a fast casual Mexican-inspired restaurant chain specializing in fire-grilled, citrus-marinated fresh chicken and other dishes prepared in front of the customer. **[**2]** Kevin Diep, a stockholder of El Pollo Loco Holdings, Inc. ("EPL"), filed derivative claims against some members of EPL's board of directors and management, as well as a private investment firm. The suit focused on two acts of alleged wrongdoing—concealing the negative impact of price increases during an earnings call and selling EPL stock while in possession of material non-public financial information.

After the Court of Chancery denied the defendants' motion to dismiss, the EPL board of directors designated a special litigation committee of the board ("SLC") with exclusive authority to investigate the derivative claims and to take whatever action **[*137]** was in EPL's best interests. After a lengthy investigation and extensive report, the SLC moved to terminate the derivative claims. All defendants but the private investment firm settled with Diep while the dismissal motion was pending. The Court of Chancery granted the SLC's motion after applying the familiar two-step review under *Zapata Corp. v. Maldonado*.[1]

On appeal, Diep challenges the Court of Chancery's decision on several grounds. He contends that there were disputed issues of material fact concerning the independence of the SLC members **[**3]** and the reasonableness of its investigation, the court abused its discretion when it found that the SLC's conclusions were reasonable, and the court erred when it applied the second prong of the *Zapata* test. After our review of the record, including the SLC's report, and the Court of Chancery's decision, we find that the court properly

---

[1] *430 A.2d 779 (Del. 1981)*.

evaluated the SLC's independence, investigation, and conclusions, and we affirm the judgment of dismissal.

I.

A.

The background facts are drawn from the derivative complaint and the SLC's 2019 Report.[2] El Pollo Loco is a restaurant chain operating in the "quick service plus" or "QSR+" category.[3] According to EPL, its restaurants provide "fresh quality food, but with a fast casual dining experience" or, in other words, "speed, convenience, and value."[4] Founded in 1980 in Los Angeles, California, it expanded to many locations, and completed an Initial Public Offering on July 25, 2014.[5] Defendant Trimaran Pollo Partners, L.L.C. ("TPP") is an investment vehicle formed in 2005 by private asset management firm Trimaran Capital Partners ("Trimaran Capital") to acquire EPL's predecessor.[6] Dean Kehler, Andrew Heyer, and Jay Bloom founded Trimaran Capital. Kehler is one **[**4]** of two managing members of Trimaran Capital, and Trimaran Capital is the managing member of TPP. TPP membership is otherwise made up of Trimaran Capital affiliates, except for one member—private investment firm Freeman Spigoli & Co ("Freeman Spigoli"). On the EPL board, TPP was represented by Kehler, John Roth, and Michael Maselli. Roth is CEO of Freeman Spigoli and Maselli is a TPP managing partner. Maselli served as chairman of the EPL board.

After the IPO, TPP owned 59.2% of EPL's outstanding common stock. EPL then adopted an insider trading policy (the "Trading Policy") restricting stock sales by EPL insiders outside of specific trading windows.[7] The insiders under the Trading Policy included "directors, officers, employees and service providers" as well as "corporations or other business entities controlled or managed by" the former.[8] The Trading Policy prohibited the purchase and sale of EPL stock unless the party was "(1) . . . not aware of material non-public information . . . ; (2) the purchase or sale [fell] within the Trading Window . . . ; and (3) the trade was pre-cleared **[*138]** under the Company's mandatory pre-clearance policy" by EPL's chief legal officer, Edith Austin. **[**5]** [9] The first trading window after the IPO opened May 19, 2015, and closed June 10, 2015. Austin notified the EPL insiders of the trading window on April 23, 2015 and reminded them that they were required to seek pre-clearance for trades.[10]

Ryan Hawley was EPL's vice president of marketing planning and analysis. His role included "develop[ing] and refin[ing] the Company's pricing strategy and . . . developing pricing recommendations."[11] Hawley created daily and weekly reports on EPL's performance and recommended price changes to the EPL executive management team. The reports included EPL's "key performance metric" of Same Store Sales or "SSS"—the year-to-year change in the number of transactions and the aggregate amount spent per transaction at each store.[12]

Hawley also tracked consumer response to price changes, in both sales and value perception. These perception reports included the overall value of the company—the experience divided by the price—and EPL's price competitiveness/value for money, drawn from consumer surveys. Given EPL's place in the QSR+ category, consumer perceptions were important to the overall business. EPL historically looked to large-scale trends rather than specific **[**6]** market responses when evaluating the importance of value scores.[13]

B.

EPL increased food prices three times between 2014 and 2015. The increases were a response to rising labor costs as well as a brand decision "to cover costs to drive

[2] App. to Opening Br. at A6-112 (Diep's Compl.); App. to Answering Br. at B3-443 (hereinafter, the "SLC Report").

[3] App to Answering Br. at B16.

[4] *Id.*

[5] *Id.*

[6] *Id.* at B18.

[7] App. to Opening Br. at A614-627.

[8] *Diep v. Sather, 2021 Del. Ch. LEXIS 166, 2021 WL 3236322, at *2 (Del. Ch. July 30, 2021)*.

[9] App. to Opening Br. at A622.

[10] App. to Answering Br. at B218.

[11] *Id.* at B83.

[12] *Id.* at B8, B30, B87, B110.

[13] "Mr. Hawley explained that there had been 'many ups and downs' with respect to value scores: M9 2014 value scores were good, M10 2014 scores dropped, M1 2015 scores increased, and then M2 2015 declined again. Mr. Hawley stated that 'the bigger concern' was the general trend over time, not any specific drop." *Id.* at B139.

top line sales[.]"[14] Together, prices increased 3% across the menu, a change EPL had never implemented in just one year.[15] In 2014 and the beginning of 2015, EPL had a larger than expected drop in sales, though revenue remained strong.

In April 2015, Hawley began preparing materials for the May 11-12 board meeting. Various insiders, including then-director, president, and chief executive officer Stephen Sather, chief financial officer Laurance Roberts, chief marketing officer Edward Valle, then-chief operating officer Kay Bogeajis, and board chair Maselli, reviewed and commented on these materials and other draft presentations.

On May 5, 2015, Sather sent Maselli a customer survey showing a decline in EPL's value score from 59.6% to 58.1% between April and May. The sample size was "less than 15.5% of the likely total responses for the month."[16] Sather asked Maselli to "keep this between us at this point as I don't want anyone to over react."[17] Maselli told **[**7]** the SLC "that he understood Mr. Sather's comment about keeping the data between them as being related to the fact that the report was a **[*139]** 'very early read,' and that he believed that Mr. Sather had wanted more data before sharing the data with others."[18] Meanwhile, the presentations were finalized and distributed to board members on May 6.

The EPL board, managing and non-managing executives, and representatives from Freeman Spigoli attended the May 11 meeting.[19] Roberts presented financial updates that showed a decline in SSS but explained that he felt EPL was still in a good place overall. He also presented a lower projected SSS for the second quarter of 2015 based on year-to-date sales. Apparently, there was no explanation given for the SSS decline, but management was optimistic that the 3rd and 4th quarters could compensate because the company had a plan to introduce new menu items.

Essentially the same group attended the May 12 session of the board meeting. For the most part, Hawley ran this meeting. His presentation had been updated since the May 6 draft and offered possible explanations for the SSS drop. Hawley explained that the first quarter issues could be attributed to **[**8]** the holidays, given the growth over the rest of the quarter, but that issues in amount-per-transaction were likely caused by the "2015 pricing action" which "had 'led to lower total sales.'"[20] He also pointed out a significant dip in the answer to the consumer survey question of whether EPL "provides good value for the money"—from 71% to 54% between 2014 and 2015.[21] During the meeting, the board and management team discounted the consumer survey analysis and the value scores because they were from a new, untested firm.[22] Hawley conceded that EPL was working with a new firm and the data could be wrong.[23]

EPL filed a Form 10-Q on May 14, 2015, reporting its first quarter earnings. Earnings failed to meet company forecasts. On an earnings call that evening (the "Earnings Call"), management gave a scripted presentation followed by a live Q&A. In drafting the presentation script, the management team discussed what they should disclose about the current quarter, which was also unlikely to meet forecasts. EPL had not typically disclosed information about quarters in progress. "Preparation for the Earnings Call thus included discussions regarding how much second-quarter forecasting to disclose **[**9]** to adequately 'manage the market's expectations' without creating an expectation that the market would continue to receive such detailed forward-looking information 'forever.'"[24]

Hawley was involved in drafting the Q&A responses. He proposed answers about the link between EPL's increased pricing and decreased performance, as well as decreases in value score. Specifically, he included a projected second-quarter Company SSS range of 1.0-2.5% instead of the 2.5% number he had presented at

---

[14] *Id.* at B131.

[15] *Id.* at B128-29.

[16] *Id.* at B143.

[17] *Id.*

[18] *Id.*

[19] *Id.* at B146.

[20] *Id.* at B157-59.

[21] *Id.* at B161.

[22] For instance, Valle thought EPL had mistakenly prioritized steak and shrimp menu items, which were not as healthy as other EPL offerings and led to the dip in earnings.

[23] *Id.* at B161-64.

[24] *Diep, 2021 Del. Ch. LEXIS 166, 2021 WL 3236322, at *6* (quoting SLC Report at 193-94 (available at App. to Answering Br. at B207-08)).

the board meeting.[25] This range showed the possibility that the previous drops were not anomalies but instead due to general sales trends. Roberts did not include the **[*140]** specific range in his draft answers, instead offering language about a strong quarter in the previous year and marketing issues. He also edited the Q&A draft answer about the drop in value scores, saying it was due to the prioritization of certain menu items. After a management meeting on May 12, Hawley inserted the SSS ranges and specific forecasts into the draft, and suggested consumer pricing resistance as a response to questions about the decreased value score.[26] Hawley's comments were not included in the final draft.[27]

The management team **[**10]** drafting the statement, conscious of the upcoming trading window, sent the draft script to outside counsel to make sure it would be "sufficient from an insider-trading standpoint."[28] The final version read on the Earnings Call revealed the likelihood that second quarter SSS would "be closer to the low end of the [previously projected] range," and attributed the drop to how strong the quarter had been the previous year (given that SSS reflected year-to-year changes from the same stores).[29] Management maintained a full-year SSS projection of 3-5%.

On the Earnings Call, a Morgan Stanley analyst asked about the earnings drop and value score decrease.[30] Roberts and Valle attributed the issues to the non-chicken proteins, and not "price resistance in the higher price points[.]"[31] Sather specifically touted EPL's value scores as consistently strong but did not mention the new scores received earlier that month.

C.

Maselli had been considering selling some of TPP's EPL stock in the upcoming trading window. On May 3, 2015, Maselli emailed Sather about a potential sale. He then met with EPL management before the May 11 board meeting to discuss. On May 18, 2015, Wesley Barton, a Trimaran Capital vice **[**11]** president and EPL director, informed EPL's chief legal officer of the possible sale. Barton said that "TPP [was] considering a block sale of some stock" and that he "suspect[ed] that the c-level team [would] participate in the block with TPP."[32] Around the same time, Maselli emailed Bogeajis, Roberts, Valle, and Sather, requesting a "quick call to discuss the process for the possible share sale."[33] According to Maselli, the underwriters involved in the Block Trade had requested executive involvement to streamline the process and avoid a subsequent block sale that lowered the value of the first stock sale.[34] Sather, Valle, and Bogeajis each requested and received pre-clearance under the EPL Trading Policy from the chief legal officer. TPP did not request approval for its sale.

[*141] EPL's stock closed at $29.06 per share on May 14, 2015, the day of the Earnings Call. It opened on May 15 at $24.96 and continued to drop. On May 19, 2015, the first day of the first trading window since the IPO, the stock opened at $24.07. TPP, Sather, Valle, and Bogeajis sold stock that day (the "Block Trade"). As the managing member of TPP, Trimaran Capital negotiated the terms of the Block Trade, and its managing **[**12]** members Kehler and Bloom authorized the trade on behalf of Trimaran Capital and TPP. In total, they sold 5,962,500 shares for $130,280,625, or $21.85 per share. The Block Trade sales were distributed as follows:

Go to table1

Distributed among the TPP members, Trimaran Capital received $68,122,313, Freeman Spigoli received $39,010,728, and other members received $10,911,584. TPP held 16,746,544 shares of EPL stock after the Block Trade. Other directors on the EPL board (Douglas Ammerman and Samuel Borgese) exercised purchase options and sold stock on May 19 separate from the

[25] App. to Answering Br. at B198.

[26] *Id.* at B197-99 ("Mr. Hawley also proposed answers to questions about franchise versus company performance, Q1 comps, Houston restaurants, and whether there was 'any negative response from consumers to our price increases [and] any impact on value scores,' the last of which Mr. Hawley answered by noting that EPL was 'seeing some potential pushback from consumers on prices.'").

[27] *Id.* at B201-03; App. to Opening Br. at A924-31 (SLC Report Ex. 193).

[28] App. to Answering Br. at B191.

[29] App. to Opening Br. at A932-44 (SLC Report Ex. 197 at 5).

[30] *Id.* at A940 (SLC Report Ex. 197 at 8).

[31] *Id.*

[32] App. to Answering Br. at B222.

[33] *Id.*

[34] *Id.* at B221.

Block Trade.

On August 13, 2015, EPL issued a press release announcing the results for the quarter ending July 1, 2015. The press release stated that "system-wide comparable restaurant sales [SSS] grew 1.3%" while company SSS declined 0.5%, driven by a "3.9% decrease in traffic, partially offset by a 3.4% increase in average check size."[35] In the press release EPL adjusted its overall SSS projection for 2015 from 3-5% to "approximately 3.0%[.]"[36] EPL stock opened at $18.04 a share on August 13, 2015. It closed at **[**13]** $14.56 per share the next day. From the beginning to the end of 2015, EPL's stock price dropped 37%.[37]

D.

On August 24, 2015, Daniel Turocy, an EPL stockholder, filed a class action against EPL, Sather, Roberts, Valle, TPP, Trimaran Capital, and Freeman Spigoli in the U.S. District Court for the Central District of California. He alleged federal securities law violations for the Block Trade (the "Turocy Action"). On November 5, 2015, Armen Galustyan, another EPL stockholder, sued TPP, Sather, Roberts, Valle, Bogeajis, Maselli, Kehler, Barton, Ammerman, and Borgese in the Court of Chancery, alleging breach of fiduciary duty and unjust enrichment for the Block Trade (the "Galustyan Action"). The parties agreed to stay the Galustyan Action pending the outcome of the Turocy Action. The Court of Chancery later granted Galustyan's motion to dismiss his suit voluntarily with prejudice.

[*142] On September 20, 2016, Diep, another EPL stockholder, filed this action after obtaining books and records through a [Section 220](#) demand. The complaint named Sather, Roberts, Valle, Bogeajis, Ammerman, Borgese, and TPP as defendants. The complaint contained two counts: first, that all defendants except Roberts breached **[**14]** their fiduciary duties by making the Block Trade—an insider trading *Brophy v. Cities Service Co.* claim—and second, that Sather, Roberts, and Valle breached their fiduciary duties by making intentionally false public disclosures in the Earnings Call.[38]

All defendants responded with a multi-pronged motion—to stay in favor of the Federal Action, to dismiss under [Court of Chancery Rule 12(b)(6)](#) for failure to state a claim, and to dismiss under [Rule 23.1](#) for failure to make a demand (the "2016 Motion to Dismiss" or "2016 Motion").[39] Specifically, the defendants argued that Diep had failed to plead facts showing a substantial likelihood of liability for the majority of the Board. According to the defendants, the alleged non-public information was disclosed publicly, the intra-quarter results were immaterial, and there was no showing of scienter.[40]

The defendants also claimed that similar defects existed in Diep's claim for relief, because the complaint did not contain "specific supporting factual allegations."[41] The 2016 Motion was filed on behalf of "Nominal Defendant El Pollo Loco Holdings, Inc." and defendants Bogeajis, Roberts, Sather, Valle, Ammerman, Borgese, and TPP.[42] The Court of Chancery stayed the count addressing the statements **[**15]** made during the Earnings Call in favor of the Turocy Action (given the potential to recover and California's interest in the matter), but denied the motions with respect to the insider trading claims. According to the court, "the plaintiffs [had] plead that it is reasonably conceivable that the executives did give knowingly false and misleading answers about the cause for the slowdown and that they subsequently traded, along with the controlling stockholder, before the full information was known by the market."[43] The court held that Delaware's interest in the matter—protecting the fiduciary relationship—"is a quintessential Delaware law concern" and refused to stay because stockholders would not benefit from the Turocy Action.[44]

Turning to the [Rule 12(b)(6)](#) motion, the court found

---

[35] *Id.* at B254.

[36] *Id.*

[37] From $20 per share on January 2, 2015, to $12.63 per share on December 31, 2015. *Id.* at B260.

[38] [31 Del. Ch. 241, 70 A.2d 5 (Del. Ch. 1949)](#); [Malone v. Brincat, 722 A.2d 5 (Del. 1998)](#).

[39] [Diep, 2021 Del. Ch. LEXIS 166, 2021 WL 3236322, at *10](#); App. to Opening Br. at A113-A175 (Defendants' Brief in Support of Their Motion to Stay or to Dismiss Pursuant to [Rules 23.1](#) and [12(b)(6)](#)).

[40] App. to Opening Br. at A117, A160-72.

[41] *Id.* at A173 (quoting [In re Gen. Motors (Hughes) S'holder Litig., 897 A.2d 162, 168 (Del. 2006)](#)).

[42] *Id.* at A114-15.

[43] *Diep v. Sather*, C.A. No. 12760, at 89 (Del. Ch. Mar. 17, 2017) (TRANSCRIPT).

[44] *Id.* at 94.

Diep had successfully pled a possible *Brophy* claim by identifying instances where Sather, Roberts, and Valle had said that higher prices had not influenced SSS, instead pointing to timing, marketing, or brand messaging.[45] Diep had demonstrated there was "a serious problem . . . a serious risk" with price increases at the time, as shown in later EPL materials which confirmed issues with **[*143]** pricing.[46] And while the **[**16]** defendants had claimed there was no scienter pled, the Court of Chancery held that "knowledge can be alleged generally under *Rule 8*."[47] The other circumstances surrounding the Block Trade, while not determinative, supported an inference of scienter at the pleading stage. As such, the *Rule 23.1* motion was dismissed because Diep had shown that five of nine directors faced a substantial likelihood of liability.[48]

E.

After the Court of Chancery denied the motions to dismiss, the EPL board formed the SLC to investigate the allegations in all three suits, as well as demands for suit from other EPL stockholders. The EPL board appointed three directors to the SLC—Douglas Babb, William Floyd, and Carol Lynton. All three newly appointed directors joined the board after the 2015 events at issue in the derivative action.

1.

Babb, an attorney, served in executive positions for various companies, more recently in the healthcare industry and previously in the transportation industry.[49] Babb and Floyd worked together before Babb joined the EPL board.[50] Floyd was the one who recommended him to serve as an outside director. When interviewing for the board position, Babb reviewed pending litigation against EPL and **[**17]** discussed the suits with Lynton and others. It was mentioned during the board interview process that he would likely join the SLC.[51] He joined the board on January 3, 2018, and the SLC on January 11, 2018.

2.

Floyd served as chairman and in executive positions for various businesses, including businesses in the restaurant and fast-food industries. He was also a member of the Board of Overseers at the University of Pennsylvania School of Nursing. Before joining the board, Floyd knew Kehler through the Board of Overseers, where the two served together.[52] The Board of Overseers meets three or four times a year and has thirty members. Kehler recruited Floyd to join the board of directors "because [EPL] was seeking independent board members to meet federal and agency requirements for public companies."[53] Floyd discussed pending litigation with Kehler but did not raise the possibility of joining the SLC until after Floyd joined the board. When Kehler recruited Floyd to the board, Kehler told Floyd "three things [about the pending litigation]. He said we did nothing illegal, we did nothing unethical, but he said the optics did not look good with the, you know, with the trading of the stock." **[**18]** [54] Floyd joined the board on **[*144]** April 1, 2016, and the SLC on October 6, 2017.

3.

Lynton was a co-founder, executive, and director for various restaurant groups, based primarily in New York. As with Floyd, Kehler recruited Lynton to join the board "because [EPL] was seeking independent board members to meet federal and agency requirements for public companies."[55] In the interview process, Kehler and Lynton discussed the litigation pending against EPL, but the possibility of an SLC was not raised until after Lynton joined the board.

Lynton attended Harvard College with Kehler's wife, where they met two or three times. From 1983 to 1985, Lynton, Kehler, and Kehler's wife all worked for Lehman

[45] *Id.* at 103.

[46] *Id.* at 105.

[47] *Id.* at 107.

[48] *Id.* at 109-10.

[49] App. to Answering Br. at B34-35.

[50] "From 2001 to 2006, Mr. Floyd was Chairman and Chief Executive Officer at Beverly Enterprises, and Mr. Babb reported to him as Executive Vice President-Chief Administrative and Legal Officer and Secretary from 2002 to 2006." *Id.* at B35.

[51] *Id.*

[52] Floyd also knew Sather and Bogeajis when the three worked at Taco Bell but had limited relationships with both individuals.

[53] *Id.* at B37.

[54] App. to Answering Br. at B469-70 (Floyd Depo. Tr. 10-11).

[55] *Id.* at B39.

Brothers. Lynton and Kehler's wife were junior analysts and Kehler was a senior associate and vice president. Lynton briefly worked with Kehler at this point, primarily on a two-week project.

Since their time in the 1980s at Lehman Brothers, Lynton has dined with the Kehlers about twenty times, including once at Lynton's mother's home. Her eldest daughter briefly went to the same high school as the Kehlers' eldest son. Lynton characterized her social activities with the Kehlers as primarily related to **[**19]** their children, who are now adults.[56] Since joining the EPL board, Lynton has dined with Kehler's wife twice. Lynton and Kehler have also donated what could be characterized as small amounts to non-profits that the other was involved in, and Lynton once asked Kehler and two other individuals for business advice about ten years ago. Lynton joined the EPL board on April 1, 2016, and the SLC on October 6, 2017.

For their SLC service, the members were paid $4000 a month, plus expenses—an amount in line with remuneration of SLC members appointed by other companies.[57] The SLC members also agreed to surrender their SLC-related compensation or have the court adjust the amount received if their compensation was found by the court to be unreasonable or to impair their impartiality or independence.

F.

The Court of Chancery stayed the suit while the SLC went to work. The SLC undertook an extensive investigation. It hired counsel whose independence has not been challenged. It reviewed over 249,000 documents that included board materials, financial updates and reports, internal governance and policies, and business and personal emails about the Board Presentation, the Management Presentation, and **[**20]** the Block Trade.[58] It also reviewed deposition transcripts from other litigation and conducted interviews with all potential defendants and key EPL employees, including Hawley. Diep's counsel and counsel for other stockholders were invited to participate in the investigation but, unfortunately, did not cooperate with the SLC.[59]

The SLC met formally sixteen times between December 2017 and February 2019 and consulted with its counsel throughout the investigation. It finalized its conclusions and published its report on February 13, 2019 (the "SLC Report"). In its 377-page report, the SLC considered 1) the merits of the claims; 2) the cost of potential litigation; 3) how distracting litigation **[*145]** would be to the company; and 4) the reputational challenges and costs to public relations.[60]

Diep had pled a *Brophy* claim against the defendants for insider trading. A *Brophy* claim requires 1) that there existed material, nonpublic information and 2) evidence that the parties were motivated to trade by the information.[61] The SLC determined that Hawley's information was not material because it was an early, sample-size estimate and because various other theories were presented at the same time.[62] The management **[**21]** team had also proactively disclosed on the Earnings Call the earnings results and the potential that the SSS would be lower than anticipated. In the SLC's view, this made any material information public, as shown by the drop in stock price after the Earnings Call.[63]

The SLC also found that there was insufficient evidence of scienter. The Block Trade took place on the first day of the trading window. Because the defendants had taken the first possible opportunity to sell stock, it was less likely that the sale was a calculated effort to benefit from inside information.[64] And the EPL board and management viewed Hawley's analysis as more of a

---

[56] *Id.* at B40, B50.

[57] *Id.* at B41, 53.

[58] *Id.* at B63-64.

[59] *Id.* at B66-77.

[60] *Id.* at B387-390.

[61] *Kahn v. Kolberg Kravis Roberts & Co., L.P., 23 A.3d 831, 838 (Del. 2011)* (*Brophy* requires "1) the corporate fiduciary possessed material, nonpublic company information; and 2) the corporate fiduciary used that information improperly by making trades because she was motivated, in whole or in part, by the substance of that information." (quoting *In re Oracle Corp., 867 A.2d 904, 934 (Del. Ch. 2004)*, *aff'd*, ***872 A.2d 960 (Del. 2005)*** (ORDER))).

[62] App. to Answering Br. at B276-77; *id.* at B285-89.

[63] *Id.* at B304-26.

[64] *Id.* at B351-52 ("[Maselli] stated that the 'norm' is to sell early in the open window because the disclosure is 'freshest' and the best data is available to the market. Thus, the timing of the Block Trade—the first day of the trading window on May 19, 2015—does not suggest an ulterior motive, but is consistent with the usual practice of private equity firms.").

contrary point of view rather than a definitive determination of value perception.[65] As such, the SLC concluded, it was unlikely that they were motivated to trade by that information.[66]

Diep and the other plaintiffs had also alleged breaches of fiduciary duty by Sather, Roberts, Valle, and TPP. Specifically, Diep contended that their failure to disclose material information on the Earnings Call "breached their fiduciary duties of loyalty and good faith by engaging in stock sales while in possession of purportedly material, nonpublic **[**22]** information."[67] And Diep also argued that Sather, Roberts, and Valle "'breached their fiduciary duties, including their duty of candor,' by purportedly making untrue statements and by failing to provide material facts."[68] EPL's certificate of incorporation contained an exculpatory provision, meaning that directors would only be liable if they "(i) engaged in intentional misconduct; (ii) committed a knowing violation of law; or **[*146]** (iii) acted in bad faith."[69] With respect to management, the SLC had to determine whether the directors were grossly negligent or had acted in bad faith, given that they were not exculpated from the duty of care.

The SLC found "that the Executive Management Team was well informed, acted in good faith, and was not grossly negligent in" not disclosing "potentially unreliable value score data" and SSS projections.[70] It also determined that the disclosures were "adequate in light of the information available to the Company during the Relevant Period."[71] Finally, the SLC found that, for all defendants, there was no "evidence of bad faith, intent to violate the law, failure to implement internal controls, or a conscious disregard of their corporate oversight duties[.]" **[**23]** [72] Among other evidence, the SLC considered the decision to settle the Turocy Action and concluded that the Turocy Defendants settled "not because they believed the allegations had merit, but because of the risks inherent in potentially proceeding to trial and the significant costs that would be incurred in doing so."[73] The SLC concluded "that the Company should move to dismiss" the instant matter and should "not pursue litigation nor otherwise take any further action against any of the Defendants[.]"[74]

G.

The SLC moved to terminate the litigation (the "SLC Motion to Dismiss" or "SLC Motion"). Before the Court of Chancery reviewed the motion, Diep and the individual defendants settled for $625,000 in exchange for a release. TPP was therefore the only remaining defendant. In his opposition to the SLC's motion, Diep challenged the SLC's independence and the reasonableness of its investigation. He argued that the SLC was not independent because Floyd and Lynton were conflicted, and that there were material questions of fact as to the SLC's conclusions. Diep argued in the alternative that the Court of Chancery should apply its own business judgment and find that even if there was **[**24]** a reasonable, good faith investigation, Diep pled claims that should be pursued in the best interests of the company.

The Court of Chancery reviewed Diep's objections "under a 'procedural standard akin to a summary judgment inquiry.'"[75] It first considered whether the directors' ties to the defendants rendered them, "*for any substantial reason*, incapable of making a decision with only the best interests of the corporation in mind," focusing on "impartiality and objectivity."[76] As part of its analysis, the court examined the relationships of the SLC members with the defendants, and whether they were "of such a nature that they might have caused [the

[65] *E.g., id.* at B283 ("Mr. Kehler, among other individuals interviewed by the SLC, said that he believed Mr. Hawley's value score slides were part of a narrative to raise warning signs about pricing. Moreover, Mr. Kehler suggested that Mr. Hawley's presentation of the survey data was 'intentionally misleading' and designed to 'soften up' the Directors and Executive Management Team to lower prices.").

[66] *Id.* at B347-56 (discussing whether there was a viable Brophy claim against the TPP representatives).

[67] *Id.* at B357.

[68] *Id.*

[69] *Id.* at B261-62.

[70] *Id.* at B359.

[71] *Id.*

[72] *Id.* at B369.

[73] *Id.* at B61 n.319.

[74] *Id.* at B391.

[75] *Id.* (quoting In re Oracle Corp. Derivative Litig., 824 A.2d 917, 928 (Del. Ch. 2003)).

[76] 2021 Del. Ch. LEXIS 166, [WL] at *15 (quoting Oracle, 824 A.2d at 938) (emphasis in original).

SLC] to consider factors other than the best interests of the corporation in making their decision to move for dismissal."[77]

Diep did not challenge Babb's independence. With respect to Floyd and Lynton, **[*147]** Diep claimed that "they prejudged Plaintiff's claims by filing a motion to dismiss this action in 2016, and [] that each lacked independence from Kehler."[78] The Court of Chancery disagreed. The only evidence that Floyd and Lynton had familiarity with the motion to dismiss was Floyd's testimony that "no one on the Board [had] objected to the filing." **[**25]** [79] The Court of Chancery viewed Diep's argument as essentially that being a board member when the motion was filed made the SLC directors conflicted, an argument with "no support in Delaware law."[80] The court also looked to the tone of the SLC Report, which it found was "even-keeled and unbiased, suggestive of a fair investigation[.]"[81]

The Court of Chancery then turned to Floyd and Lynton's relationships with Kehler. The court found that Floyd and Kehler primarily interacted through the Pennsylvania Nursing School's Board of Overseers, which only met occasionally and had many members. This, the court held, was "plainly not enough to impugn Floyd's independence."[82] The court also examined the statements Kehler made to Floyd while recruiting him to the EPL Board and held that, compared with Floyd's extensive testimony, there was "no basis to conclude that Kehler's conclusory statements to Floyd would have caused Floyd to prejudge the merits of the litigation."[83] The SLC, the court concluded, had shown Floyd's independence.

Although Lynton's independence presented a closer call, the court reviewed the personal ties described earlier and observed that "[t]o meet its burden, the SLC must **[**26]** establish that Lynton's relationship with the Kehlers would not have biased Lynton in her investigation of the claims against Pollo Partners."[84] The court observed that our courts have recognized that social ties are not as strong as familial ones, and Lynton's role in the industry gave her "a reputational incentive to act independently."[85] Moreover, the court found that because the social ties of the directors were centered around the directors' children, they did not create a "sense of obligation" and were "unlikely to result in the type of awkward post-investigation encounters that would weigh on a director's decision-making during the course of the SLC's investigation."[86] Finally, the charitable contributions, given their relatively small size, would not compromise Lynton's independence. The Court of Chancery concluded that the SLC had established Lynton's independence, and there was no genuine dispute of material fact as to the independence of any of the SLC directors.

The court looked next at whether the SLC had "conducted a reasonable investigation of the matters alleged in the complaint in good faith."[87] Diep had two primary grounds for objection: the SLC's failure to consider **[**27]** settlements and scienter on the part of TPP. The Court of **[*148]** Chancery first determined that the SLC had considered the Turocy Action and concluded that the SLC could have reasonably decided that non-legal business decisions led the parties to settle. The court also found that the SLC could not have considered the settlement in the instant case with the individual defendants because it took place over a year after the SLC finalized its report.

Regarding scienter, the court found that the SLC had conducted a full and comprehensive investigation of the materiality of the information, the scienter of the defendants, and the violation of the Trading Policy, all aspects Diep had alleged were insufficiently considered. The court also found that the SLC had reasonable bases for its conclusions. As the court held, the SLC considered Hawley's statements, including "statements

[77] *Id.* (quoting *London, 2010 Del. Ch. LEXIS 54, 2010 WL 877528, at *13*) (alteration in original).

[78] *Id.*

[79] *2021 Del. Ch. LEXIS 166, [WL] at *16* (citing Floyd Dep. Tr. at 66, App. to Answering Br. at B482).

[80] *Id.*

[81] *Id.*

[82] *2021 Del. Ch. LEXIS 166, [WL] at *17*.

[83] *Id.*

[84] *2021 Del. Ch. LEXIS 166, [WL] at *18*.

[85] *Id.*

[86] *Id.* (quoting *London, 2010 Del. Ch. LEXIS 54, 2010 WL 877528, at *15*).

[87] *2021 Del. Ch. LEXIS 166, [WL] at *19* (quoting *Kaplan v. Wyatt, 484 A.2d 501, 507 (Del. Ch. 1984)*, *aff'd*, *499 A.2d 1184 (Del. 1985)*).

discounting a correlation between value scores and pricing increases" and came to the conclusion that he "had been, in effect, providing his own point of view throughout his portion of the [Management Presentation]."[88] And the SLC noted that the recipients of Hawley's reports did not ascribe certainty to the reports as they **[**28]** did with his formal quarterly forecasts. Hawley himself had concluded the lower sale numbers were early data and might not be indicative of longer-term trends. While it was possible to view the evidence in a different light than the SLC had, the court held that this did not render the SLC Report devoid of reasonable bases.

As for consciously making material misstatements on the Earnings Call, Diep had alleged only misstatements against individuals, not TPP. The court found that "[n]o Pollo Partners representatives participated in the Earnings Call where information was purportedly 'affirmatively concealed'" and thus could not be liable for a breach of a fiduciary duty.[89] Nevertheless, the SLC concluded that, because Hawley's forecasts were only estimates, not disclosing a specific SSS range on the call was within the discretion of the EPL board and management team. The Court of Chancery also agreed with the SLC's determination that the sale in the trading window did not support scienter because of TPP's private equity investment goals and the fact that the trading window was the first selling opportunity.

Finally, the Court of Chancery reviewed the SLC Motion under the second step **[**29]** of *Zapata* to decide "whether the SLC's recommended result falls within a range of reasonable outcomes that a disinterested and independent decision maker for the corporation, not acting under any compulsion and with the benefit of the information then available, could reasonably accept."[90] According to the court, the extensive, well-reasoned SLC Report and the scope of the investigation led to the conclusion that the SLC's decision was reasonable. Specifically, the court concluded, "[o]nly the Brophy claim of Count I is asserted against [TPP]. That claim requires a showing of scienter. The SLC directly addressed the facts on which Plaintiff relies to support a finding of scienter and concluded that they offered **[*149]** little support."[91] The court found that the SLC's conclusion not to pursue a "weak *Brophy* claim" against TPP was reasonable because it was "not worth the expense of protracted and uncertain litigation."[92] It therefore granted the SLC Motion to Dismiss.

Diep has appealed the Court of Chancery's application of the *Zapata* analysis. On appeal, "*Zapata*'s first prong is subject to a summary judgment standard, our review of which is *de novo*. Because *Zapata*'s second prong implicates the Court of **[**30]** Chancery's business judgment, we review for an abuse of discretion."[93] We review the Court of Chancery's "legal conclusions *de novo*."[94]

II.

The "business and affairs" of a Delaware corporation are managed by or under the direction of its board of directors.[95] An important aspect of a board's managerial decisions is whether to initiate, or refrain from initiating, litigation on the corporation's behalf.[96] Like a fleet of trucks or a factory, a lawsuit is a corporate asset that must be managed by the board consistent with its fiduciary duties.[97]

While the board typically controls litigation on the corporation's behalf, "a stockholder is not powerless to challenge director action which results in harm to the

[88] 2021 Del. Ch. LEXIS 166, [WL] at *22 (quoting SLC Report at 154 (available at App. to Answering Br. at B168); and citing *id.* at 151 (available at App. to Answering Br. at B165)) (alteration in original).

[89] *Id.*

[90] 2021 Del. Ch. LEXIS 166, [WL] at *23 (quoting In re Primedia, Inc. S'holders Litig., 67 A.3d 455, 468 (Del. Ch. 2013); and citing Obeid v. Hogan, 2016 Del. Ch. LEXIS 86, 2016 WL 3356851, at *12 n.14 (Del. Ch. June 10, 2016)) (footnote omitted); Zapata, 430 A.2d 779.

[91] Diep, 2021 Del. Ch. LEXIS 166, 2021 WL 3236322, at *23.

[92] 2021 Del. Ch. LEXIS 166, [WL] at *24.

[93] Kahn, 23 A.3d at 840-41 (first citing Williams v. Geier, 671 A.2d 1368, 1375 (Del. 1996); then citing Neponsit Inv. Co. v. Abramson, 405 A.2d 97, 100 (Del. 1979)).

[94] Id. at 836 (citing Alaska Elec. Pension Fund v. Brown, 941 A.2d 1011, 1015 (Del. 2007)).

[95] 8 Del. C. § 141(a).

[96] Grimes v. Donald, 673 A.2d 1207, 1215 (Del. 1996).

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

corporation."[98] As this Court stated in Aronson v. Lewis:

> The machinery of corporate democracy and the derivative suit are potent tools to redress the conduct of a torpid or unfaithful management. The derivative action developed in equity to enable shareholders to sue in the corporation's name where those in control of the company refused to assert a claim belonging to it. The nature of the action is two-fold. First, it is the equivalent of a suit by the shareholders to compel the corporation **[**31]** to sue. Second, it is a suit by the corporation, asserted by the shareholders on its behalf, against those liable to it.[99]

To strike a balance between the "managerial freedom of directors" and a stockholder's desire to police the conduct of her fiduciaries, a stockholder must, before filing a derivative suit, "(1) make a demand on the company's board of directors or (2) show that demand would be futile."[100] A **[*150]** stockholder who makes a demand concedes that the board as a whole is capable of considering a demand.[101] After receiving a demand, the board can establish a demand review committee to conduct a review of the demand proportional to the nature and strength of the claims and decide whether it is in the best interests of the corporation to pursue the claims. If the demand review committee investigates and concludes that the demand should be refused, an independent and disinterested demand review committee decision is accorded a business judgment standard of review. A plaintiff claiming wrongful demand refusal must raise a reasonable doubt about "the good faith and reasonableness of [the board's] investigation."[102]

If the stockholder files a derivative action without first **[**32]** making a demand on the board, and the board contests whether demand is futile, the court must review on a director-by-director basis:

> (i) whether the director received a material personal benefit from the alleged misconduct that is the subject of the litigation demand;
> (ii) whether the director would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand; and
> (iii) whether the director lacks independence from someone who received a material personal benefit from the alleged misconduct that is the subject of the litigation demand or who would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand.[103]

Here we deal with the "demand excused" paradigm, where the Court of Chancery found at the motion to dismiss stage that it was reasonably conceivable that members of the board misled the public and traded on material nonpublic information. The court also decided that, as pled, a majority of the EPL board received a material benefit from the alleged misconduct and faced

---

[98] *Id.*

[99] *Id.*

[100] ***United Food and Commercial Workers Union and Participating Food Industry Employers Tri-State Pension Fund v. Zuckerberg, 262 A.3d 1034, 1047 (Del. 2021)*** (*Zuckerberg II*) (cleaned up). *See* Grimes v. Donald, 673 A.2d 1207, 1216 (Del. 1996) ("The demand requirement serves a salutary purpose. First, by requiring exhaustion of intracorporate remedies, the demand requirement invokes a species of alternative dispute resolution procedure which might avoid litigation altogether."); Aronson, 473 A.2d 805, 812 ("Thus, by promoting this form of alternate dispute resolution, rather than immediate recourse to litigation, the demand requirement is a recognition of the fundamental precept that directors manage the business and affairs of corporations."); Ct. Ch. R. 23.1.

[101] Scattered Corp. v. Chi. Stock Exch., Inc., 701 A.2d 70, 74 (Del. 1997) ("If the stockholders make a demand, as in this case, they are deemed to have waived any claim they might otherwise have had that the board cannot independently act on the demand."); Grimes, 673 A.2d at 1218-19 ("If a demand is made, the stockholder has spent one—but only one—'arrow' in the 'quiver.' The spent 'arrow' is the right to claim that demand is excused."). The concession is limited to the board's ability to consider the demand. The stockholder does not waive the right to challenge on independence and disinterestedness grounds the board's disposition of the demand. Grimes, 673 A.2d at 1219. The Scattered and Grimes decisions were overruled on grounds not pertinent here. *See* Brehm, 746 A.2d at 253-54 (overruling prior precedent that the Court of Chancery's decision under Rule 23.1 is reviewed by the Supreme Court under an abuse of discretion standard).

[102] Spiegel v. Buntrock, 571 A.2d 767, 777 (Del. 1990); *see also* Grimes, 673 A.2d at 1219 ("If a demand is made and rejected, the board rejecting the demand is entitled to the presumption of the business judgment rule unless the stockholder can allege facts with particularity creating a reasonable doubt that the board is entitled to the benefit of the presumption.").

[103] ***Zuckerberg II, 262 A.3d at 1058***.

a substantial likelihood of liability.[104]

[*151] Although the Court of Chancery gave the green light for the litigation to **[**33]** proceed at the stockholder's direction, the conflicted board had one final arrow in its quiver to gain control of the derivative litigation—the special litigation committee. Unlike a demand review committee formed in response to a stockholder demand, the special litigation committee typically comes into existence after demand is excused. The board can appoint independent and disinterested board members to the SLC to investigate and decide what action should be taken to address the litigation.

In *Zapata*, the Court recognized that a conflicted board appoints the SLC, and the SLC is charged with scrutinizing the conduct of the board members who have appointed them.[105] If the SLC then moves to dismiss the derivative litigation, it is not a typical motion to dismiss. The motion "is addressed necessarily to the reasonableness of dismissing the complaint prior to trial without any concession of liability on the part of the defendants and without adjudicating the merits of the cause of action itself."[106] In this atypical procedural posture, the SLC motion to dismiss is treated as a hybrid under *Court of Chancery Rules 41(a)(2)* and *56*. To terminate derivative litigation, the SLC must show, and the court must be satisfied, that no **[**34]** disputed issues of material fact exist about the independence, good faith, and reasonableness of the SLC's investigation and whether the SLC had reasonable bases for its conclusions. As a second discretionary step, the court can review, in its business judgment, whether litigation dismissal or some other course of action proposed by the SLC is in the corporation's best interests.[107]

A.

For the first prong of the *Zapata* two-step analysis:

> the Court should inquire into the independence and good faith of the committee and the bases supporting its conclusions. . . . The corporation should have the burden of proving independence, good faith and a reasonable investigation, rather than presuming independence, good faith and reasonableness. If the Court determines either that the committee is not independent or has not shown reasonable bases for its conclusions, or, if the Court is not satisfied for other reasons relating to the process, including but not limited to the good faith of the committee, the Court shall deny the corporation's motion.[108]

In most challenges to director independence, the court must confront the personal and professional relationships between those who judge and those being judged. **[**35]** Directors have relatives and friends. They have acquaintances who may be classmates, professional associates, or business contacts. They hold memberships in clubs and other organizations and have political affiliations. They own property, make financial investments, and have other business activities. It is a fact of life that "business dealings seldom take place between **[*152]** complete strangers" and "it would be a strained and artificial rule which required a director to be unacquainted or uninvolved with fellow directors in order to be regarded as independent."[109]

Given the common personal and professional relationships between board members, the independence question "is a fact-specific determination made in the context of a particular case."[110] Under

[104] *Diep*, C.A. No. 12760, at 89 (TRANSCRIPT) ("In my view . . . the plaintiffs have been able to plead that it is reasonably conceivable that the executives did give knowingly false and misleading answers about the cause for the slowdown and that they subsequently traded, along with the controlling stockholder, before the full information was known by the market."); *id.* at 109-10 (finding Sather, Ammerman, and Borgese "face[d] a substantial risk of liability for a breach of the duty of loyalty, again, under a pleading-stage analysis. Three other directors are affiliated with Trimaran Pollo Partners, which is the company's controlling stockholder and a major seller . . . [and that Maselli, Kehler, and Roth] are insiders of the controller when the controller unloaded shares. So that is five of nine. That means that demand is futile.").

[105] *Zapata, 430 A.2d at 786* (citing *8 Del. C. §§ 141(a)*, *(c)*).

[106] *Kaplan, 484 A.2d at 507*.

[107] *Zapata, 430 A.2d at 787-89* ("If, however, the Court is satisfied under *Rule 56* standards that the committee was independent and showed reasonable bases for good faith findings and recommendations, the Court may proceed, in its discretion, to the next step.").

[108] *Id. at 788-89*.

[109] *Sutherland v. Sutherland, 958 A.2d 235, 241 (Del. Ch. 2008)* (quoting *In re Oracle Sec. Litig., 852 F.Supp. 1437, 1442 (N.D. Cal. 1994)*).

[110] *Beam v. Stewart, 845 A.2d 1040, 1049 (Del. 2004)*.

Zapata, a director is independent "when he is in a position to base his decision on the merits of the issue rather than being governed by extraneous considerations or influences."[111] In other words, the court must ask whether the SLC member would be more willing to risk her reputation than the personal or professional relationship with the director subject to investigation.[112] Thus, "[t]he composition and conduct of a special litigation committee . . **[**36]** . must be such as to instill confidence in the judiciary and, as important, the stockholders of the company that the committee can act with integrity and objectivity."[113]

For the EPL SLC, it was undisputed that Babb was independent, and the Court of Chancery found that Floyd and Lynton had not prejudged the merits of the suit by serving on the board when EPL filed its motion to dismiss the derivative suit. The court also held that the SLC demonstrated that the business and personal connections between the two SLC members and Kehler did not impact their independence or the reasonableness of the SLC's conclusions. Finally, the court held that the SLC conducted a reasonable investigation and had reasonable bases for its conclusions. On appeal, Diep challenges each of the Court of Chancery's findings. We address his arguments in turn.

1. Independence

Diep argues that Floyd and Lynton, as EPL board members, prejudged the merits of the investigation when EPL moved to dismiss Diep's claims for failure to state a claim. In other words, as members of a board that controls EPL's litigation decisions, the two SLC directors authorized EPL to take the litigation position that the derivative claims **[**37]** were without merit before the SLC was formed.

As noted earlier, "[i]ndependence is a fact-specific determination made in the context of a particular case."[114] In the demand futility context, directors have been held to be independent despite being defendants in litigation and filing motions to dismiss the claims against them.[115] If that **[*153]** was not possible, a few stockholders could "incapacitate an entire board of directors merely by leveling charges against them[.]"[116] The qualifier is, of course, that the board member defendants must not face a substantial likelihood of personal liability for their conduct.[117]

While the procedural posture of the demand futility context is different than the SLC context, Diep has not raised a disputed issue of material fact showing the two

---

[111] *Kaplan, 499 A.2d at 1189*.

[112] *Beam, 845 A.2d at 1052*.

[113] *Oracle, 824 A.2d at 940*. In the dissent, our colleague states that the SLC members must be "above reproach." The "above reproach" and "Caesar's wife" descriptions come from a decision referring to a single member SLC. *See* *Lewis v. Fuqua, 502 A.2d 962, 967 (Del. Ch. 1985)* ("If a single member committee is to be used, the member should, like Caesar's wife, be above reproach."). Although the Court in *Beam v. Stewart* quoted from *Lewis*, the Court also made clear in *Beam* that "[w]e need not decide whether the substantive standard of independence in an SLC case differs from that in a presuit demand case." *Beam, 845 A.2d at 1055*.

[114] *Beam, 845 A.2d at 1049*.

[115] *E.g., Aronson, 473 A.2d at 810* (noting that because futility is judged at the time a derivative suit begins, a motion to dismiss by the board does not create a conflict); *Rales v. Blasband, 634 A.2d 927, 937 (Del. 1993)* ("the appropriate inquiry is whether Blasband's amended complaint raises a reasonable doubt regarding the ability of a majority of the Board to exercise properly its business judgment in a decision on a demand had one been made at the time this action was filed.").

[116] *Zapata, 430 A.2d at 785* (quoting *Lewis v. Anderson, 615 F.2d 778, 783 (9th Cir. 1979)*).

[117] *Rales, 634 A.2d at 936* (distinguishing between "mere threat" and "substantial likelihood" of liability in determining independence in ruling on a *Rule 23.1* motion (quoting *Aronson, 473 A.2d at 815*)); *Katell v. Morgan Stanley Grp., Inc., 1995 Del. Ch. LEXIS 76, 1995 WL 376952, at *7 (Del. Ch. June 15, 1995)* (holding a defendant in a lawsuit facing potential liability could determine whether to pursue the suit as an SLC member). While our colleague in dissent says that "the SLC process is not necessarily unavailable where an entire board is named in a lawsuit and moves to dismiss it," Dissent at 27, it is hard to square the words "above reproach" and "Caesar's wife" with anything other than a lack of independence in that situation. Our point is not to lessen the independence inquiry for SLC members. The point is to recognize that those words came from a case involving a single member SLC and these descriptions are not always helpful to decide the independence inquiry. The Court has never required that board members named as defendants appoint new board members to serve on an SLC to meet the independence requirement. As we stated in *Beam*, the independence inquiry should be treated as a "fact-specific determination made in the context of a particular case." *Beam, 845 A.2d at 1049*.

SLC directors prejudged the merits of the litigation when EPL as nominal defendant joined in the motion to dismiss. The record does not show that Floyd and Lynton approved or participated in a substantive way in the decision to file the motion on EPL's behalf. As explained next, at most, the record shows they attended a board meeting when the motion was discussed.

The board minutes of October 31 and November 1, 2016 show that **[**38]** the board granted signatory authority for various matters, scheduled upcoming meetings, and received an audit committee update.[118] Sather and Roberts presented on business and financial matters, Austin provided an update regarding "pending litigation," and the meeting adjourned.[119] The minutes do not mention the motion to dismiss. While our colleague in dissent argues as a "logical conclusion" that the board "at least tacitly approved and authorized filing the 2016 Motion after that discussion," the record does not support tacit approval or authorization of anything. Although Lynton attended the meeting, the record is devoid of evidence that Lynton was involved in any discussion about, or approved the filing of, the motion to dismiss. As to Floyd, he testified at his deposition that he was "sure" there "would have" been a "litigation update" and "discussion" on the subject, but "did not recall the details of it."[120] Although he did not recall anyone objecting to the motion, he did not say that he "approved" its filing. Instead, he testified that:

> As a member of the board, I don't recall whether it was put to a formal vote, how it was handled, but I don't -- I don't remember any details that **[**39]** -- of getting **[*154]** into depth about this at the board meeting.[121]

At best, what can be said about the pending litigation discussion and the motion to dismiss is that the motion was discussed as part of the litigation review, it was not discussed in depth, and Floyd does not remember anyone objecting to the motion. In our view, these facts do not raise a material question of fact about whether Floyd and Lynton prejudged the merits of the suit because they were exposed to a litigation review that included a less than in-depth discussion of the motion to dismiss.

Diep relies heavily on *London*, where the Court of Chancery found that directors had prejudged a lawsuit against the company. There, the court found the SLC directors had significant "prior exposure" and "familiarity" with the issues because they sat on an audit committee that reviewed valuations related to the alleged wrongdoing.[122] The directors also characterized their committee actions as an "attack" on those valuations—and therefore the merits of the underlying litigation.[123] The Court of Chancery concluded: "Given the SLC members' relationships to [the alleged wrongdoer], their exposure to the merits of plaintiffs' suit well before the **[**40]** SLC was formed, and the unsatisfactory scope of the investigation conducted, the court was not convinced that the SLC was independent."[124]

The facts here are starkly different. The directors did not express hostility towards Diep's claims, nor does Diep claim that they formed any opinion about the claims. Mere familiarity with an issue does not compromise independence.[125] Like the Court of Chancery, we are satisfied that the SLC demonstrated there are no issues of material fact about whether Floyd and Lynton had prejudged the merits of the derivative complaint when the board caused EPL to join the motion to dismiss.[126]

---

[118] Attach. to Diep's Letter, Apr. 4, 2022.

[119] *Id.* at 4-5.

[120] App. to Answering Br. at B481-82.

[121] *Id.* at B482-83.

[122] *London, 2010 Del. Ch. LEXIS 54, 2010 WL 877528, at *15*.

[123] *2010 Del. Ch. LEXIS 54, [WL] at *16*.

[124] *Id.*

[125] *See* *Katell, 1995 Del. Ch. LEXIS 76, 1995 WL 376952, at *10* (holding that prior knowledge of the deals at issue did not show a prejudgment of the issues).

[126] *See also* Stephen A. Radin, The Business Judgment Rule 4776 n.6704 (6th ed. 2009); *Strougo ex rel. The Brazil Fund, Inc. v. Padegs, 27 F. Supp. 2d 442 (S.D.N.Y. 1998)* (holding that SLC members who participated in a *Rule 12(b)(6)* motion while on the board were independent); *Mills v. Esmark, Inc., 544 F.Supp. 1275, 1283 n.5 (N.D. Ill. 1982)* ("The independence and good faith of [the SLC members] is also unimpaired by their earlier motions to dismiss plaintiffs' original complaint. Those motions, seeking dismissal on the ground that plaintiffs had failed to make adequate demand on the board under *Rule 23.1*, did not manifest any prejudgment of the merits of this case."); *Scalisi v. Grills, 501 F. Supp. 2d 356, 362 (E.D.N.Y. 2007)* (where the preliminary complaint was dismissed on the grounds that demand was not excused, the court held that "[s]imilarly unavailing in establishing lack of independence is plaintiffs' contention that the Committee members authorized or participated in efforts by defendants to

As to the professional and personal relationships of two of the SLC members with Kehler and his family, we agree with the Court of Chancery that the SLC carried its burden to show the absence of a material issue of fact as to their independence. As noted previously, Lynton had professional and social connections with the Kehler family over many years, with less frequent contact recently. Floyd had a professional relationship with Kehler through the Board of Overseers of the University of Pennsylvania Nursing **[*155]** School. While the personal and professional relationship **[**41]** between Lynton and Kehler and his family were closer than what one would ordinarily expect of SLC members, several factors showed that, overall, the SLC members were capable of acting independently:

- The SLC members were individuals with significant backgrounds in business with prominent company positions and industry experience;
- The SLC members disclosed fully and upfront in the SLC process their personal and professional connections with Kehler and his family;[127]
- Neither SLC member was a defendant in the derivative litigation, having been brought on the EPL board after the events in question;
- No SLC member had exposure to liability or participated in the conduct in question;
- All SLC members were outside, non-management directors;
- No SLC member had a business relationship with EPL;
- The SLC was represented by independent counsel with no prior EPL relationship; and
- The SLC had a member whose independence is uncontested, and who joined in the SLC's report and agreed with the decision to move to dismiss the complaint.

We agree with the Court of Chancery that, based on the facts before it, the two SLC members were unlikely to sacrifice their personal and professional reputations **[**42]** for their relationship with Kehler and his family.

2. Reasonableness of the SLC's Investigation and Conclusions

The Court of Chancery concluded that the SLC conducted a good faith investigation of reasonable scope that yielded reasonable bases supporting its conclusions.[128] On appeal, Diep claims that the court "improperly resolved disputed questions of material fact" about "the negative impact of higher prices," "defendants' scienter," and "deterioration in 2015 Q2 Company SSS."[129] Diep's arguments on appeal, however, misunderstand the nature of the court's review. When reviewing the good faith and reasonableness of the SLC's investigation:

> the granting of the SLC's motion using the *Rule 56* standard does not mean that the court has made a determination that the claims the SLC wants dismissed would be subject to termination on a summary judgment motion, only that the court is satisfied that there is no material factual dispute that the SLC had a reasonable basis for its decision to seek termination.[130]

In other words, the question is not whether there were disputed issues of material fact about the three merits-based issues raised by Diep. Instead, the question is whether disputed issues of material fact **[**43]** were raised about the scope of the investigation and the reasonableness of the SLC's conclusions. We agree with the Court of Chancery that the SLC had reasonable **[*156]** bases to conclude that the TPP directors did not have material nonpublic information when TPP authorized the Block Trade.

First, the SLC found that the TPP directors had a reasonable basis to question Hawley's view that EPL's pricing actions caused a sales slowdown in Q2 2015. Without a causal link between the two, the SLC concluded that the TPP directors could not have material, nonpublic information about the connection between the pricing actions and the sales slowdown. While Diep focuses his arguments on how Hawley expressed concerns about pricing decisions and its impact on sales, the quarters immediately following the pricing increases showed sales growth.[131] It was not

dismiss the earlier October 2002 action.").

[127] *See* *Oracle, 824 A.2d at 929* ("Noticeably absent from the SLC Report was any disclosure of several significant ties between Oracle or the Trading Defendants and Stanford University, the university that employs both members of the SLC.").

[128] *Diep, 2021 Del. Ch. LEXIS 166, 2021 WL 3236322, at *14* (quoting *London, 2010 Del. Ch. LEXIS 54, 2010 WL 877528, at *11*) (articulating the *Zapata* standard of a good faith reasonable investigation).

[129] Opening Br. at ii.

[130] *Oracle, 824 A.2d at 929 n.20*.

[131] App. to Answering Br. at B129, 136, 140-41.

until April and May 2015 that sales began to slump.[132] The record supports the SLC's view that it was not a situation where the board implemented a pricing change and saw an immediate impact. Rather, it was a long-term, larger-scale change that, in retrospect, influenced EPL's performance.[133]

To support its conclusion, the SLC relied on the board's contemporaneous **[**44]** reaction to Hawley's reports. The board members believed factors other than price increases better explained the price dip.[134] Hawley was just one point of view, and while he oversaw pricing reports, he was focused on short term results. Hawley also did not hold a consistent view and acknowledged to the SLC that the sales issues could be attributed to other factors, such as business trends.[135] EPL had variable sales patterns influenced by "the introduction of new products, refocusing of market emphasis, [and] operational issues[.]"[136] Roberts' presentation the day before Hawley's also supports the SLC's conclusion.[137] The SLC reviewed many documents and sources, and fully considered material unhelpful to EPL such as the draft Q&A answers. It determined that the board and the TPP directors could have reasonably believed that slowing sales were not attributable to the pricing actions. The SLC's conclusion was supported by the record and reasonable.

Second, the SLC had reasonable bases to support its conclusion that the financial information that formed the basis for Diep's insider trading claims was immaterial or made public. "For information to be material, there must be a 'substantial likelihood' **[**45]** that the nonpublic fact 'would have assumed actual significance in the deliberations' of a person deciding whether to buy, sell, vote, or tender stock."[138] When dealing with intra-quarter results and forecasts, the information is material "only when [it is] . . . likely that the company will either outperform or underperform its projections in some markedly unexpected manner[.]"[139]

Here, the SLC determined that the Q2 SSS sales information was not material **[*157]** because there was significant intra-quarter variability in EPL's results,[140] and it was public because EPL representatives disclosed the possibility of lower-than-expected results on the Earnings Call.[141] The SLC considered the information known to the EPL board and the TPP directors and found that "the internal performance data and dynamic forecasting of EPL's future performance, while indicating that EPL was performing below Plan for Company SSS, did not establish a likelihood that its sales performance would deviate in a markedly unexpected or extreme manner from the Company's prior projections . . . ."[142] And even if it was material, the SLC observed that the information was disclosed publicly, when the observation was **[**46]** made that it was likely the quarter results would be on the "low end of the range."[143]

Finally, as to whether TPP was motived to sell EPL stock by material nonpublic information, the SLC found that there was insufficient evidence to support the allegation. TPP's desire to sell EPL stock had been expressed prior to Hawley's presentation;[144] the sale took place on the first day of the first available sale window;[145] and TPP's actions were consistent with the behavior of private equity firms following an initial public offering.[146]

The SLC did consider facts pointing in the other direction. TPP failed to comply with EPL's Insider Trading Policy before conducting the Block Trade. While the failure was evidence of the need for more respect

---

[132] *Id.* at B141.

[133] *Id.* at B252-54 (discussing the Q2 2015 results and the influence of pricing in greater detail).

[134] *Id.* at B283-84.

[135] App. to Opening Br. at A1751.

[136] App. to Answering Br. at B294.

[137] *Id.* at B146-51.

[138] In re Oracle Corp., 867 A.2d 904, 934 (Del. Ch. 2004), *aff'd sub nom.* ***In re Oracle Corp. Derivative Litig., 872 A.2d 960 (Del. 2005)*** (quoting Rosenblatt v. Getty Oil Co., 493 A.2d 929, 944 (Del. 1985)).

[139] *Id. at 940*; *see also* App. to Answering Br. at B298 (citing same).

[140] App. to Answering Br. at B421-25, B428-29.

[141] *Id.* at B304-05, B309.

[142] *Id.* at B299.

[143] *Id.* at B305.

[144] *Id.* at B219-22.

[145] *Id.* at B347.

[146] *Id.* at B215-16 & n.1415.

for corporate formalities, the SLC concluded that this fact was mitigated by EPL's knowledge of the Block Trade.[147] The SLC also considered an email that Sather sent Maselli with the early results of the customer survey value scores. In the email, Sather asked that the results be kept "between us at this point as I don't want anyone to over react."[148] The SLC accepted Maselli's explanation that he understood Sather to be saying the report was an "early **[**47]** read" and more data was needed before circulating the report more broadly.[149] The email was also sent after Maselli first looked into a sale and did not mean that Maselli was motivated to trade on inside information.[150]

We agree with the Court of Chancery that no disputed issues of material fact existed about the reasonableness of the SLC's investigation and its conclusions.

B.

The Court of Chancery decided to apply *Zapata*'s second step and saw no reason to upset the SLC process or its comprehensive report. In a one paragraph argument on appeal, Diep claims that "the Court of Chancery abused its discretion by ruling, under the second step of *Zapata*, that the SLC's conclusions were 'reasonable.'"[151] According to Diep, the discretionary **[*158]** second step addresses "instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit."[152] He argues that, "[g]iven the extensive factual record supporting [insider trading claims] against a controlling stockholder," the Court of Chancery should have found that dismissal "violates the spirit of *Zapata*."[153]

The second step of the *Zapata* analysis is "wholly within the discretion of the court[.]"[154] If **[**48]** it chooses to do so, the court determines, in its own business judgment, whether the suit should be dismissed. The discretionary second step preserves the court's role as the ultimate decider of whether litigation should be dismissed.[155] It serves as "the essential key in striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation's best interests as expressed by an independent investigating committee."[156] The court should exercise its discretion under *Zapata*'s second step and refuse to dismiss a derivative suit when "corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation's interest."[157] As part of its review, the court should give "special consideration to matters of law and public policy in addition to the corporation's best interests."[158]

The Court of Chancery did not abuse its discretion when it applied *Zapata*'s second step. The record surrounding the SLC's report and its conclusions did not reveal any unusual concerns about the merits **[**49]** of the claims, the committee's process, or matters of law and public policy such that the court should have intervened and refused to dismiss the derivative suit as a matter of its own business judgment.

III.

We affirm the Court of Chancery's judgment.

Dissent by: VALIHURA

Dissent

VALIHURA, J., dissenting:

As this Court recognized in *Zapata Corp. v. Maldonado*,[1] the SLC process affords a Delaware

[147] *Id.* at B295.

[148] *Id.* at B143.

[149] *Id.*

[150] *Id.* at B219-20 (describing interest in a sale at least by May 1, 2015); *id.* at B347-48 (same).

[151] Opening Br. at 44.

[152] *Id.* (quoting *Zapata, 430 A.3d at 789*).

[153] *Id.*

[154] *Kaplan, 499 A.2d at 1192*.

[155] *Zapata, 430 A.3d at 789*; *see also id. at 789 n.18* ("This step shares some of the same spirit and philosophy of the statement by the Vice Chancellor: 'Under our system of law, courts and not litigants should decide the merits of litigation.'").

[156] *Id. at 789*.

[157] *Id.*

[158] *Id.*

[1] *430 A.2d 779 (Del. 1981)*.

corporation the unique opportunity to dismiss claims against directors and officers, even after those claims have survived a pleading stage dismissal motion, and even after "years of vigorous litigation."[2] One of the trade-offs is that the independence of the members of the SLC must be "above reproach."[3]

[*159] I respectfully dissent because I believe there is an issue of fact as to the SLC's independence. The problem with the SLC's independence concerns Floyd's and Lynton's authorization of a motion to dismiss which challenged the substance of the very claims they were later charged with investigating as members of the SLC. Although the mere filing of a motion to dismiss need not be an automatic disqualifying event, I do not believe that this SLC has met its burden of establishing its **[**50]** independence.[4]

The court applies a two-step test, articulated in *Zapata*, to determine whether the special litigation committee's motion to dismiss should be granted. The first step of *Zapata*'s two-step test emphasizes that a special litigation committee *must* be independent and above reproach.[5] The first step requires the court to "inquire into the independence and good faith of the committee and the bases supporting its conclusions."[6] "[T]he inquiry into the independence of SLC members is a narrow one[,]"[7] and the court conducts the inquiry without regard to whether the members acted in good faith, or conducted a reasonable investigation. Instead, the court investigates the members' personal interest in the disputed transactions, and "scrutinizes the members' relationship with the interested directors."[8] If the committee has ties to key officials suspected of malfeasance, is not fully empowered to act, or if the "committee behaves in a manner inconsistent with the duty to carefully and *open-mindedly* investigate the alleged wrongdoing, its ability to instill confidence is, at best, compromised and, at worst, inutile."[9] The burden is on the corporation to prove the **[*160]** special litigation committee's **[**51]** independence, and the special litigation committee is entitled to no presumption

---

[2] *Id. at 787*; *see also* *Lewis v. Fuqua, 502 A.2d 962, 967 (Del. Ch. 1985)* (observing that, "[t]he only instance in American Jurisprudence where a defendant can free itself from a suit by merely appointing a committee to review the allegations of the complaint is in the context of a stockholder derivative suit[,]" and that "[a] defendant who desires to avail itself of this unique power to self destruct a suit brought against it ought to make certain that the Special Litigation Committee is truly independent").

[3] The phrase, "like Caesar's wife--above reproach," is more than just a famous aphorism. "Above reproach" means avoiding actions that suggest an appearance of a lack of objectivity or of behaving in a manner inconsistent with the duty to open-mindedly investigate the claims. *See* Merriam-Webster defines "above/beyond reproach" as "not calling for any criticism." *Above Reproach*, Merriam-Webster, https://www.merriam-webster.com/dictionary/above%20reproach (last visited June 21, 2022). Similarly, American Heritage defines "above/beyond reproach" as "[s]o good as to preclude any possibility of criticism." *Above Reproach*, The American Heritage Dictionary, https://ahdictionary.com/word/search.html?q=above+reproach (last visited June 21, 2022).

[4] *See* *Zapata, 430 A.2d at 789* (stating that the corporation has the burden of proving independence to the court under *Court of Chancery Rule 56* standards).

[5] *See* *Lewis, 502 A.2d at 967* ("If a single member committee is to be used, the member should, like Caesar's wife, be above reproach."); *Gesoff v. IIC Indus., Inc., 902 A.2d 1130, 1146 (Del. Ch. 2006)* ("[I]n those rare circumstances when a special committee is comprised of only one director, Delaware courts have required the sole member, 'like Caesar's wife, to be above reproach.'" (quoting *Lewis, 502 A.2d at 967*)). The "above reproach" standard for a single member committee has since been used to describe the responsibilities of special litigation committee members generally. *See* *id. at 1146 n.101* ("[I]n the context of a special litigation committee, [above reproach] has been used repeatedly to describe the responsibilities of directors charged with managing committees[.]"); *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1055 (Del. 2004)* ("Unlike the demand-excusal context, where the board is presumed to be independent, the SLC has the burden of establishing its own independence by a yardstick that must be 'like Caesar's wife'—'above reproach.'" (quoting *Lewis, 502 A.2d at 967*)).

[6] *Zapata, 430 A.2d at 788*.

[7] *Sutherland v. Sutherland, 958 A.2d 235, 239 (Del. Ch. 2008)*.

[8] *Id.* (internal quotation marks omitted) (quoting *Katell v. Morgan Stanley Grp., Inc., 1995 Del. Ch. LEXIS 76, 1995 WL 376952, at *8 (Del. Ch. June 15, 1995)*).

[9] *Biondi v. Scrushy, 820 A.2d 1148, 1156 (Del. Ch. 2003)* (emphasis added), *aff'd sub nom.* ***In re HealthSouth Corp. S'holders Litig., 847 A.2d 1121 (Del. 2004)***.

of independence.[10]

Two of the three SLC members in this case, Floyd and Lynton, were elected to the Board of Directors on April 1, 2016. The Verified Stockholder Derivative Complaint was filed on September 20, 2016, against Stephen J. Sather, Laurance Roberts, Edward Valle, Kay Bogeajis, Douglas K. Ammerman, Samuel N. Borgese, and Trimaran Pollo Partners, L.L.C. ("TPP"). El Pollo Loco Holdings, Inc. (the "Company" or "EPL") was named as a nominal defendant. Floyd and Lynton were not named as defendants.[11] The two count Complaint alleged breaches of fiduciary duties for insider trading and misappropriation of information (the "*Brophy*" claim), and breaches of fiduciary duties for issuing materially misleading statements and omissions.[12] The Complaint's allegations centered on the May 19, 2015 stock sales, as well as the disclosures (or lack thereof) leading up to those sales.

According to the Complaint, the Defendants misled and misdirected investors on a conference call two business days prior to the stock sales by stating that the decline in same stores sales **[**52]** growth in 2015 1Q and 2Q was attributable to the timing of New Year's eve, poor marketing communication, higher priced offerings, and a tough comparison with a strong 2014 2Q forecast.[13] Diep alleged that the problem was "more straightforward" in that "customers had reacted negatively and immediately because of the increases in price on the Company's value menu."[14]

On May 19, 2015, two business days after the May 14th conference call, "CEO Sather, CMO Valle, COO Bogeajis, the Company's controlling stockholder, Trimaran Pollo Partners, and other Company insiders collectively sold approximately ***6 million shares*** of El Pollo Loco stock for **[*161]** gross proceeds of ***over $132 million***[.]"[15] The Complaint alleged that the stock sales were "suspicious in amount and timing, and were not made pursuant to any 10b5-1 trading plans."[16] It alleged that in making these trades, the defendants violated the Company's Insider Trading Policy -- a fact not disputed.[17] Further, the Complaint stated that "[a]t the time of the [] trades, the insiders were all aware of material, negative information that had not been fully disclosed to (indeed, deliberately withheld from) investors on the May 14, 2015 conference call."[18]

According **[**53]** to the Complaint, on August 10 and 11, 2015, EPL's Board held a two-day regular meeting. On the second day of the meeting, the Director of Marketing Planning and Analysis, Ryan Hawley, stated that "sales had fallen across *all* demographics, across

---

[10] *Zapata, 430 A.2d at 788*; *Kaplan v. Wyatt, 484 A.2d 501, 507 (Del. Ch. 1984)* ("For purposes of the motion the [c]ommittee is entitled to no presumption of independence, good faith and reasonableness."), *aff'd*, *499 A.2d 1184 (Del. 1985)*.

[11] Plaintiffs defined Sather, Valle, Boreajis, Ammerman, Borgese, and Trimaran Pollo Partners as the "Insider Trading Defendants." A107 (Compl. ¶ 120). The first count is asserted against them. As the Vice Chancellor observed in denying the defendants' motion to dismiss this claim, "[t]he core concept of *Brophy* is to obtain disgorgement of the proceeds generated when insiders sell by misusing confidential company information." *Diep v. Sather*, C.A. No. 12760, at 93 (Del. Ch. Mar. 17, 2017) (TRANSCRIPT) [hereinafter 2017 VC Oral Ruling Tr.].

[12] A107, A109 (Compl. ¶¶ 119-34). *See* *Brophy v. Cities Serv. Co., 31 Del. Ch. 241, 70 A.2d 5 (Del. Ch. 1949)*. The Complaint defines Sather, Roberts, and Valle as the "Disclosure Defendants." A109 (Compl. ¶ 129). The second count is asserted against them.

[13] A110 (Compl. ¶¶ 69, 73, 95, 133). "It was not so much the 'extended tests of alternative proteins'—a reference to the promotions of shrimp and carne asada (beef)—or a tougher comparison with 2014, that caused the declining trend in the 2015 2Q. Instead, as the presentation two days earlier by CMO Valle revealed, it was the effect of higher prices across the entire existing menu that had hit customer traffic, causing the Company to forecast a 1% fall in customer traffic at Company-operated restaurants in the 2015 2Q." A91-92 (Compl. ¶ 71).

[14] A99 (Compl. ¶ 91). Diep alleged that: "[a]lthough the information regarding the Company's declining sales performance and the reasons for this performance were highly material, Defendants omitted to disclose [sic] this material information, even when directly asked about the subject. Indeed, Defendants affirmatively misled stockholders." A90 (Compl. ¶ 67).

[15] A95-96 (Compl. ¶ 81) (emphasis in original). The Complaint further alleges that the prices of the stock ranged from "$2.62 to 5.84 per share, a fraction of the market price." A96 (Compl. ¶ 82).

[16] A96 (Compl. ¶ 83).

[17] *See* A1636 (Special Litigation Committee's Opening Br. in Supp. of Mot. to Dismiss Count I Against TPP at 32) (acknowledging that "TPP did not comply with the [Insider Trading] Policy's written pre-clearance procedures").

[18] A97 (Compl. ¶ 86).

all modes of orders (dine in/take-out/drive-through), and *all* parts of the day (lunch, snack and dinner)."[19] The Complaint alleged that "Hawley pointed to price increases in February 2015, the 'steady increase in LTO [limited time offering] prices through Q2,' and 'significant price increases on all of our top sell[ing products]' for a drop in the Company's value scores and the decline in transaction (traffic) growth in the 2015 1Q and 2Q."[20]

The Complaint further alleged that on August 13, 2015, nearly three months after the alleged insider sales, "El Pollo Loco was forced to reveal the truth when announcing its 2015 2Q results."[21] Specifically,

> After the close of trading on August 13, 2015, the Company issued a press release announcing its results for the 2015 2Q (the three-month period ended July 1, 2015). Contrary to the Company's prior claims of being on track to achieve 3%-5% comparable store sales increases, the Company reported that the 2015 **[**54]** 2Q '[s]ystem-wide comparable restaurant sales [had only grown] ***1.3% including a 0.5% decrease for company-operated restaurants***, and a 2.6% increase for franchised restaurants.' The 0.5% decrease at Company-operated restaurants was driven by a ***3.9% decrease in traffic***, much worse than the internal forecast of a 1% decrease.[22]

The Company announced that "it was cutting its fiscal year 2015 guidance for comparable store sales growth from a range of 3% to 5% to just 3% because of the Company's significant miss in the 2015 2Q."[23] According to the Complaint, "[a]nalysts reacted with surprise to all of El Pollo Loco's revelations, reflecting the extent to which they had been misled by senior management[,]"[24] and ultimately, "El Pollo Loco's stock price fell by 20%, from its closing price of $18.36 per share on August 13, 2015 to $14.56 per share on **[*162]** August 14, 2015 - ***33% below the price at which Company insiders had sold $132 million of their own stock***, and erasing more than ***$410 million*** in market capitalization."[25]

All defendants, including nominal defendant EPL, responded with a motion to dismiss (the "2016 Motion"),[26] and they filed a brief captioned, "Defendants' Brief in Support of Their Motion to **[**55]** (A) Stay This Action in Deference to the Prior Pending Federal Securities Action or (B) in the Alternative, Dismiss Pursuant to *Rules 23.1* and *12(b)(6)*" on December 17, 2016. The 2016 Motion sought dismissal of the Complaint on two grounds: (i) failure to plead demand futility under *Court of Chancery Rule 23.1*; and (ii) failure to state a claim under *Court of Chancery Rule 12(b)(6)*.[27] Nominal defendant EPL joined the motion to dismiss on demand futility grounds under *Rule 23.1* only, and expressly stated that it was not joining in the *Rule 12(b)(6)* ground.[28] Counsel from Skadden, Arps, Slate, Meagher & Flom LLP signed the 2016 Motion on behalf of nominal defendant EPL and on behalf of defendants Chief Operating Officer Kay Bogeajis, Chief Marketing Officer Edward J. Valle, Chief Financial Officer Laurance Roberts, and Chief Executive Officer Stephen J. Sather. Of these defendants, Bogeajis, Sather, and Valle were Insider Trading Defendants.[29]

Counsel from Richards, Layton & Finger, P.A. and Sullivan & Cromwell LLP signed the 2016 Motion on behalf of outside director defendants Douglas K. Ammerman and Samuel N. Borgese (both of whom were Insider Trading Defendants),[30] and Counsel from Ballard Spahr LLP signed on behalf of EPL's controlling stockholder defendant, TPP (an Insider Trading Defendant). **[**56]** [31] Floyd and Lynton were on the Board when the 2016 Motion was filed but, as noted,

[19] A98 (Compl. ¶ 88) (emphasis in original).

[20] A98 (Compl. ¶ 89) (alterations in original).

[21] A99 (Compl. ¶ 91).

[22] A99-100 (Compl. ¶ 93) (alterations and emphasis in original).

[23] A100 (Compl. ¶ 94).

[24] A102 (Compl. ¶ 99).

[25] A103 (Compl. ¶ 101) (emphasis in original).

[26] At the time of the 2016 Motion, the EPL Board consisted of nine members: Michael Maselli, Stephen Sather, Dean Kehler, John Roth, Douglas Ammerman, Samuel Borgese, Mark Buller, Bill Floyd, and Carol "Lili" Lynton. A131 (Defs.' Br. Supp. Mot. to Stay or Dismiss at 11).

[27] A113-75 (Defs.' Br. Supp. Mot. to Stay or Dismiss).

[28] A173 (Defs.' Br. Supp. Mot. to Stay or Dismiss at 53) ("Nominal Defendant El Pollo Loco does not join in the motion to dismiss pursuant to *Rule 12(b)(6)*.").

[29] A107 (Compl. ¶ 120).

[30] *Id.*

[31] *Id.*

were not named as defendants in the action.[32]

[*163] Defendants collectively argued that the Complaint failed to plead particularized facts demonstrating that a majority of the board faced a substantial likelihood of liability. Defendants also argued that the "alleged non-public information was disclosed," the "undisclosed intra-quarter results were immaterial," and that there were "no particularized facts demonstrating scienter."[33]

The 2016 Motion did not merely raise technical or procedural arguments as to why the derivative claims should be dismissed. Instead, the 2016 Motion affirmatively argued the very substantive issues that the SLC would later be tasked with independently investigating. For example, the 2016 Motion asserted the following:

- "[N]either the timing nor the amounts of stock sold were suspicious. Three directors and a large stockholder sold only a fraction of their El Pollo Loco holdings. They did so at their first opportunity to sell after the expiration of lockup agreements and other trading restrictions."[34]
- "[N]one of **[**57]** Plaintiffs insider trading allegations are sufficient as to any of the directors."[35]
- "The undisclosed intra-quarter results were immaterial."[36]
- "[T]he first time a permitted selling window opened for corporate insiders was on May 19, 2015, the day the Sellers made their disputed sales." "It is hardly suspicious that corporate insiders would take advantage of the first liquidity opportunity after an IPO. Indeed, courts uniformly find that such timing ***negates*** an inference of scienter."[37]
- "[T]he Sellers sold at a time that did not maximize their potential return, further negating an inference that they calculated the sales to reap the benefits of insider information."[38]
- "[T]he fact that the Sellers retained a significant percentage of their holdings also negates scienter. Insiders' sales fail to create an inference of scienter when the sales constitute a portion of their total holdings in the company."[39]
- "[T]he lapse in time between the May 19 sales and the alleged bad news disclosed months later on August 13 further underscores the lack of scienter."[40]
- "The alleged non-public information was disclosed."[41]

[*164] • "The market's awareness of El Pollo Loco's menu changes and the impact on same store traffic **[**58]** is confirmed by contemporaneous analyst reports."[42]

The Company, as nominal defendant, joined in each of

[32] Although separate representation is not mandated in all situations, and although courts have divided on the issue, "there is substantial support for the idea that the corporation and the shareholders should retain separate counsel in [a] derivative lawsuit where the underlying claim sounds in fraud (as opposed to negligence) and where the corporation takes '*an active role*' in the litigation." [*Scott v. New Drug Servs., Inc., 1990 Del. Ch. LEXIS 146, 1990 WL 135932, at *4 (Del. Ch. Sept. 6, 1990)*](#) (emphasis added), *reprinted in* [16 Del. J. Corp. L. 1561, 1567 (1991)](#). *See* 3 Robert S. Saunders, Jennifer C. Voss & Cliff C. Gardner, *Folk on the Delaware General Corporation Law* §327.07 (7th ed. 2021-3 Supp.) ("Whether circumstances require separate representation of corporate and individual defendants in a derivative action is a 'highly fact specific' question. The Court of Chancery has [also] noted that [although], in theory, separate representation may be the better practice, it may be 'unreasonable and wastefully expensive to require separate counsel to represent the corporate and individual defendants [when] the corporation will remain a neutral party whose counsel is generally unable to alter the outcome of the litigation' and, therefore, separate representation is not mandated in all situations." (third alteration in original) (footnotes omitted)). The bottom line is that although representation decisions require careful attention to a myriad of facts and circumstances that make setting bright-line rules difficult, courts have recognized the difficulties that are created by dual representation in a shareholder derivative suit alleging fraud, intentional misconduct, or self-dealing on the part of the directors and officers.

[33] A161, A165, A168 (Defs.' Br. Supp. Mot. to Stay or Dismiss at 41, 45, 48).

[34] A127 (Defs.' Br. Supp. Mot. to Stay or Dismiss at 7).

[35] A159 (Defs.' Br. Supp. Mot. to Stay or Dismiss at 39).

[36] A165 (Defs.' Br. Supp. Mot. to Stay or Dismiss at 45).

[37] A168-69 (Defs.' Br. Supp. Mot. to Stay or Dismiss at 48-49) (emphasis in original).

[38] A170 (Defs.' Br. Supp. Mot. to Stay or Dismiss at 50).

[39] A171 (Defs.' Br. Supp. Mot. to Stay or Dismiss at 51).

[40] *Id.*

[41] A161 (Defs.' Br. Supp. Mot. to Stay or Dismiss at 41).

[42] A163 (Defs.' Br. Supp. Mot. to Stay or Dismiss at 43).

these arguments,[43] which were directed to the very heart of the *merits* of the derivative suit. Counsel for EPL presented oral argument on behalf of all Defendants on March 17, 2017.[44] Thus, the Company did not take a neutral position.[45] Although a company is not required to take a neutral position, taking an active, or as here, a leading role challenging the substance of the claims, may come with some risks as the litigation develops.[46] One **[*165]** such risk is that a court may not be convinced that the SLC members' independence is "above reproach" when the company has argued previously in court that the claims were meritless.

In the 2016 Reply Brief, the Company doubled down arguing:

- "Plaintiff failed to allege that any of the nine directors faces a substantial likelihood of liability on the *Brophy* claim."[47]
- "Plaintiff has failed to plead that any member of the Board possessed material, non-public information, or acted with scienter."[48]
- "[T]he supposed **[**59]** non-public information was, in fact, disclosed."[49]
- "[T]he information about second quarter 2015 sales projections was not material because it was provided only three weeks into the second quarter, the Board was informed that various initiatives were being taken to boost sales, and the projected sales were consistent with what was disclosed to stockholders."[50]

---

[43] The *12(b)(6)* portion of the 2016 Motion consisted of one full paragraph discussing the *Rule 12(b)(6)* standard, and the sentence: "Here, for the same reasons discussed above, Plaintiff has failed to plead sufficient facts to state an insider trading claim under *Brophy*." A173 (Defs.' Br. Supp. Mot. to Stay or Dismiss at 53). During the argument on the 2016 Motion, Counsel for EPL, who also represented certain of the Insider Trading Defendants, commented that the directors had also moved to dismiss under *Rule 12(b)(6)* but "the interaction of the arguments under *12(b)(6)* and *23.1* is -- or the overlap of the arguments is virtually complete because of the standard that applies here." 2017 VC Oral Ruling Tr., C.A. No. 12760, at 24. Counsel's argument centered on the "heart of the case" which was whether plaintiffs had alleged a *Brophy* claim with respect to the members of the board who were alleged to have sold directly or indirectly on May 19. *Id.* at 25-26.

[44] 2017 VC Oral Ruling Tr., C.A. No. 12760, at 4.

[45] *See* *Scott, 1990 Del. Ch. LEXIS 146, 1990 WL 135932, at *4* ("While, in theory, separate representation may be the better practice (and might be expected to enhance the credibility of any position taken by the corporation), I am mindful that it may be 'unreasonable and wastefully expensive to require separate counsel to represent the corporate and individual defendants . . . [when] the corporation will remain a neutral party whose counsel is generally unable to alter the outcome of the litigation.'" (alteration in original) (quoting *Independent Representation for Corporate Defendants in Derivative Suits*, 74 Yale L.J. 524, 530 (1965))). Chancellor Allen commented further in *Scott* that, "[w]hat circumstances will require separate representation is obviously a question that is highly fact-specific[,]" and that "[c]ounsel (and a court required to pass upon a disqualification motion) must attempt to assess the likelihood that the corporation will be required, or it will be in its interest, to take an active part in the litigation." *Id.*

[46] Retaining the same counsel for the corporation and the defendant directors comes with potential risks, especially if the complaint survives a motion to dismiss. *See* 1 R. Franklin Balotti, Jesse A. Finkelstein, John Mark Zeberkiewicz & Blake Rohrbacher *Delaware Law of Corporations and Business Organizations* § 13.10 (4th ed. 2022-1 Supp.), Westlaw (database updated 2022) ("[I]t is the customary practice for the corporation and the defendant directors to have separate counsel in a derivative action, especially if the complaint has survived a motion to dismiss."). *See, e.g.,* *Essential Enters. Corp. v. Dorsey Corp., 40 Del. Ch. 343, 182 A.2d 647, 654 (Del. Ch. 1962)* ("[T]he same attorneys represented both the corporation and the individual defendants. I need not pass upon the desirability or propriety of this practice. The present practice in this court is for the corporation to have a different attorney. This might seem artifical [sic], but, in theory, the 'interests' involved may be quite different and the corporate attorney should so understand his obligation."). *See also* Robert L. Haug, Ed., Business and Commercial Litigation in Federal Courts, § 26.18 (Responding to a Derivative Claim) (Dec. 2021 Update) ("While courts have allowed all defendants to be represented by the same counsel, courts generally have 'no hesitation in holding that—except for potentially frivolous cases—allegations of directors' fraud, intentional misconduct, or self-dealing requires separate counsel.'" (citing *Bell Atl. Corp. v. Bolger, 2 F.3d 1304, 1317 (3d Cir. 1993)*)). In *Bell*, joint representation was permitted as there were allegations of breaches of the duty of care with little support and a special litigation committee had decided that the "corporation's interests were more in line with those of the defendants than plaintiffs." *Bell, 2 F.3d at 1316*.

[47] Defs.' Reply Br. in Further Supp. of Mot. to Stay or Dismiss, C.A. No. 12760-VCL, Dkt. No. 18, at 19 (Del. Ch. Feb. 6, 2017).

[48] *Id.* at 20.

[49] *Id.*

[50] *Id.* at 26.

• "Plaintiff has not pleaded particularized facts demonstrating scienter because the challenged stock sales were the first time that insiders were permitted to sell shares as a result of IPO lockups and trading windows, the sellers sold only a portion of their holdings, and they sold after El Pollo Loco's stock price dropped almost 20%."[51]

On March 17, 2017, the Court of Chancery issued an oral ruling denying the 2016 Motion on both *Rule 23.1* and *12(b)(6)* grounds.[52] The court found that Diep had successfully pleaded a *Brophy* claim sufficient to withstand dismissal because the Complaint "specifically highlight[ed] what [wa]s in the board book and why it support[ed] an inference that the statements made at the conference call were incorrect and that the defendants had material information to the contrary."[53]

Regarding the argument that there was no **[**60]** inference of scienter, the court stated that "knowledge can be alleged generally under *Rule 8*[,]" and that "[t]here is plenty of circumstantial evidence to support this."[54] The court then highlighted some of the factual allegations pled in the Complaint. For example, the court noted that the fact that the directors "might have sold more doesn't negate an inference of scienter."[55] The court also found that the fact **[*166]** that the directors sold in a declining market did not negate scienter. Further, the court noted that "CEOs usually don't sell because it sends a negative signal to the market when they abandon the company."[56] The court emphasized that "[t]he fact that a defendant could have used insider information more effectively does not defeat an otherwise valid inference of insider trading."[57] Therefore, the court found that "at this stage of the case there's a reasonable inference of scienter[,]"[58] and denied the motion to dismiss on both *12(b)(6)* and *23.1* grounds.

Having denied the *Rule 12(b)(6)* motion, the court stated that the "*Rule 23.1* motion becomes easy."[59] To exercise disinterested and independent judgment, "there needs to be a board majority that is disinterested and independent."[60] It found that at least five of **[**61]** the nine directors who were on the board when the Complaint was filed were not. Sather, Ammerman, and Borgese were sellers and faced a substantial risk of liability for breach of the duty of loyalty, and the three other directors affiliated with TPP were "insiders of the controller when the controller unloaded shares."[61] Thus, demand was found to be futile.

Following the court's oral ruling on March 17, 2017, the parties began to engage in discovery. Thereafter, on October 6, 2017, EPL's board of directors appointed Floyd and Lynton to the SLC to investigate and evaluate the allegations and issues raised in the Complaint. In January of 2018, the Board added a third member.[62] Also in January of 2018, the parties stipulated and agreed to stay all proceedings in the action, including all discovery, until the SLC concluded its investigation.[63]

---

51 *Id.* at 29.

52 2017 VC Oral Ruling Tr., C.A. No. 12760, at 88. The court also stayed Count II in favor of the California federal securities actions, and denied the stay as to Count I, which asserted a *Brophy* claim under Delaware law.

53 *Id.* at 103 (citing Compl. ¶¶ 53-66). The Court of Chancery rejected some of the defendants' other arguments, such as the results were just preliminary, or that this was a "pure projections case." *Id.* at 105-07. The court also provided its explanation for the different outcome in this case compared to the federal action, noting that the federal case "was evaluated under a higher standard under the Private Securities Litigation Reform Act, which require[d] that the allegations support a strong inference of scienter," and also that it was "evaluated in a context where the plaintiffs in that case, having not used *Section 220*, could only cite to the public transcript . . . ." *Id.* at 90.

54 *Id.* at 107.

55 *Id.* at 108.

56 *Id.*

57 *Id.*

58 *Id.* at 109.

59 *Id.*

60 *Id.*

61 *Id.* at 110.

62 Diep does not challenge the independence of Babb, the third member of the SLC, who was appointed four months after the SLC was created. One could infer that adding a third member to the SLC four months after creating the SLC suggests that the Board perceived an issue with the SLC's independence.

63 Stipulation and Proposed Order Staying Proceedings Pending Special Litigation Committee Investigation, C.A. No. 12760-VCL, Dkt. No. 56 (Del. Ch. Jan. 16, 2018).

On February 13, 2019, the SLC filed its initial Motion to Dismiss based on the Report of the SLC (the "Report").[64] The parties then engaged in further discovery based on the Report.

Diep's counsel, Hung G. Ta, took Floyd's deposition on January 17, 2020.[65] During his deposition, Floyd testified that he discussed the litigation with Kehler "briefly" before **[**62]** joining the Board.[66] He recalled that Kehler said that "we did nothing illegal, we did nothing unethical, but he said the optics did not look good with the, you know, with the trading of the stock."[67] Floyd was also asked whether he recalled the board discussing the 2016 Motion. The following exchange took place:

> **[*167]** Q. But is your understanding that back in 2016, as one of the steps to stop this litigation from proceeding, that El Pollo Loco Holdings applied to the Delaware Chancery Court to have this case dismissed? Do you recall - -
> A. Yes.
> Q. Do you understand that?
> A. Yes.
> Q. Okay. And do you recall the process by which the board -- well, first of all, did the board discuss this step of getting the Delaware Chancery Court to dismiss this litigation back in 2016?
> A. Yes, they did, but I don't recall any of the details of it.
> Q. Do you recall if there were discussions on the board about the subject?
> A. At that period of time, as part of the board agenda, we would have a litigation update of which I'm sure this was part and — I'm sure there is -- there was discussion about it, but I don't recall the details.
>
> Q. And when you were on the board at that time -- withdraw that. Do you recall any one on **[**63]** the board objecting to applying to the Delaware Chancery Court to have the case dismissed back in 2016?
> A. I don't recall anybody objecting.
> Q. Did you object to applying to the Delaware Chancery Court back in 2016 to have this case dismissed?
> A. I did not.[68]
> . . . .
> Q. You approved the filing of this application to the Delaware Chancery Court?
> A. As a member of the board, I don't recall whether it was put to a formal vote, how it was handled, but I don't -- I don't remember any details that -- of getting into depth about this at the board meeting.[69]

Based upon the limited excerpts of Lynton's deposition provided to this Court, it appears that Lynton was not questioned about her recollection of the board meetings, whether the litigation was discussed, or whether she objected to the filing of the motion to dismiss.[70]

The SLC filed its Opening Brief in Support of its Motion to Dismiss Count I against TPP on September 25, 2020.[71] After briefing concluded, the Court of Chancery scheduled oral argument on the SLC's motion to dismiss on April 23, 2021.[72] The day before oral argument, on April 22, 2021, Diep and defendants Bogeajis, Roberts, Sather, Valle, Ammerman, and Borgese (the "Settling **[**64]** Defendants") filed their Stipulation and Agreement of Compromise and Settlement.[73] The Settling Defendants agreed to collectively pay $625,000 in exchange for Diep's agreement to release them from the claims asserted in this action.[74] At that point, TPP

---

[64] Stipulation and Proposed Order Staying Proceedings Pending Special Litigation Committee Investigation, C.A. No. 12760-VCM, Dkt. No. 161 (Del. Ch. Mar. 30, 2020).

[65] *See* B488 (Excerpts of Floyd's Dep. at 238). This Court was provided extremely limited excerpts of Floyd's deposition.

[66] B469 (Excerpts of Floyd's Dep. at 10).

[67] B469-70 (Excerpts of Floyd's Dep. at 10-11).

[68] B481-82 (Excerpts of Floyd's Dep. at 65-66).

[69] B482-83 (Excerpts of Floyd's Dep. at 66-67).

[70] *See generally* B444-66 (Excerpts of Lynton's Dep.).

[71] Special Litigation Committee's Opening Br. in Supp. of Mot. to Dismiss Count I Against TPP, C.A. No. 12760-KSJM, Dkt. No. 163 (Del. Ch. Sept. 25, 2020).

[72] Letter to Counsel Confirming Oral Argument Date and Time, C.A. No. 12760-KSJM, Dkt. No. 173 (Del. Ch. Jan. 25, 2021).

[73] Stipulation and Agreement of Compromise and Settlement, C.A. No. 12760-KSJM, Dkt. No. 176 (Del. Ch. Apr. 22, 2021).

[74] *Id.* The settlement figures associated with this suit ($625,000) and the federal "*Turocy* Class Action" and settlement ($20 million), taken together, suggest that the allegations were not merely conclusory. *See* A1696-97 (Pl.'s Br. in Opp. to Special Litigation Committee's Mot. to Dismiss at 18-19) ("In January 2019, the parties to the *Turocy* Class Action reached an agreement to settle the action in principle for a cash payment of $20 million.").

was the only remaining defendant.

[*168] Diep relies upon this limited record to argue that there is a material issue of fact about whether Floyd and Lynton prejudged the merits of the suit. He centers his argument on their participation in the 2016 Motion. The record reflects that Floyd and Lynton were on the Board at the time the 2016 Motion was filed. It also suggests, through Floyd's testimony, that the Board discussed the 2016 Motion as part of a ligation update,[75] and that no director objected to the filing.

The Court of Chancery viewed Diep's contentions as essentially challenging whether merely being a board member when the motion was filed resulted in the SLC members being conflicted. But the record shows more than just their mere presence on the Board when the 2016 Motion was filed. It shows that the 2016 Motion was discussed with the Board and that no director objected to its filing. Floyd specifically stated that he **[**65]** did not object to the filing. The logical conclusion is that the Board, at least tacitly, approved and authorized filing the 2016 Motion after that discussion. An important aspect of a board's managerial decision-making is whether to initiate, or refrain from initiating, litigation on the corporation's behalf.[76] When faced with serious insider trading claims against certain directors and officers of the company, and with the decision of whether or not to initiate suit against them, or move to dismiss the suit, it follows that the Board would consider this an important decision. The 2016 Motion was obviously authorized by someone. Given that a corporation acts through its board of directors,[77] and given that the motion was the subject of a Board discussion, the record suggests that the Board authorized it.

Appellees have pointed us to the minutes from the October 21, November 1, 2016 Board meeting -- minutes which the **[*169]** SLC chose not to produce in discovery. Rather, the SLC apparently submitted the minutes with their reply brief to the 2016 Motion. Nor did the SLC include the minutes in our record -- Diep submitted them after oral argument before **[**66]** our Court.[78] These belated productions suggest to me that neither side thought they added much to the mix of information. To be clear, the relevant portion of those minutes states:

<u>IV. BOARD DISCUSIONS</u>

The Board received the following updates:

> **. . . .**
>
> **(c) Edith R. Austin, Vice President, Legal concerning pending litigation**.
>
> **The meeting was adjourned at 5:45 p.m. Pacific Daylight Time on October 31, 2016**.

Appellees have argued that "[t]he minutes contain no indication that any member of the Board was asked to approve the filing of the 2016 [Motion.]"[79] But if any

[75] The parties sent letters to our Court after oral argument before this Court regarding an alleged misstatement by Diep's counsel. Specifically, Diep's counsel's letter stated that during oral argument, Mr. Ta stated "We [Appellants] don't have anything more than that Your Honor because as we said, this discovery was one-sided. We weren't given the Board minutes for the meetings in 2016 when this litigation update was provided." Diep's Letter, Apr. 4 (alteration in original) (citing Oral Argument video at 19, https://livestream.com/accounts/5969852/events/10198585/videos/230258828/player). The letter clarified that "although not included in the limited discovery of the SLC, the minutes for the two-day Board meeting that occurred on October 31 and November 1, 2016 were subsequently appended as Exhibit D to the Reply Brief in Further Support of its Motion to Dismiss, that the SLC filed in the Court of Chancery on January 21, 2021[.]" *Id.*

[76] *See* *Grimes v. Donald, 673 A.2d 1207, 1215 (Del. 1996)*, *overruled on other grounds by* *Brehm v. Eisner, 746 A.2d 244 (Del. 2000)*.

[77] *See, e.g.,* *In re Aerojet Rocketdyne Holdings, Inc., 2022 Del. Ch. LEXIS 140, 2022 WL 2180240, at *10 (Del. Ch. June 16, 2022)* ("'A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law.' 'Because it lacks a body and mind, a corporation only can act through human agents.' Under Delaware law, a company's directors are the corporate agents charged with managing the business and affairs of the corporation." (quoting *Trs. of Dartmouth Coll. v. Woodward, 17 U.S. 518, 636, 4 L. Ed. 629 (1819)*; *Prairie Cap. III, L.P. v. Double E Holding Corp., 132 A.3d 35, 60 (Del. Ch. 2015)*) (citing *8 Del. C. § 141(a)*)); *Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281, 1291 (Del. 1998)* ("One of the most basic tenets of Delaware corporate law is that the board of directors has the ultimate responsibility for managing the business and affairs of a corporation." (citing *8 Del. C. § 141(a)*)).

[78] In contrast to the weight given to these minutes by the Majority, Diep's counsel's transmittal letter to this Court states that "neither party included these minutes in the Record for this appeal." Diep's Letter, Apr. 4.

[79] SLC Letter in Resp. to Diep's Letter, Apr. 5, 2022.

conclusion from these minutes is to be drawn, it should be that these minutes, along with Floyd's testimony, suggest that the Board discussed the 2016 Motion and approved of its filing.

Moreover, it does not matter whether Floyd or Lynton read the 2016 Motion.[80] Given that it is completely reasonable to conclude that they authorized the filing, they should have known what they were authorizing. The SLC bears the burden of establishing its independence which, in this case, includes establishing that they did not prejudge the merits of serious insider trading claims they previously challenged in a direct and substantive way when the Company **[**67]** battled with Diep for six months over the dismissal motion. The SLC cannot satisfy that burden simply by claiming ignorance about the Company's and the Board's prior involvement in litigating those claims. Giving the SLC a pass on what I believe is a credible factual challenge to their independence because they claim ignorance of the arguments made on the Company's behalf would not create the right incentives.

Determining whether an SLC is independent is a fact-intensive inquiry. In *London v. Tyrrell*,[81] **[*170]** the Court of Chancery stated that "[w]hen SLC members are simply exposed to or become familiar with a derivative suit before the SLC is formed this may not be enough to create a material question of fact as to the SLC's independence."[82] But a question of fact as to the SLC's independence may be raised "if evidence suggests that the SLC members *prejudged the merits* of the suit based on that prior exposure or familiarity, and then conducted the investigation with the object of putting together a report that demonstrates the suit has no merit."[83] Similarly, if the potential conflicts of interest or divided loyalties, when considered as a whole, raise a question of fact as to an SLC member's **[**69]** independence, then the moving party has not borne its burden of showing the absence of *any* possible issue of fact material to the independence of the SLC.[84]

Here, Floyd's testimony confirms that the directors discussed the 2016 Motion, that he did not recall anyone objecting, and that he did not object to the filing. Further, the 2016 Motion challenged the core arguments set forth in the complaint. EPL, as a nominal defendant, affirmatively joined the 2016 Motion pursuant to *Rule 23.1* and, in fact, took the lead in challenging the "heart" of Diep's core allegations. EPL was hardly acting in a neutral capacity. In my view, the SLC failed to show there was an absence of a material issue of fact as to the independence of Floyd and Lynton.

Furthermore, a side-by-side comparison of the assertions in the 2016 Motion and the SLC's motion to

---

[80] The SLC's counsel was asked during oral argument before this Court whether determining if Floyd or Lynton read the briefs was even relevant.

> The Court: Is this even the question that's relevant, I would ask, and that is, a lawyer has taken a position on behalf of a client that may be seen as having prejudged claims that the client has had to review later on? I'm not sure whether she read the brief is even relevant.
>
> Mr. Offenhartz: Well, Your Honor, I think it is because, well, I think the issue we're grappling with is, did the brief, and we respectfully think that if they didn't read it, it would not cause them to prejudge anything, but what we're really looking at is, were Ms. Lynton or Mr. Floyd prejudging their investigation before they started? Did the existence of the motion to dismiss cause them to prejudge anything? I mean, I think that's ultimately the test. I don't think, and in fact the Delaware cases are **[**68]** clear, they don't want a box, if you do "X" you're out, it's got to look at the totality of circumstances.
>
> The Court: Doesn't a motion have to be authorized by a client?
>
> Mr. Offenhartz: Well, Your Honor, yes, but a motion to dismiss, even if authorized by the client, it doesn't mean that these two individuals reviewed it, absorbed it, necessarily got into the minutia of it, and adopted it and made it their own. . . .

Oral Argument video at 35:17, https://livestream.com/delawaresupremecourt/events/10198585/videos/230258828.

[81] *London v. Tyrrell, 2010 Del. Ch. LEXIS 54, 2010 WL 877528 (Del. Ch. Mar. 11, 2010)*.

[82] *2010 Del. Ch. LEXIS 54, [WL] at *15*.

[83] *Id.* (emphasis added).

[84] *Lewis, 502 A.2d at 967* (After listing the circumstances which lead the Court of Chancery to question a committee member's independence, the court stated that "[t]hese potential conflicts of interest or divided loyalties, when considered as a whole, raise a question of fact as to whether Terry Sanford could act independently. This is not to say that he actually acted improperly, but [the court] find[s] that the moving party has not borne its burden of showing the absence of any possible issue of fact material to the issue of the independence of Mr. Sanford." (citing *Warshaw v. Calhoun, 42 Del. Ch. 437, 213 A.2d 539, 541-42 (Del. Ch. 1965)*, *aff'd*, *43 Del. Ch. 148, 221 A.2d 487 (Del. 1966)*)).

dismiss illustrates the similarities between the 2016 Motion and the SLC Motion:

Go to table2

The SLC cites four cases,[94] namely, Kaplan v. Wyatt,[95] Katell v. Morgan Stanley ***[**71]*** Group, Inc.,[96] and *Kindt v. Lund*,[97] as well as the United States District Court for the Southern District of New York case, *Strougo ex rel. The Brazil Fund, Inc. v. Padegs*.[98] Only three address the independence of the committee members and only one does so in the context of the members' participation in a prior motion to dismiss.[99]

The SLC in Kaplan consisted of two members, Marshall and Holliday. Neither Marshall nor Holliday were named as defendants in the lawsuit. The plaintiff did not challenge the independence of Holliday, who died after filing the SLC's report. Instead, plaintiff focused primarily on the claimed independence of Marshall, who was a director at the time of the events complained of, and the SLC's legal counsel. The plaintiff articulated seventeen different reasons as to why the motion to dismiss brought by the SLC should be denied.[100] The main thrust of plaintiff's issue with the independence of Marshall was that he was a director who approved of the transaction complained of (even though he was not a named defendant in the action), and that Marshall, along with members of his family, owned stock in companies that had done business with Coastal over the years.[101] Without **[**72]** addressing each reason identified by plaintiff, the Court of Chancery stated that it was "convinced" there were no material facts in dispute, and found that the SLC operated independently.

In Katell, the SLC was comprised of one member, a partnership, CIGNA LCF, which was also a defendant in the lawsuit. CIGNA LCF was the only general partner that purportedly did not stand to benefit from the transaction, and therefore, it was authorized by the general partners, and a vote of a majority of the limited partners, to review the merits of the derivative lawsuit. As the only special committee member, CIGNA LCF appointed three employees of its parent corporation, CIGNA, to conduct the business of the SLC. All three employees were part of CIGNA's investment division, and none had been directly involved in CIGNA LCF prior to serving on the SLC. Although the three employees of CIGNA acted as the SLC, the court determined that it was CIGNA LCF's independence, not the three employees' independence, that should be the focus of the analysis.[102] Plaintiffs argued that CIGNA LCF was

---

[94] The Majority cites two other cases, namely, Scalisi v. Grills, 501 F. Supp. 2d 356 (E.D.N.Y. 2007) and Mills v. Esmark, Inc., 544 F. Supp. 1275 (N.D. Ill. 1982). These decisions do not analyze the prior motion to dismiss in any substantive way. In addition, Scalisi applies Maryland law, and appears to apply a different standard. In Scalisi, the parties disagreed as to what the appropriate standard was under Maryland law. Without making a determination as to which standard was correct, it appears that the court applied a combination of the two suggestions. First, the court applied a standard set forth by the New York Court of Appeals that limited the courts review to "an analysis of the adequacy or appropriateness of the investigation and to an inquiry into the independence of the committee members." Scalisi, 501 F. Supp. 2d at 361. Second, the court took an "additional step set forth in *Zapata*" and also considered whether the court was satisfied with the SLC's conclusions. Id. at 362. The Scalisi court did not expressly apply *Zapata*'s first prong, which includes the heightened independence standard discussed herein. Thus, the limited inquiry into the independence of the SLC in Scalisi is unavailing. The relevant discussion in Mills is contained in a footnote that merely mentions that the two SLC members earlier moved to dismiss plaintiffs' original complaint and that the motion, made on Rule 23.1 grounds, "did not manifest any prejudgment of the merits of this case." Mills, 544 F. Supp. at 1283 n.5.

[95] Kaplan, 484 A.2d 501.

[96] Katell, 1995 Del. Ch. LEXIS 76, 1995 WL 376952.

[97] 2003 Del. Ch. LEXIS 62, 2003 WL 21453879 (Del. Ch. May 30, 2003).

[98] 27 F. Supp. 2d 442 (S.D.N.Y. 1998).

[99] The plaintiff in *Kindt* did not challenge the independences of the SLC.

[100] The Court of Chancery counted "seventeen in number." Kaplan, 484 A.2d at 517.

[101] Id. at 512-13. The specifics of plaintiff's argument against Marshall regarding his stock ownership are as follows: Marshall, along with members of his family, owned a 9% shareholder interest in a company that had done business with Coastal over the years. Marshall was also a 50% owner of a company (Petco) which acted or had acted as a general partner of limited partnerships in oil and gas exploration programs, of which Coastal had participated in. Finally, Petco owned 38% of a company (IRC), in which plaintiff argued made Marshall, as 50% owner of Petco, a 19% owner of IRC. Coastal and IRC "engaged in past transactions." *Id.* at 513.

[102] The court stated that the three CIGNA employees "cannot

not only a defendant, but it had, as general partner, approved the challenged transactions. However, the Court of Chancery **[**73]** held that "the undisputed facts put forth by [d]efendants conclusively support CIGNA LCF's independence." Specifically, the court noted that an overwhelming majority of the limited partners approved of CIGNA LCF's appointment as the special committee. Further, CIGNA LCF was in the same economic position as the limited partners during both transactions, and CIGNA LCF did not stand to benefit from the transactions at the expense of the partnership.

Finally, the SLC cites *Strougo ex rel. The Brazil Fund, Inc.* Procedurally, this case is arguably the most analogous to the situation presented here. Without making a prior demand on the board, Strougo filed his complaint, and the directors moved for dismissal, arguing, among other things, that Strougo failed to state a claim and failed to make a pre-suit demand on the board. The court denied the motion against the directors (except for one outside director), and pre-suit demand was held to be excused. The nominal defendant's motion to stay all proceedings for three months to permit the SLC to investigate allegations of the lawsuit was granted.[103] The SLC was comprised of two members—one original defendant who was dismissed (DaCosta), and a new **[**74]** director who was added over a year after the complaint was filed.[104] After the SLC investigation, the defendants moved to terminate and dismiss the action based upon the report of the SLC.

The court considered plaintiffs argument that DaCosta was not independent because he had been named as a defendant and had moved to dismiss the complaint. The plaintiffs cited a portion of the defendants' brief in support of that motion to dismiss in an attempt to demonstrate DaCosta's prejudgment. The court rejected that argument by simply stating that a motion to dismiss is designed to test the legal sufficiency of the complaint.[105] There was no discussion or analysis of the substance of the prior motion beyond that.

A motion to dismiss, in and of itself, is not necessarily disqualifying. Rather, the court should examine the substance of the motion, including the nature of the allegations against the directors and whether the corporation has elected to take an active role in the litigation. If the motion to dismiss was authorized by the SLC member or members and challenges the very core issues that the SLC is subsequently charged with investigating, that may be enough to create an issue of fact as **[**75]** to their independence. This requires a case-by-case determination, and the SLC bears the burden on this issue.[106] I do not think the SLC has met its burden.

Finally, I mention two other points. First, I do not think that *London* changed the standard for determining the independence of an SLC member. I note that the Court of Chancery stated that the SLC Report was "not a 'combative attack' on Plaintiff's claims[,]"[107] and, therefore, did not create a material fact as to Floyd or Lynton's independence. That should not be a new standard in evaluating the independence of SLC members who have previously participated in moving to dismiss claims they are charged with investigating. The standard, rather, is still that they must be "above reproach."

Second, the SLC process is not necessarily unavailable where an entire Board is named in a lawsuit, and then moves to dismiss it. But that is not this case. Here, Lynton and Floyd had a role in authorizing a motion to dismiss claims involving loyalty issues.[108] Not only that,

make CIGNA LCF independent if it would not otherwise meet the test for independence." *Katell, 1995 Del. Ch. LEXIS 76, 1995 WL 376952, at *6*.

[103] *Strougo ex rel. The Brazil Fund, Inc., 27 F. Supp. 2d at 444*.

[104] *See* *Strougo ex rel. Brazil Fund, Inc. v. Padegs, 1 F. Supp. 2d 276, 278 (S.D.N.Y. 1998)*.

[105] *Strougo ex rel. The Brazil Fund, Inc., 27 F. Supp. 2d at 449*.

[106] In *Beam*, our Court observed that this procedural fact could be outcome determinative. *See* *Beam, 845 A.2d at 1055* ("We need not decide whether the substantive standard of independence in an SLC case differs from that in a presuit demand case. As a practical matter, the procedural distinction relating to the diametrically-opposed burdens and the availability of discovery into independence may be outcome-determinative on the issue of independence.").

[107] *Diep v. Sather, 2021 Del. Ch. LEXIS 166, 2021 WL 3236322, at 16 (Del. Ch. July 30, 2021)*.

[108] The Majority acknowledges that an important aspect of a board's managerial decision-making role is whether to initiate, or refrain from initiating, litigation on the corporation's behalf. Maj. Op. at 30. Yet the Majority contends that this Board merely attended a board meeting when that motion was discussed. Maj. Op. at 38. In fact, its decision is premised on that tenuous conclusion. That conclusion is inconsistent with the record, with the role of the board, and with the fact that the SLC bears the burden on the independence issue. After all, this was not a decision about where to hold the next board

the Company under their managerial direction, took an active role and even the lead role, in challenging the merits of the claims. The thorny issues regarding Floyd's and Lynton's independence **[**76]** could have been avoided. As pointed out by Diep, EPL could have formed an SLC as soon as Diep filed the Complaint in 2016. EPL, as nominal defendant, could have avoided taking a position on the merits of the substantive issues. EPL also could have selected or added different directors who were not on the Board when the 2016 Motion was filed, as it did with Babb.

In sum, Diep raised serious loyalty challenges including directors and officers of the Company—challenges centered on insider trading and disclosure claims that survived an initial motion to dismiss. If the SLC process is to have any sanctity and credibility in dismissing claims simply by having a committee investigate them, the SLC's independence must be above reproach.[109] Because there is a legitimate factual issue as to Floyd's and Lynton's independence, I respectfully DISSENT.

---

meeting. It was a decision about what position the Company should be asserting in court regarding serious loyalty claims asserted against other directors and officers.

[109] *See* Balotti, *supra* note 46, § 13.17 ("One of the obvious purposes for forming a special litigation committee is to promote confidence in the integrity of corporate decision making by vesting the company's power to respond to accusations of serious misconduct by high officials in an impartial group of independent directors. By forming a committee whose **[**77]** fairness and objectivity cannot be reasonably questioned, giving them the resources to retain advisors, and granting them the freedom to do a thorough investigation and to pursue claims against wrongdoers, the company can assuage concern among its stockholders and retain, through the SLC, control over any claims belonging to the Company itself." (citing *Biondi, 820 A.2d at 1156*)). The Majority's questioning of the "above reproach" standard is unfortunate in that, at best, it avoids an opportunity to provide more clear guidance for those involved in the SLC process, and at worst, lowers the "independence" bar as it applies to an already anomalous and unusual procedure whereby defendants can free themselves of serious claims merely by appointing a committee.

Table1 (*Return to related document text*)

Seller	Number of Shares	Proceeds
TPP	5,402,500	$118,044,625
Sather	360,000	$7,866,000
Valle	175,000	$3,823,750
Bogeajis	25,000	$546,250

Table1 (*Return to related document text*)

Table2 (*Return to related document text*)

2016 Motion to Dismiss	SLC Motion to Dismiss
"Neither the timing nor amounts of stock sold were suspicious. Three directors and a large stockholder sold only a fraction of **[**70]** their [EPL] holdings. They did so *at their first opportunity to sell after the expiration of lockup agreements* and other trading restrictions."[85]	"[T]he timing of the Block Trade . . . does not suggest an ulterior motive, but instead supports the notion that TPP was liquidating a long-standing investment *at each available opportunity*."[86]
"It is hardly suspicious that corporate insiders would take advantage of the first liquidity opportunity after an IPO."[87]	"[T]he timing of the Block Trade—during the first open trading window following the November 19, 2014 secondary offering . . . supports the notion that TPP was liquidating a long-standing investment at each available opportunity."[88]
	"[I]n advance of the Block Trade, the Company accurately disclosed that Q2 2015 [same-store sales] would likely be below market expectations."[90]

[86] A1663 (SLC's Opening Br. Supp. Mot. to Dismiss at 59) (emphasis added).

[85] A127 (Defs.' Br. Supp. Mot. to Stay or Dismiss at 7) (emphasis added).

[87] A169 (Defs.' Br. Supp. Mot. to Stay or Dismiss at 49).

[88] A1663 (SLC's Opening Br. Supp. Mot. to Dismiss at 59). The "secondary offering" refers to the second opportunity that TPP had to sell its shares.

2016 Motion to Dismiss	SLC Motion to Dismiss
"The alleged non-public information was disclosed."[89]	"The SLC determined that (i) TPP did not possess material, nonpublic information, and (ii) TPP was not motivated, in whole or in part, to sell EPL shares by the allegedly material, nonpublic information at issue."[91]
"The undisclosed intra-quarter results were immaterial."[92]	"The intra-quarter performance and forecasting data available to the TPP Directors at the time of the Block Trade was not material under Delaware law."[93]

Table2 (*Return to related document text*)

[90] A1664 (Defs.' Br. Supp. Mot. to Stay or Dismiss at 60). Stated another way, "in recognition of the Company's early Q2 2015 performance in comparison to market expectations, the TPP Directors supported the decision to disclose the softness in sales despite the Company's prior practice of only providing full-year guidance, which likewise cuts against a claim that TPP was seeking to trade on undisclosed information." *Id.*

[89] A161 (Defs.' Br. Supp. Mot. to Stay or Dismiss at 41).

[91] A1637 (Defs.' Br. Supp. Mot. to Stay or Dismiss at 33).

[92] A165 (Defs.' Br. Supp. Mot. to Stay or Dismiss at 45).

[93] A1657 (Defs.' Br. Supp. Mot. to Stay or Dismiss at 53).

Firemen's Ret. Sys. v. Sorenson

Court of Chancery of Delaware

July 7, 2021, Submitted; October 5, 2021, Decided

C.A. No. 2019-0965-LWW

Reporter

2021 Del. Ch. LEXIS 234 *; 2021 WL 4593777

FIREMEN'S RETIREMENT SYSTEM OF ST. LOUIS, derivatively on behalf of Marriott International, Inc., Plaintiff, v. ARNE M. SORENSON, J.W. MARRIOTT, JR., KATHLEEN K. OBERG, DEBORAH MARRIOTT HARRISON, BAO GIANG VAL BAUDUIN, BRUCE HOFFMEISTER, STEPHANIE C. LINNARTZ, ERIC HIPPEAU, LAWRENCE W. KELLNER, GEORGE MUÑOZ, MARY K. BUSH, DEBRA L. LEE, FREDERICK A. HENDERSON, AYLWIN B. LEWIS, BRUCE W. DUNCAN, W. MITT ROMNEY, STEVEN S. REINEMUND, and SUSAN C. SCHWAB, Defendants, and MARRIOTT INTERNATIONAL, INC., a Delaware Corporation, Nominal Defendant.

Notice: THIS OPINION HAS NOT BEEN RELEASED FOR PUBLICATION. UNTIL RELEASED, IT IS SUBJECT TO REVISION OR WITHDRAWAL.

Prior History: *In re Marriott Int'l, Inc., 363 F. Supp. 3d 1372, 2019 U.S. Dist. LEXIS 24046 (J.P.M.L., Feb. 6, 2019)*

Counsel: **[*1]** Samuel L. Closic and Eric Juray, PRICKETT, JONES & ELLIOTT, P.A., Wilmington, Delaware; Brian J. Robbins, Craig W. Smith, Gregory E. Del Gaizo, and Emily R. Bishop, ROBBINS LLP, San Diego, California; Counsel for Plaintiff Firemen's Retirement System of St. Louis.

Raymond J. DiCamillo and John M. O'Toole, RICHARDS, LAYTON & FINGER, P.A., Wilmington, Delaware; Jason J. Mendro and Jeffrey S. Rosenberg, GIBSON, DUNN & CRUTCHER LLP, Washington, D.C.; Adam H. Offenhartz and Laura Kathryn O'Boyle, GIBSON, DUNN & CRUTCHER LLP, New York, New York; Counsel for Defendants Arne M. Sorenson, J.W. Marriott, Jr., Kathleen K. Oberg, Deborah Marriott Harrison, Bao Giang Val Bauduin, Bruce Hoffmeister, Stephanie C. Linnartz, Eric Hippeau, Lawrence W. Kellner, George Muñoz, Mary K. Bush, Debra L. Lee, Frederick A. Henderson, Aylwin B. Lewis, Bruce W. Duncan, W. Mitt Romney, Steven S. Reinemund, and Susan C. Schwab, and Nominal Defendant Marriott International, Inc.

Judges: WILL, Vice Chancellor.

Opinion by: WILL

Opinion

MEMORANDUM OPINION

WILL, Vice Chancellor

In the fall of 2018, Marriott International, Inc. discovered a data security breach that had exposed the personal information of up to 500 million guests. An investigation revealed **[*2]** that the cyberattack was perpetrated through the reservation database of Starwood Hotels and Resorts—which Marriott had acquired two years prior—and had begun in 2014. Marriott publicly announced the incident on November 30, 2018. A series of stockholder and consumer actions followed.

The stockholder plaintiff in this action brought a derivative lawsuit against several key executives and Marriott's directors for breaches of fiduciary duty. The plaintiff's claims are based on the defendants' conduct both before and after the acquisition of Starwood. Regarding the pre-acquisition time period, the plaintiff alleges that the defendants breached their fiduciary duties by failing to conduct adequate due diligence of Starwood's cybersecurity technology. Regarding the post-acquisition period, the plaintiff alleges that the defendants continued to operate Starwood's deficient systems, failed to timely disclose the data breach, and that the directors breached their duty of loyalty under *Caremark*. The defendants have moved to dismiss the complaint for failure to plead demand futility.

In this decision, I conclude that demand was not excused because none of the director defendants faces a substantial **[*3]** likelihood of liability on a non-exculpated claim. First, the plaintiff's claims regarding pre-acquisition due diligence are time barred. They arose more than three years before the plaintiff's complaint was filed and no basis for tolling applies. Second, none of the directors face a substantial likelihood of liability under *Caremark*. Cybersecurity has increasingly become a central compliance risk deserving of board level monitoring at companies across sectors. But the allegations in the complaint do not meet the high bar required to state a *Caremark* claim. The plaintiff has not shown that the directors completely failed to undertake their oversight responsibilities, turned a blind eye to known compliance violations, or consciously failed to remediate cybersecurity failures. Finally, the plaintiff's claim based on unmet notification requirements is also unsupported by allegations of bad faith.

The Marriott board therefore retained its ability to assess whether to pursue litigation on behalf of the company. Demand is not excused. The motion to dismiss is granted pursuant to Court of Chancery Rule 23.1.

I. BACKGROUND

Unless otherwise noted, the following facts are drawn from the Amended Verified Stockholder Derivative **[*4]** Complaint and the documents it incorporates by reference.[1] Any additional facts are either not subject to reasonable dispute or are subject to judicial notice.[2]

A. The Starwood Acquisition

Nominal defendant Marriott International, Inc. (the "Company") is a Delaware corporation headquartered in Bethesda, Maryland.[3] Founded in 1927, Marriott is one of the largest hospitality companies in the world.[4] Marriott operates, manages, and franchises a broad portfolio of over 6,900 hotels and lodging facilities.[5]

On November 16, 2015, Marriott announced its intent to acquire Starwood Hotels and Resorts Worldwide, Inc. (the "Acquisition"), a hotel and leisure company whose brands included W Hotels, St. Regis, and Le Meridien.[6] At that time, Starwood had more than 1,270 properties providing approximately 360,000 rooms in 100 countries.[7] Marriott and Starwood would together create a more globally diversified company operating or franchising more than 5,500 hotels and 1.1 million rooms worldwide.[8]

In discussing the Acquisition, Marriott's then-President and Chief Executive Officer, Arne M. Sorenson,[9]

---

[1] Verified Am. Deriv. Compl. ("Am. Compl.") (Dkt. 33). *See* Winshall v. Viacom Int'l, Inc., 76 A.3d 808, 818 (Del. 2013) ("[A] plaintiff may not reference certain documents outside the complaint and at the same time prevent the court from considering those documents' actual terms." (quoting Fletcher Int'l, Ltd. v. ION Geophysical Corp., 2011 Del. Ch. LEXIS 53, 2011 WL 1167088, at *3 n.17 (Del. Ch. Mar. 29, 2011))); Freedman v. Adams, 2012 Del. Ch. LEXIS 74, 2012 WL 1345638, at *5 (Del. Ch. Mar. 30, 2012) ("When a plaintiff expressly refers to and heavily relies upon documents in her complaint, these documents are considered to be incorporated by reference into the complaint . . . ."). The parties agreed that documents produced by Marriott pursuant to 8 Del. C. § 220 would be deemed incorporated into any complaint the plaintiff filed. *See* Defs.' Opening Br. 8 n.2 (Dkt. 40); Amalgamated Bank v. Yahoo! Inc., 132 A.3d 752, 797 (Del. Ch. 2016). Citations in the form "Defs.' Ex. _" refer to exhibits to the Transmittal Declaration of John M. O'Toole, Esq. in Support of Defendants' Opening Brief in Support of their Motion to Dismiss the Verified Amended Stockholder Derivative Complaint (Dkt. 41, 66). Page numbers to these exhibits are designated by the last four digits of a Bates number, where appropriate.

[2] *See, e.g.*, In re Books-A-Million, Inc. Stockholders Litig., 2016 Del. Ch. LEXIS 154, 2016 WL 5874974, at *1 (Del. Ch. Oct. 10, 2016) ("This court may consider the Proxy Statement to establish what was disclosed to stockholders and other facts that are not subject to reasonable dispute." (citing In re Gen. Motors (Hughes) S'holder Litig., 897 A.2d 162, 170 (Del. 2006)); Lima Delta Co. v. Glob. Aerospace, Inc., 2017 Del. Super. LEXIS 495, 2017 WL 4461423, at *4 (Del. Super. Oct. 5, 2017) (explaining that dockets, pleadings, and transcripts from a foreign action are subject to judicial notice).

[3] Am. Compl. ¶ 19.

[4] *Id.* ¶ 49.

[5] *Id.* ¶¶ 19, 69.

[6] *Id.* ¶¶ 1, 104.

[7] Defs.' Ex. 29 at 8.

[8] *Id.* at 97.

[9] On February 16, 2021, Marriott announced that Sorenson passed away on February 15, 2021. Marriott International, Inc.

described Starwood's guest loyalty program, Starwood Preferred Guest, as the **[*5]** "central, strategic rationale for the transaction" and the "most important piece of the [A]cquisition."[10] Starwood Preferred Guest had a devoted following of business travelers. Acquiring the program would expand Marriott's client base, increase its brand loyalty, and enhance the Company's ability to compete in an evolving global marketplace.[11]

B. Marriott's Due Diligence and Starwood's Data Security

Eleven months of due diligence commenced in late 2015, with ten months passing between the signing of the Agreement and Plan of Acquisition on November 15, 2015 and closing on September 23, 2016.[12] During that time, the Company, and Sorenson in particular, publicly touted Marriott's "extensive" diligence into Starwood and "joint integration planning" efforts.[13]

In the midst of the Company's diligence of Starwood, Marriott's Board of Directors ranked cybersecurity as the number one risk facing Marriott in 2016.[14] The Board at that time consisted of 11 members: defendants Sorenson, J.W. Marriott, Jr. (the Company's Executive Chairman and Chairman of the Board), Deborah Marriott Harrison (the Company's Global Cultural Ambassador Emeritus), Lawrence W. Kellner, George Muñoz, Mary K. Bush, Debra **[*6]** L. Lee, Frederick A. Henderson, Steven S. Reinemund, Susan C. Schwab, and W. Mitt Romney (together, the "Pre-Acquisition Board").[15] Despite knowing that cybersecurity was a pervasive risk in the hospitality industry that could affect Marriott's ability to achieve its goals,[16] the Pre-Acquisition Board did not order any specific due diligence into cybersecurity in connection with the planned Acquisition.[17]

On November 20, 2015—five days after Marriott and Starwood signed the merger agreement—Starwood disclosed that the point-of-sale systems at 54 of its hotels in North America had been infected by malware.[18] Several months later, an internal Marriott report summarizing the costs of integrating the Marriott Guest Loyalty and Starwood Preferred Guest databases noted that Starwood's systems lacked certain protections such as tokenization—the process of replacing sensitive data with unique identification symbols—and point-to-point encryption across its point-of-sale systems.[19] None of this information reached the Board before the Acquisition closed.

C. Starwood's Information Security Systems Post-Closing

Cybersecurity remained a **[*7]** "top level risk[]" for Marriott after the $13 billion Acquisition of Starwood closed on September 23, 2016.[20] Cybersecurity was viewed by the Board as the second biggest risk facing Marriott for fiscal year 2017.[21] By then, Marriott's data systems included Starwood's legacy systems, some of which remained in use post-Acquisition.[22]

The Board and Audit Committee were routinely apprised of cybersecurity issues after the Acquisition.[23] On February 8, 2017, for example, the Audit Committee—comprised of director defendants Henderson, Bush, Aylwin B. Lewis, and Muñoz—was told by Marriott's independent auditor Ernst & Young that audit committees were "expected to have an understanding of the business implications of cyber risks."[24] Internal Audit and Chief Audit Executive Keri Day also told the Audit Committee that Marriott had "established a Security

(Form 8-K) (Feb. 16, 2021). Sorenson had served as Marriott's President from May 2009 and Chief Executive Officer from May 2012 until his passing. Am. Compl. ¶ 20.

[10] *Id.* ¶ 78.

[11] *Id.* ¶¶ 75, 81; Defs.' Ex. 29 at 97.

[12] Am. Compl. ¶¶ 87, 109.

[13] *Id.* ¶¶ 179-81.

[14] *Id.* ¶ 100.

[15] *Id.* ¶¶ 20-21, 23, 28-32, 35-37.

[16] *Id.* ¶ 100.

[17] *Id.* ¶ 5.

[18] *Id.* ¶¶ 79, 88.

[19] *Id.; see* Kevin Batchelor, *What is Tokenization, and Why Is It So Important*?, Forbes (Apr. 19, 2019).

[20] Am. Compl. ¶¶ 76, 121.

[21] *Id.* ¶ 121.

[22] *Id.* ¶¶ 126-27.

[23] *Id.* ¶ 118.

[24] *Id.* ¶ 118; Defs.' Ex. 12 at 1238, 1240.

Operations Center (SOC), an Incident Response (IR) plan, and related procedures" because its "incident response plan [wa]s not up to date."[25] Day further reported that "[t]he Company [wa]s actively evaluating Starwood's exposures to cybersecurity risks."[26]

At a regularly scheduled meeting on February 10, 2017, the Marriott Board—which now included **[*8]** former Starwood directors Bruce W. Duncan, Eric Hippeau, and Lewis (together with the Pre-Acquisition Board members, the "Post-Acquisition Board")—was allegedly told for the first time about deficiencies in Starwood's cybersecurity controls.[27] During the February 10, 2017 meeting, defendant Bruce Hoffmeister, Marriott's Global Chief Information Officer, gave a presentation titled "Marriott Cybersecurity Report" to the full Post-Acquisition Board.[28] Hoffmeister discussed various steps that Marriott had taken to protect against data breaches, including the engagement of a "specialized security company" to manage its "Security Operations Center."[29] The "primary" step Marriott had taken to protect its own systems was tokenization.[30]

Hoffmeister told the Board that a review of Starwood's legacy data systems "revealed that, while there was a vibrant framework, tokenization was not adopted as a matter of course."[31] He described early findings by PricewaterhouseCoopers ("PwC"), which Marriott had hired post-Acquisition to conduct a "Starwood Security Program Assessment."[32] Hoffmeister's presentation explained that, in addition to not mandating tokenization, Starwood's "[b]rand standards did not mandate **[*9]** [payment card industry ('PCI')] compliance . . . or point-to-point encryption."[33] The Payment Card Industry Data Security Standard ("PCI DSS") is a set of security standards required by credit card companies to ensure the security of credit card transactions in the payment industry.[34]

The Board was also informed about PwC's four "Key Recommendations" for Marriott to "[u]pdate Starwood's brand standards," including mandating PCI and setting clear cybersecurity expectations.[35] Consistent with PwC's recommendation, Hoffmeister advised the Board on February 10, 2017 that there would be efforts to implement tokenization across Starwood's data systems.[36]

D. Ongoing Migration of Starwood's Systems

The full Post-Acquisition Board was next updated on cybersecurity at a regularly scheduled meeting held on February 9, 2018.[37] At that meeting, defendant Chief Financial Officer Kathleen K. Oberg advised the Board that Marriott had undertaken several "Key Mitigating Activities" to address the Company's top risks including cybersecurity.[38] Those activities included adopting new technologies to strengthen cybersecurity and "[m]igration of Starwood systems to the Marriott established technology standards" with **[*10]** a September 2019 estimated completion date.[39] In addition, Marriott had "implement[ed] patching compliance tools and reporting framework within Starwood environments."[40] On May 3, 2018, Ernst & Young presented to the Audit Committee an assessment of "the effectiveness of the Company's controls over IT risks," which included "testing the conversion of Starwood legacy activities" to new systems.[41]

On August 9, 2018, Hoffmeister updated the full Board on "Noteworthy Security Events/Incidents," including 4 cybersecurity events which involved legacy Starwood systems.[42] Those incidents included a cyberattack on a

[25] Am. Compl. ¶ 119; Defs.' Ex. 11 at 1118.

[26] Am. Compl. ¶ 118; Defs.' Ex. 11 at 1067.

[27] Am. Compl. ¶¶ 123-24.

[28] *Id.* ¶ 122; Defs.' Ex. 14 at 1279.

[29] Defs.' Ex. 14 at 1282.

[30] Am. Compl. ¶ 126; Defs.' Ex. 13 at 1249.

[31] Am. Compl. ¶ 124. Defs.' Ex. 13 at 1250.

[32] Am. Compl. ¶ 124; Defs.' Ex. 14 at 1287-88.

[33] Am. Compl. ¶¶ 124, 126; Defs.' Ex. 13 at 1249-50; Defs.' Ex. 14 at 1288.

[34] Am. Compl. ¶ 53.

[35] *Id.* ¶ 125; Defs.' Ex. 14 at 1287-88.

[36] Defs.' Ex. 13 at 1250.

[37] Am. Compl. ¶ 127; Defs.' Ex. 16 at 1394.

[38] Am. Compl. ¶ 130.

[39] *Id.* ¶ 127; Defs.' Ex. 15 at 1386.

[40] Am. Compl. ¶ 127; Defs.' Ex. 15 at 1386.

[41] Defs.' Ex. 17 at 1496.

[42] Am. Compl. ¶ 128; Defs.' Ex. 19 at 1741; Defs.' Ex. 20 at 1783-90. Lewis was absent from the meeting. Defs.' Ex. 19 at

legacy Starwood franchise network and malware found on a legacy Starwood server utilized by the Marriott Law Department.[43] Hoffmeister "confirmed there were no successful attempts to download [or] install" the malware onto that server.[44] Hoffmeister also reported that the Company had "engaged a consultant to execute a cybersecurity assessment."[45]

E. Discovery of a Starwood Guest Reservation Database Breach

On September 7, 2018, Marriott received an alert that an unknown user had run a query in Starwood's guest reservation database.[46] A third party contractor that managed the guest reservation **[*11]** database informed Marriott's Information Technology department about the incident the following day.[47] Ten days later, on September 17, 2018, outside investigators engaged by Marriott uncovered malware on Starwood's system that had the potential to access, surveil, and gain administrative control over the system computer.[48] Marriott's Information Technology department informed Sorenson about the ongoing investigation the same day.[49] On September 18, 2018, Sorenson notified the Board.[50] The Company notified the FBI of the intrusion on October 29, 2018 after Marriott's investigators found evidence of other malware in Starwood's database, including malware that hackers use to search a device for usernames and passwords.[51]

The Company's investigation continued into November 2018, with the Board and Audit Committee receiving regular updates from management and privileged briefings from Marriott's General Counsel.[52] In early November 2018, Marriott learned that the breach began as far back as July 2014.[53] On November 13, 2018, "[Marriott's] investigators discovered evidence that two compressed encrypted files had been deleted from a device they were examining."[54] On November 19, 2018, the **[*12]** Company discovered that those files contained customers' personal information.[55]

Eleven days later, on November 30, 2018, the Company publicly announced the data security incident.[56] Marriott's press release explained that there had been unauthorized access to the Starwood network since 2014 that exposed the personal information of approximately 500 million guests.[57] The exploited information included guests' names, passport numbers, birth dates, email and mailing addresses, payment card details, and Starwood Preferred Guest account information.[58] The cyber attack resulted in one of the biggest data breaches in history.[59]

Marriott's stock price dropped by more than 5.5% following the announcement.[60] In the weeks that followed, the stock price dropped $15.45 per share (more than 12%) from its high on November 29, 2018.[61]

1741.

43 Am. Compl. ¶ 128; Defs.' Ex. 20 at 1783, 1790. No guest data was lost from the franchise network attack. *Id.* at 1790.

44 *Id.* at 1783.

45 Defs.' Ex. 19 at 1746.

46 Am. Compl. ¶¶ 8, 133.

47 *Id.* at ¶ 133.

48 *Id.*

49 *Id.* ¶ 136.

50 *Id.*

51 *Id.* ¶¶ 137-38.

52 *E.g., id.* ¶¶ 139-42; Defs.' Ex. 21 at 1946; Ex. 22 at 2079; Ex. 23 at 2084; *see also* Defs.' Exs. 25-27.

53 Am. Compl. ¶ 139.

54 Defs.' Ex. 28 at 2743.

55 Am. Compl. ¶ 140; Defs.' Ex. 28 at 2743.

56 Am. Compl. ¶¶ 140-41, 143.

57 *Id.* ¶ 143; *see also* Defs.' Ex. 28 at 2744 (Sorenson stating that the Breach involved less than 383 million unique guests).

58 Am. Compl. ¶ 143.

59 *Id.* ¶ 217 (calling the incident the "second largest data breach in history"); *see* Aisha Al-Muslim, Dustin Volz, and Kimberly Chin, *Marriott Says Starwood Data Breach Affects Up to 500 Million People*, Wall St. J. (Nov. 30, 2018); Nicole Perlroth, Amie Tsang, and Adam Satariano, *Marriott Hacking Exposes Data of Up to 500 Million Guests*, N.Y. Times (Nov. 30, 2018) ("The assault . . . was one of the largest known thefts of personal records, second only to a 2013 breach of Yahoo that affected three billion user accounts and larger than a 2017 episode involving the credit bureau Equifax.").

60 Am. Compl. ¶ 151.

61 *Id.*

F. Federal Lawsuits and Regulatory Investigations

Numerous lawsuits and regulatory investigations followed Marriott's November 30, 2018 announcement. Attorneys general of all 50 states and the District of Columbia, the Securities **[*13]** and Exchange Commission, the Federal Trade Commission, and certain committees of the U.S. Senate and House of Representatives, among others, opened investigations into the data breach.[62] Marriott also faced class action lawsuits for violations of federal securities laws, violations of state and federal consumer protection laws, and violations of state disclosure laws. Those lawsuits, along with a lawsuit by a financial institution accusing Marriott of failing to perform adequate due diligence during the acquisition, were consolidated for multi-district litigation (the "Federal Action") in the United States District Court for the District of Maryland.[63]

With respect to the consumer class action, the District of Maryland denied, in part, Marriott's motion to dismiss certain "bellwether" claims that the parties had selected to test the sufficiency of the pleadings. In doing so, the court held that the consumer plaintiffs plausibly stated claims that Marriott had violated the Maryland Personal Information Privacy Act's requirement to provide "timely notice to customers affected by [a] breach" by "fail[ing] to disclose the data breach for more than two months."[64] The court similarly denied **[*14]** Marriott's motion under *Michigan's Identity Theft Protection Act*, which also required timely notice to consumers.[65]

As for the federal securities law claims, the District of Maryland held that the statements challenged by the plaintiffs—including statements about due diligence and integration, risk factors, and protection of customer data—were not materially false or misleading and dismissed those claims with prejudice.[66] Delaware state law claims for breach of fiduciary duty, waste of corporate assets, and unjust enrichment were also dismissed without prejudice.[67]

G. This Derivative Litigation

The plaintiff filed this derivative action on December 3, 2019 after obtaining roughly 3,000 pages of documents from the Company pursuant to *8 Del. C. § 220*.[68] The plaintiff's books and records request was limited to Board-level "cybersecurity" documents since May 23, 2014.[69] On March 16, 2020, the plaintiff filed an amended complaint, the operative complaint in this action (the "Complaint").[70]

The Complaint asserts a single claim for breach of fiduciary duty against 13 of the 14 directors who served on the Board when the Complaint was filed (*i.e.*, the Post-Acquisition Board), several officers, and one former director **[*15]** (Romney).[71] The claim is based on allegations that the individual defendants breached their fiduciary duties by (1) failing to "undertake cybersecurity and technology due diligence" during the Acquisition; (2) failing to implement adequate internal controls after the Acquisition; and (3) concealing the data security incident until November 30, 2018.[72]

---

[62] *Id.* ¶¶ 14, 152-54.

[63] *In re Marriott Int'l Inc., Customer Data Sec. Breach Litig., 2021 U.S. Dist. LEXIS 110301, 2021 WL 2401641, at *1-3 (D. Md. June 11, 2021)*.

[64] *In re Marriott Int'l Inc. Customer Data Sec. Breach Litig., 440 F. Supp. 3d 447, 488 (D. Md. 2020)*.

[65] *Id. at 490*.

[66] *Marriott, 2021 U.S. Dist. LEXIS 110301, 2021 WL 2401641, at *6-7*.

[67] *2021 U.S. Dist. LEXIS 110301, [WL] at *19*.

[68] Defs.' Opening Br. 16.

[69] Am. Compl. ¶ 107; *see* Pl.'s Answering Br. 23 n.10 (Dkt. 51). The production did not include officer-level documents. *Id.*; Mot. to Dismiss Hr'g Tr. 55 (noting that the plaintiff did not press to receive a beneath-the-board *Section 220* production).

[70] Dkt. 33.

[71] Am. Compl. ¶¶ 20-37. The four officer defendants are Oberg, Hoffmeister, Bao Giang Val Bauduin (Marriott's Controller and Chief Accounting Officer), and Stephanie C. Linnartz (Marriott's Chief Commercial Officer and Executive Vice President). Am. Compl. ¶¶ 22, 24-26.

[72] *Id.* ¶¶ 20-37, 246-47. The Complaint also advances other theories for breach of fiduciary duty such as "violating the Company's Guidelines" and suggests that certain defendants could not impartially consider a demand because of the Securities Class Action. *See* Am. Compl. ¶ 238. But these issues were not briefed or pressed at argument. Issues not briefed are waived. *See, e.g., Emerald P'rs v. Berlin, 726 A.2d 1215, 1224 (Del. 1999)*. The plaintiff also withdrew its assertions of breach of fiduciary duty based on disclosure violations after overlapping claims were dismissed in the

On April 30, 2020, the defendants moved to dismiss the Complaint.[73] After the reassignment of this matter from then-Chancellor Bouchard, I heard re-argument on the motion to dismiss on July 7, 2021.[74]

II. ANALYSIS

The defendants have moved to dismiss the Complaint under *Court of Chancery Rule 23.1* for failure to make a demand on the Board. For the reasons explained below, I conclude that demand was not excused. The Complaint is therefore dismissed in its entirety.

A. The Legal Standard for Demand Excusal

"The decision whether to initiate or pursue a lawsuit on behalf of the corporation is generally within the power and responsibility of the board of directors."[75] A stockholder plaintiff can pursue claims belonging to the corporation if (1) the corporation's directors wrongfully refused a demand to authorize the corporation to bring the suit or (2) a demand **[*16]** would have been futile because the directors were incapable of impartially considering the demand.[76] Because the plaintiff did not make a demand on Marriott's Board, the Complaint must plead particularized factual allegations establishing that demand was excused.[77]

The parties initially debated whether the *Aronson* or *Rales* standard for assessing demand excusal should apply.[78] The defendants argued that the *Rales* standard applied because the plaintiff's claims are predicated upon the Board's alleged failure to act and not a challenge to an affirmative decision.[79] The plaintiff agreed that *Rales* applied other than to the claim challenging the Board's decision to complete the Acquisition without conducting cybersecurity due diligence, which it argued should be analyzed under *Aronson*.[80]

That question became moot after the Delaware Supreme Court's decision in *United Foods & Commercial Workers Union v. Zuckerberg*.[81] There, the Court held that it is "no longer necessary to determine whether the *Aronson* test or the *Rales* test governs a complaint's demand-futility allegations."[82] Instead, the Court adopted a three-part "universal test" for assessing demand futility **[*17]** that is "consistent with and enhances" *Aronson, Rales*, and their progeny, which "remain good law."[83] Going forward:

> Delaware courts should ask the following three questions on a director-by-director basis when evaluating allegations of demand futility:
> (i) whether the director received a material personal benefit from the alleged misconduct that is the subject of the litigation demand;
> (ii) whether the director faces a substantial likelihood of liability on any of the claims that would be the subject of the litigation demand; and
> (iii) whether the director lacks independence from someone who received a material personal benefit from the alleged misconduct that would be the subject of the litigation demand or who would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand.[84]

Demand is excused as futile if "the answer to any of the questions is 'yes' for at least half of the members of the demand board."[85] The "analysis is conducted on a claim-by-claim basis."[86]

Federal Action. *See* Mot. to Dismiss Hr'g Reargument Tr. at 67 (hereinafter "Reargument Hr'g Tr.") (Dkt. 87); *Marriott*, 2021 WL 2407518, at *45.

[73] Dkt. 39.

[74] Dkt. 87.

[75] ***In re Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 120 (Del. Ch. 2009)*** (citing *8 Del. C. § 141(a)*).

[76] *See Rales v. Blasband, 634 A.2d 927, 932 (Del. 1993)*.

[77] *Ct. Ch. R. 23.1*; *see, e.g., Guttman v. Huang, 823 A.2d 492, 499 (Del. Ch. 2003)*.

[78] *See Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984) overruled on other grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000)*; *Rales 634 A.2d at 932-935*.

[79] Defs.' Reply Br. 5 (Dkt. 65).

[80] Pl.'s Answering Br. 20-22.

[81] ***262 A.3d 1034, 2021 Del. LEXIS 298, 2021 WL 4344361 (Del. 2021)***.

[82] *2021 Del. LEXIS 298, [WL] at *17*.

[83] *Id.*

[84] *Id.*

[85] *Id.*

[86] *Beam v. Stewart, 833 A.2d 961, 977 (Del. Ch. 2003)*.

While engaging in this analysis, I confine myself to the well-pleaded allegations of the Complaint, the documents incorporated into the Complaint by reference, and facts subject **[*18]** to judicial notice.[87] All reasonable inferences from the allegations in the Complaint are drawn in favor of the plaintiff.[88] "*Rule 23.1* is not satisfied by conclusory statements or mere notice pleading."[89] Instead, "[w]hat the pleader must set forth are particularized factual statements that are essential to the claim."[90]

B. The Demand Excusal Analysis in This Case

"The court 'counts heads' of the members of a board to determine whether a majority of its members are disinterested and independent for demand futility purposes."[91] The Board in place when this litigation was filed had 14 members: the Post-Acquisition Board members (Sorenson, Marriott, Jr., Harrison, Kellner, Muñoz, Bush, Lee, Henderson, Reinemund, Schwab, Duncan, Hippeau, and Lewis), excluding Romney who was replaced by non-party Margaret M. McCarthy (together, the "Demand Board").[92] The plaintiff does not challenge the impartiality of McCarthy. Nor does the plaintiff claim that any director received a material personal benefit from the challenged conduct.

The plaintiff only alleges that four members of the Demand Board—Sorenson, Marriott, Jr., Harrison, and Reinemund—lack (or lacked) independence.[93] Even if the plaintiff **[*19]** could sufficiently demonstrate that these four directors lacked independence, it must also impugn the disinterestedness of at least three others to show that a majority of the Demand Board could not consider a demand.[94] The plaintiff attempts to make that showing by arguing that the Post-Acquisition Board members all face a substantial likelihood of personal liability.[95]

"To establish a substantial likelihood of liability at the pleading stage, a plaintiff must 'make a threshold showing, through the allegation of particularized facts, that their claims have some merit.'"[96] Because Marriott's certificate of incorporation contains a provision exculpating its directors for breaches of the duty of care, as permitted under *8 Del. C. § 102(b)(7)*,[97] "the plaintiff[] must plead with particularity facts that support a meritorious claim for breach of the duty of loyalty."[98] The Complaint focuses on three areas of potential liability based on the Board's alleged failure to: (1) conduct pre-Acquisition due diligence into Starwood's cybersecurity; (2) remedy deficiencies in Starwood's information protection systems post-Acquisition; and (3) timely disclose the data security incident.

The outcome of my analysis on **[*20]** each issue is that none of the Post-Acquisition Board members face a substantial likelihood of liability for a non-exculpated claim. Any claim based on pre-Acquisition due diligence is time-barred. The remaining claims fall short of pleading a breach of the directors' duty of loyalty. At least 10 of the 14 Demand Board members were therefore both disinterested and independent with respect to a pre-suit litigation demand. I need not decide whether the remaining four directors lacked independence.

1. <u>The Plaintiff's Challenge to Pre-Acquisition Due Diligence is Time Barred</u>.

The plaintiff asserts that the 11 members of the Pre-

---

[87] *See, e.g.,* *White v. Panic, 783 A.2d 543, 546-47 (Del. 2001)*; *see also* *Gen. Motors, 897 A.2d at 170*.

[88] *Brehm, 746 A.2d at 255*.

[89] *Id. at 254*.

[90] *Id.*

[91] *See* *In re Zimmer Biomet Holdings, Inc. Derivative Litig., 2021 Del. Ch. LEXIS 185, 2021 WL 3779155, at *10 (Del. Ch. Aug. 25, 2021)*.

[92] Am. Compl. ¶¶ 20-21, 23, 27-37, 227.

[93] Pl.'s Answering Br. 59.

[94] *See* *Zuckerberg, 2021 Del. LEXIS 298, 2021 WL 4344361, at *17*.

[95] Pl.'s Answering Br. 20-21.

[96] *In re TrueCar, Inc. S'holder Deriv. Litig., 2020 Del. Ch. LEXIS 303, 2020 WL 5816761, at *12 (Del. Ch. Sept. 30, 2020)* (quoting *Rales, 634 A.2d at 934*).

[97] Defs.' Ex. 4 at 12.

[98] *Zimmer, 2021 Del. Ch. LEXIS 185, 2021 WL 3779155, at *12*; *see* *Zuckerberg, 2021 Del. LEXIS 298, 2021 WL 4344361, at *8-15* (holding that exculpated care claims do not satisfy the second prong of *Aronson* and do not render a director incapable of impartially considering a litigation demand).

Acquisition Board face a substantial likelihood of personal liability for their "decision to complete the Acquisition without conducting any due diligence into Starwood's cybersecurity."[99] The defendants contend that the claim is time barred.[100] Delaware's three-year statute of limitations applies by analogy to equitable claims seeking legal relief.[101] Absent tolling, the limitations period "begins to run from the time of the [allegedly] wrongful act, without regard for whether the plaintiff became aware of the wrongdoing at that time."[102]

Here, the plaintiff's **[*21]** breach of fiduciary duty claim seeking monetary damages is subject to the analogous three-year statute of limitations.[103] The alleged wrongful act—the Pre-Acquisition Board's approval of the Acquisition, allegedly without adequate cybersecurity due diligence—occurred before Marriott announced that approval on December 22, 2015.[104] At the latest, the statute of limitations began to run on September 23, 2016 when the Acquisition closed.[105] The plaintiff filed this action more than three years later on December 3, 2019. The plaintiff's due diligence-based claim is therefore barred as untimely "absent tolling or other extraordinary circumstances."[106] The plaintiff contends that the defendants waived their untimeliness defenses and also advances two tolling arguments. None of the plaintiff's arguments have merit.

a. Waiver

The plaintiff first contends that defendants waived their untimeliness argument because it was not raised in their opening brief.[107] "Under the briefing rules, a party is obliged in its motion and opening brief to set forth all of the grounds, authorities and arguments supporting its motion."[108]

No such waiver occurred. As I wrote to counsel when requesting supplemental briefing, **[*22]** it was not apparent from the Complaint that the plaintiff was challenging the closing of the Acquisition as an affirmative act of the Board.[109] The plaintiff's answering brief squarely presented the argument that the Board's "decision to complete the acquisition without conducting . . . due diligence into Starwood's cybersecurity" was itself a breach of the duty of loyalty.[110] The defendants raised the untimeliness of that "reformulated" claim in their reply brief,[111] which appropriately "consisted of material necessary to respond to the answering brief."[112]

b. Equitable Tolling and Fraudulent Concealment

The plaintiff also argues that the claim is not time-barred because the statute of limitations was tolled pursuant to fraudulent concealment and equitable tolling.[113] The

---

99 Pl.'s Answering Br. 21 (emphasis removed).

100 *See* Defs.' Reply Br. 8 n.3; Defs.' Supp. Br. 5 (Dkt. 81).

101 *See* Kraft v. WisdomTree Invs., Inc., 145 A.3d 969, 979-983 (Del. Ch. 2016) (explaining that for equitable claims seeking legal relief, such as "a breach of fiduciary duty action seeking monetary damages," the "analogous limitations period [will] operate as a strong presumption of laches"); *see also* 10 Del. C. § 8106.

102 Kraft, 145 A.3d at 989 (citing Wal-Mart Stores, Inc. v. AIG Life Ins. Co., 860 A.2d 312, 319 (Del. 2004)); *see also* Tilden v. Cunningham, 2018 Del. Ch. LEXIS 510, 2018 WL 5307706, at *14 (Del. Ch. Oct. 26, 2018) ("[T]he law in Delaware is crystal clear that a claim accrues as soon as the wrongful act occurs.").

103 *See* Kraft, 145 A.3d at 983.

104 Defs.' Ex. 29 at 97 (explaining that the Board approved the merger agreement on November 15, 2015 and recommended stockholder approval).

105 Am. Compl. ¶ 104; *see* Mot. to Dismiss Hr'g Tr. at 51-52, 54 ("The Court: [W]hat are you alleging is the wrongful act that would have triggered the statute of limitations? Is it the acquisition or is it the board approval? [Counsel]: It is the acquisition, Your Honor. It is not the board approval.").

106 Kraft, 145 A.3d at 982-83.

107 Pl.'s Supp. Br. 2 (Dkt. 82).

108 Franklin Balance Sheet Inv. Fund v. Crowley, 2006 Del. Ch. LEXIS 188, 2006 WL 3095952, at *4 (Del. Ch. Oct. 19, 2006) (citing Ct. Ch. R. 7(b), 171); *see* Thor Merritt Square, LLC v. Bayview Malls LLC, 2010 Del. Ch. LEXIS 52, 2010 WL 972776, at *5 (Del. Ch. Mar. 5, 2010) ("The failure to raise a legal issue in an opening brief generally constitutes a waiver of the ability to raise that issue in connection with a matter under submission to the court.").

109 Dkt. 78 at 2-3.

110 Pl.'s Answering Br. 21-22; *compare* Am. Compl. ¶ 228.

111 Defs.' Reply Br. 8 n.3.

112 Crowley, 2006 Del. Ch. LEXIS 188, 2006 WL 3095952, at *4.

113 Pl.'s Supp. Br. 5.

doctrines of fraudulent concealment and equitable tolling "permit[] tolling of the limitations period where 'the facts underlying the claim [are] so hidden that a reasonable plaintiff could not timely discover them.'"[114] Fraudulent concealment may be demonstrated where a defendant conceals information through an affirmative act of "actual artifice" that prevents a plaintiff from gaining knowledge of the facts or misdirects a **[*23]** plaintiff from the truth.[115] Equitable tolling can toll the statute of limitations for self-dealing claims, even without actual concealment, where a plaintiff relies "on the competence and good faith of a fiduciary."[116]

The plaintiff asserts that the defendants cannot "point to a single allegation in the Complaint" demonstrating that stockholders were on notice that the Pre-Acquisition Board did not conduct cybersecurity due diligence.[117] But it is the plaintiff's burden to plead specific facts demonstrating that the statute of limitations was tolled before this litigation was filed.[118] Assuming the facts alleged in the Complaint as true, neither tolling doctrine is applicable.

The plaintiff does not allege any affirmative acts of concealment that could support the application of fraudulent concealment. "Mere silence is insufficient . . . ."[119] The only acts that the plaintiff cites are public statements by Sorenson and others touting Marriott's "extensive" due diligence of Starwood.[120] There is no reason to doubt the truth of those statements generally. The plaintiff points to no representation that Marriott was undertaking cybersecurity diligence in particular. Nor does the plaintiff allege specific **[*24]** facts that would suggest Marriott's statements were meant to throw stockholders "off the trail of inquiry."[121]

As to equitable tolling, there are no allegations in the Complaint that permit a reasonable inference of wrongful self-dealing. In fact, the plaintiff does not allege that any of the individual defendants benefitted from the conduct challenged in the Complaint. For claims that do not involve self-dealing, "equitable tolling operates in much the same way as the doctrine of fraudulent concealment," and an affirmative act of concealment is required.[122] Again, the plaintiff has not made that showing.

c. Tolling During Inspection Demand

Finally, the plaintiff argues the statute of limitations was tolled while the plaintiff pursued an inspection demand pursuant to 8 Del. C. § 220. Even if the analogous statute of limitations began to run on September 23, 2016 when the Acquisition closed, it was not tolled by the plaintiff's January 4, 2019 books and records demand.[123] The plaintiff relies on precedent where the court has tolled the statute of limitations during the

---

[114] Weiss v. Swanson, 948 A.2d 433, 451 (Del. Ch. 2008) (quoting In re Dean Witter P'ship Litig., 1998 Del. Ch. LEXIS 133, 1998 WL 442456, at *6 (Del. Ch. July 17, 1998)).

[115] *Id.* (quoting In re Tyson Foods, Inc., 919 A.2d 563, 585 (Del. Ch. 2007)); State v. Pettinaro Enters., 870 A.2d 513, 531 (Del. Ch. 2005) ("Fraudulent concealment may be found to exist where a defendant knowingly acted to prevent a plaintiff from learning facts or otherwise made misrepresentations intended to 'put the plaintiff off the trail of inquiry.'" (quoting Halpern v. Barran, 313 A.2d 139, 143 (Del. Ch. 1973))).

[116] Weiss, 948 A.2d at 451.

[117] Pl.'s Supp. Br. 7.

[118] Weiss, 948 A.2d at 451.

[119] Krahmer v. Christie's Inc., 911 A.2d 399, 407 (Del. Ch. 2006).

[120] Pl.'s Supp. Br. 5 (citing Am. Compl. ¶¶ 12, 104, 174, 179, 180-83). The court need not consider similar statements about the Company's general due diligence in Marriott's Form S-4, filed in connection with the Acquisition. *See* Pl.'s Supp. Br. 7 (asking that the court decline to take judicial notice of the Form S-4).

[121] Pettinaro Enters., 870 A.2d at 531.

[122] Litman v. Prudential-Bache Props., Inc., 1994 Del. Ch. LEXIS 3, 1994 WL 30529, at *3 (Del. Ch. Jan. 14, 1994). In *Litman*, then-Vice Chancellor Chandler discussed then-Chancellor Allen's decision in Kahn v. Seaboard Corp., 625 A.2d 269 (Del. Ch. 1993), where the court explained that affirmative acts of concealment may not be necessary to apply the doctrine of equitable tolling if "the parties to the litigation stand in a fiduciary relationship to each other *and* where the plaintiff alleges self-dealing." Litman, 1994 Del. Ch. LEXIS 3, 1994 WL 30529, at *3 (emphasis added). *Litman* held that "[i]n situations that do not involve self-dealing, equitable tolling . . . operate[s] to toll a limitations period when the defendant has engaged in certain acts that would prevent the plaintiff from discovering the alleged wrong." *Id.*

[123] Am. Compl. ¶¶ 79, 218; *see supra* 23-24. No allegation that the Board undertook the "wrongful act" of closing the Acquisition is found in the Complaint. The Board's recommendation that stockholders approve the Acquisition is the last affirmative act of the Board in the pre-Acquisition time period.

pendency of Section 220 litigation.[124] The plaintiff does not, however, cite any authority to support the notion that service of a books **[*25]** and records demand alone tolls the statute of limitations for a subsequent plenary lawsuit.

In *Technicorp*, the court explained that "the institution of other litigation to ascertain the facts involved in the later suit will toll the statute of limitations while that litigation proceeds."[125] Likewise, in *Sutherland*, the court noted that the Section 220 lawsuit tolled the applicable three-year statute of limitations . . . during the pendency of the plaintiff's Section 220 action"[126] Here, despite the running of the statute of limitations during its Section 220 investigation, the plaintiff did not file a Section 220 lawsuit. Further, "there is no hard and fast rule tolling the running of the statute of limitations during the pendency of books and records litigation."[127] Nor did the plaintiff obtain a tolling agreement with the defendants while its investigation continued.[128]

Tolling considerations are different for a Section 220 demand and a Section 220 lawsuit. The former has no formal schedule. A stockholder could serve a Section 220 demand that fails to satisfy even the basic statutory requirements of Section 220(b) and use the demand effectively as a placeholder. A Section 220 lawsuit, by contrast, is a summary proceeding **[*26]** with "expedited discovery and a prompt hearing."[129] Unlike a demand, a Section 220 action presents "strong evidence that [a] plaintiff was aggressively asserting its claims."[130] There may be an instance where a stockholder's dogged pursuit of its statutory books and records rights provides a basis for tolling. But this lawsuit, where the stockholder took nearly 11 months between serving a demand and filing a plenary lawsuit, is not it.

2. The Plaintiff's Challenges to Cybersecurity Oversight Post-Closing Do Not Excuse Demand.

The plaintiff next argues that a majority of the Demand Board faces a substantial likelihood of liability for their "conscious and bad faith decision not to remedy Starwood's severely deficient information protection systems post-Acquisition."[131] As often stated, oversight liability under *Caremark* is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[132] To prevail, the plaintiff must plead particularized facts showing that either (1) "the directors utterly failed to implement any reporting or information system or controls" or (2) "having implemented such a system or controls, consciously failed to monitor or oversee its operations **[*27]** thus disabling themselves from being informed of risks or problems requiring their attention."[133]

Compliance risk oversight generally falls within the governance responsibilities of the board of directors.[134]

---

[124] *See* Technicorp Int'l II v. Johnston, 2000 Del. Ch. LEXIS 81, 2000 WL 713750, at *9 (Del. Ch. May 31, 2000); Sutherland v. Sutherland, 2009 Del. Ch. LEXIS 46, 2009 WL 857468, at *4-5 (Del. Ch. Mar. 23, 2009).

[125] 2000 Del. Ch. LEXIS 81, 2000 WL 713750, at *9.

[126] 2009 Del. Ch. LEXIS 46, 2009 WL 857468, at *5.

[127] Sutherland, 2009 Del. Ch. LEXIS 52, 2009 WL 1177047, at *1; *see also* Sutherland v. Sutherland, 2010 Del. Ch. LEXIS 88, 2010 WL 1838968, at *5 n.19 (Del. Ch. May 3, 2010) (explaining that a court should consider whether the plaintiff "was, or should have been, aware of [the derivative] claims during the pendency of the § 220 Action"). In *Gotham P'rs, L.P. v. Hallwood Realty P'rs, L.P.*, the court explained that a plaintiff could defeat a laches defense by showing "that it asserted its rights in a timely manner by making [a] demand [under Section 220] *and* filing th[at] action." 714 A.2d 96, 104-05 (Del. Ch. 1998) (emphasis added). The court did not say that a timely demand alone would toll the statute of limitations until a subsequent plenary action was filed. Rather, the court was discussing how a stockholder can demonstrate that it asserted its rights or claim—both through a books and records demand and in pursuing litigation—in a manner that defeats a laches defense. *Id.*

[128] As a result, there is no basis to apply the doctrine of equitable estoppel, as the plaintiff suggests. *See* Pl.'s Supp. Br. 10-11. The plaintiff asserts that the defendant "slow-rolled" the process of producing documents in response to its Section 220 demand, leading the plaintiff to rely on that conduct to its detriment. *Id.* But the plaintiff had the right to file Section 220 litigation, a plenary suit, or demand a tolling agreement.

[129] Cutlip v. CBA Int'l, Inc. I, 1995 Del. Ch. LEXIS 136, 1995 WL 694422, at *1 (Del. Ch. Oct. 27, 1995).

[130] Gotham P'rs, 714 A.2d at 105.

[131] Pl.'s Answering Br. 34.

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

[133] Stone v. Ritter, 911 A.2d 362, 370 (Del. Ch. 2006).

[134] *See* Okla. Firefighters Pension & Ret. Sys. v. Corbat, 2017 Del. Ch. LEXIS 848, 2017 WL 6452240, at *18 (Del. Ch. Dec.

Key enterprise risks affecting a corporation's "mission critical" components has been a focus of Delaware courts in assessing potential oversight liability, particularly where a board has allegedly failed to implement reporting systems or controls to monitor those risks.[135] Cybersecurity, however, is an area of consequential risk that spans modern business sectors. In the past several years alone, cyberattacks have affected thousands of companies and government agencies. High-profile data breaches have exposed customer data at businesses from Yahoo! to Target and Home Depot.[136] Targeted attacks have shut down hospitals and taken offline major fuel pipelines.[137] Regulators in the United States and abroad have become more active in issuing cybersecurity guidance and undertaking enforcement activities in response.[138] The President of the United States has named cybersecurity a "top priority and essential to national and economic security."[139]

Delaware courts have not broadened a board's *Caremark* duties to include monitoring risk in the context of business decisions.[140] Oversight violations are typically found where companies—particularly those operating within a highly-regulated industry—violate the law or run afoul of regulatory mandates.[141] But as the

---

18, 2017) ("[E]valuation of risk is a core function of the exercise of business judgment."); ***Marchand v. Barnhill, 212 A.3d 805, 824 (Del. 2019)*** (describing the board's duty to "put in place a reasonable system of monitoring and reporting about the corporation's central compliance risk").

135 *See, e.g.,* ***Marchand, 212 A.3d at 824*** (finding that board-level monitoring on food safety was needed where "food safety . . . essential and mission critical" to an ice cream manufacturer); *In re Boeing Co. Derivative Litig., 2021 Del. Ch. LEXIS 197, 2021 WL 4059934, at *26 (Del. Ch. Sept. 7, 2021)* (finding airplane safety "mission critical" to an airplane manufacturer's business); *see also* *In re Clovis Oncology, Inc. Derivative Litig., 2019 Del. Ch. LEXIS 1293, 2019 WL 4850188, at *14-15 (Del. Ch. Oct. 1, 2019)* (denying motion to dismiss in the context of *Caremark*'s second prong where red flags about a "monoline" company's single promising drug were ignored).

136 Stockholder litigation followed. *See, e.g.,* *In re Home Depot, Inc. S'holder Deriv. Litig., 223 F. Supp. 3d 1317 (N.D. Ga. 2016)*; *Davis v. Steinhafel, Lead Case No. 14-cv-203 (PAM/JJK), 2016 U.S. Dist. LEXIS 195486 (D. Minn. July 7, 2016)* (ORDER) **[*28]** ; *Okla. Firefighters Pension & Ret. Sys. v. Brandt*, C.A. No. 2017-0133-SG (Del. Ch. Feb. 23, 2017); *In re Yahoo! Inc., S'holder Litig.*, No. 17-CV-307054 (Cal. Super. Ct. Mar. 2, 2018).

137 *See* Robert McMillan and Melanie Evans, *Ransomware Attack Hits Universal Health Services*, Wall St. J. (Sept. 30, 2020); Christopher Bing and Stephanie Kelly, *Cyber Attack Shuts Down U.S. Fuel Pipeline 'Jugular,' Biden Briefed*, Reuters (May 8, 2021).

138 *See, e.g.*, ***Cal. Civ. Code §§ 1798.110***, ***1798.150*** (West 2021) (imposing data collection obligations on companies doing business in California and providing consumers with a private right of action to address harms caused by data breaches); European Union General Data Protection Regulation, Council Regulation 2016/679 (mandating data security measures and breach notification); *Commission Statement and Guidance on Public Company Cybersecurity Disclosures, 83 Fed. Reg. 8,166 (Feb. 22, 2018)* (Sec. & Exch. Comm'n) ("[T]he Commission believes that the development of effective disclosure controls and procedures is best achieved when a company's directors, officers, and other persons responsible for developing and overseeing such controls and procedures are informed about the cybersecurity risks and incidents that the company has faced or is likely to face."); Jared Ho, *Corporate Boards: Don't Underestimate Your Role in Data Security Oversight*, Fed. Trade Comm'n (Apr. 28, 2021).

139 Exec. Order No. 14,208, 86 Fed. Reg. at 26,633 (2021).

140 *See, e.g.,* *Reiter v. Fairbank, 2016 Del. Ch. LEXIS 158, 2016 WL 6081823, at *8 (Del. Ch. Oct. 18, 2016)* ("This Court has been careful to distinguish between failing to fulfill one's oversight obligations with respect to fraudulent or criminal conduct as opposed to monitoring the business risk of the enterprise."); *In re Goldman Sachs Grp., Inc. S'holder Litig., 2011 Del. Ch. LEXIS 151, 2011 WL 4826104, at *21 (Del. Ch. Oct. 12, 2011)* (stating that the Court of Chancery has "not definitively stated whether a board's *Caremark* duties involve a duty to monitor business risk"); *Corbat, 2017 Del. Ch. LEXIS 848, 2017 WL 6452240, at *18* (stating that a "failure to monitor or properly limit business risk" is a "theory of director liability that this Court has never definitively accepted"); *In re Facebook, Inc. Section 220 Litig., 2019 Del. Ch. LEXIS 197, 2019 WL 2320842, at *14 (Del. Ch. May 30, 2019)* ("The legal academy has observed that Delaware courts are more inclined to find Caremark oversight liability at the board level when the company operates in the midst of obligations imposed upon it by positive law yet fails to implement compliance systems, or fails to monitor existing compliance systems, such that a violation of law and resulting liability occurs.").

141 *E.g.,* *La. Mun. Police Emples. Ret. Sys. v. Pyott, 46 A.3d 313, 355 (Del. Ch. 2012)* (finding it was reasonable to infer directors approved a business plan allowing for illegal off-label marketing); *In re Massey Energy Co. Derivative & Class Action Litig., 2011 Del. Ch. LEXIS 83, 2011 WL 2176479, at *20-21 (Del. Ch. May 31, 2011)* ("[A] fiduciary of a Delaware corporation cannot be loyal to a Delaware corporation by knowingly causing it to seek profit by violating the law.").

legal and regulatory frameworks governing cybersecurity advance and the risks become manifest, corporate governance must evolve to address them.[142] The corporate harms presented by non-compliance with cybersecurity safeguards increasingly call upon directors to ensure that companies have appropriate oversight systems in place.

The growing risks posed by cybersecurity threats do not, however, lower the high threshold that a plaintiff must meet to plead a *Caremark* claim. For either **[*29]** prong of *Caremark*, "a showing of bad faith conduct . . . is essential to establish director oversight liability."[143] Only a "sustained or systemic failure of the board to exercise oversight . . . will establish the lack of good faith that is a necessary condition to liability."[144] The Complaint in this case falls well short of demonstrating that the Post-Acquisition Board members face a substantial likelihood of liability for a sustained, bad faith failure of oversight. Demand is therefore not futile on that basis.

a. Cybersecurity Reporting Systems and Controls

To the extent the plaintiff attempts to put forward a claim under *Caremark*'s first prong, I find that effort unpersuasive. Delaware law imposes on directors a duty to ensure that board-level monitoring and reporting systems are in place. But because doing so is a disinterested business judgment, "directors have great discretion to design context-and industry-specific approaches tailored to their companies' businesses and resources."[145] For directors to face liability under Caremark's first prong, a plaintiff must show that the director "made no good faith effort to ensure the company had in place any 'system of controls.'"[146]

Marriott's Board **[*30]** consistently ranked cybersecurity as a primary risk facing the Company.[147] The plaintiff does not, however, assert that the Post-Acquisition Board "utterly failed" to implement any reporting system or internal controls to address it.[148] Instead, the Complaint and documents incorporated into it demonstrate that the directors surpassed *Caremark*'s baseline requirement that they "try" in good faith to put a "reasonable compliance and reporting system in place."[149]

The Complaint, for example, describes how the Board and Audit Committee were "routinely apprised" on cybersecurity risks and mitigation, provided with annual reports on the Company's Enterprise Risk Assessment that specifically evaluated cyber risks, and engaged outside consultants to improve and auditors to audit corporate cybersecurity practices.[150] The Complaint also describes internal controls over the Company's public disclosure practices.[151] And when management received information that the plaintiff describes as "red flags" indicating vulnerabilities, the reports were delivered to the Board.[152] To the extent that the plaintiff contends the Post-Acquisition Board faces liability under the first prong of *Caremark*, that argument **[*31]** is

[142] *See* Leo E. Strine, Jr., Kirby M. Smith & Reilly S. Steel, *Caremark and ESG: Perfect Together: A Practical Approach to Implementing an Integrated, Efficient and Effective Caremark and EESG Strategy*, 106 Iowa L. Rev. 1885, 1893 (describing "the first principle of corporate law: corporations may only conduct lawful business by lawful means").

[143] Stone, 911 A.2d at 370.

[144] Caremark, 698 A.2d at 971.

[145] ***Marchand, 212 A.3d at 821***; ***Citigroup, 964 A.2d at 125*** (explaining that although "directors of Delaware corporations have certain responsibilities to implement and monitor a system of oversight" that "obligation does not eviscerate the core protections of the business judgment rule").

[146] ***Marchand, 212 A.3d at 822***.

[147] *E.g.*, Am. Compl. ¶¶ 100, 118.

[148] *See* Rojas v. Ellison, 2019 Del. Ch. LEXIS 281, 2019 WL 3408812, at *9 (Del. Ch. July 29, 2019); Horman v. Abney, 2017 Del. Ch. LEXIS 13, 2017 WL 242571, at *8 & n.46 (Del. Ch. Jan. 19, 2017) (noting that, in the *Caremark* context, "utterly failed" is a "linguistically extreme formulation" that means "absolute, total" (citations omitted)).

[149] ***Marchand, 212 A.2d at 821***.

[150] *See* Am. Compl. ¶¶ 118-130; *supra notes* 6-10 (describing ongoing updates to directors on information protection and cybersecurity).

[151] Am. Comp. ¶¶ 42-44.

[152] *Compare* ***Marchand, 212 A.2d at 809*** ("Consistent with this dearth of any board-level effort at monitoring, the complaint pleads particularized facts supporting an inference that during a crucial period when yellow and red flags about food safety were presented to management, there was no equivalent reporting to the board.").

meritless.[153] The Complaint itself shows that the Board has systems in place to assess cybersecurity risks.

b. No Failure to Monitor or Oversee Operations

The plaintiff's primary argument is that the Post-Acquisition Board faces a substantial likelihood of liability under the second prong of Caremark for consciously disregarding "red flags" indicating that Marriott was violating positive law.[154] For purposes of *Caremark*, a plaintiff must plead that the board knew about "red flags" alerting them to corporate misconduct and "consciously failed to act after learning about evidence of illegality."[155] The plaintiff has not, however, pleaded with particularity that the Post-Acquisition Board learned of legal or regulatory violations. And even if it had, the Board did not consciously choose to remain idle.

i. *No known violations of law*

The plaintiff argues that the Post-Acquisition Board knew that Starwood's systems violated the law because it learned in February 2017 that Starwood's "[b]rand standards did not mandate PCI compliance, tokenization, or point-to-point encryption."[156] But the PCI DSS standards are required by financial **[*32]** institutions with which companies contract, not mandated by law.[157] Nor is tokenization, which can reduce the amount of cardholder data in a digital environment and streamline PCI DSS compliance efforts.[158] Pleading non-compliance with non-binding industry standards, like the PCI DSS, is not the same as pleading that directors knowingly permitted a company to violate positive law.[159]

The plaintiff also argues that the failure to improve Starwood's deficient systems risked the violation of various laws, including the FTC Act, state privacy acts and unfair competition laws, and "international regulatory standards."[160] Simply listing statues "in vague, broad terms" without alleging what law was violated and how is insufficient to state a *Caremark* claim.[161] The only law the parties specifically address in their briefs is the FTC Act. The plaintiff asserts that the Board's knowledge of PCI DSS non-compliance is

---

[153] *See* Home Depot, 223 F. Supp. 3d at 1326 (applying Delaware law and finding, in the context of a data security incident, that allegations of "numerous instances where the Audit Committee received regular reports from management on the state of [the company's] data security, and the Board in turn received briefings from both management and the Audit Committee" led to the conclusion that "the Board was fulfilling its duty of loyalty to ensure that a reasonable system of reporting existed"); *see also* Corp. Risk Holdings LLC v. Rowlands, 2018 U.S. Dist. LEXIS 171346, 2018 WL 9517195, at *4 (S.D.N.Y. Sept. 28, 2018) (finding swift efforts "to address [security] breach with contingency plans to ascertain and mitigate the harm" foreclosed claim under the "first category of *Caremark* liability").

[154] Pl.'s Answering. Br. 34-35.

[155] Pyott, 46 A.3d at 341; *see also* Melbourne Mun. Firefighters' Pension Trust Fund v. Jacobs, 2016 Del. Ch. LEXIS 114, 2016 WL 4076369, at *12 (Del. Ch. Aug. 1, 2016) (distinguishing *Pyott* and *Massey* because "the Board, at all times, was under the impression that its conduct did *not* violate applicable . . . laws"); South v. Baker, 62 A.3d 1, 14-15 (Del. 2012) (explaining that a plaintiff who cannot plead actual director involvement in "decisions that violated positive law" can "plead that the board consciously failed to act after learning about evidence of illegality—the proverbial 'red flag'"); *see generally* Elizabeth Pollman, Corporate Disobedience, 68 Duke L.J. 709, 723 (2019).

[156] Am. Compl. ¶ 124.

[157] Those standards, set by the PCI Security Standards Council, founded by American Express, Discover, JCB International, Mastercard and Visa, are intended to reduce credit card fraud. *See* PSI Security Standards Council, *PCI Security* https://www.pcisecuritystandards.org/pci_security/.

[158] *See* PCI Security Standards Council, *Tokenization Product Security Guidelines* (Apr. 2015) https://www.pcisecuritystandards.org/documents/Tokenization_Product_Security_ Guidelines.pdf.

[159] Wilkin v. Narachi, 2018 Del. Ch. LEXIS 70, 2018 WL 1100372, at *12 (Del. Ch. Feb. 28, 2018) ("Pleading violations of nonbinding recommendations does not constitute pleading a violation of positive law such that the board faces a substantial likelihood of liability and cannot consider demand.").

[160] Am. Compl. ¶¶ 58-63.

[161] *See* Narachi, 2018 Del. Ch. LEXIS 70, 2018 WL 1100372, at *12 (finding demand not excused where the plaintiff listed various statutes and regulations but did not specify what law was violated because "[m]erely discussing these statutes in vague, broad terms does not support a finding that Director Defendants' decisions somehow violated these statutes"); Desimone v. Barrows, 924 A.2d 908, 928 (Del. Ch. 2007) ("I do not accept cursory contentions of wrongdoing as a substitute for the pleading of particularized facts. Mere notice pleading is insufficient to meet the plaintiff's burden to show demand excusal in a derivative case.").

enough to support a reasonable inference that its members knew Starwood's cybersecurity practices fell short of the FTC's heightened requirements.[162] The defendants respond that the FTC only "recommends" data security practices and requires **[*33]** companies to maintain "reasonable" cybersecurity practices.[163] Whether the FTC expects PCI DSS standards or tokenization, however, does not change the fact that there are no allegations in the Complaint that the Post-Acquisition Board knew about the FTC's requirements or that Marriott was violating them. A *Caremark* claim requires that a plaintiff demonstrate scienter.[164] The plaintiff here has not.

In short, there is no known illegal conduct, lawbreaking, or violations of a regulatory mandate alleged in the Complaint that could support a finding that the Post-Acquisition Board faces a substantial likelihood of liability for failed oversight. That reality distinguishes this case from those relied upon by the plaintiff. In *Massey*, the plaintiffs pleaded "a myriad of particularized facts" demonstrating the board's knowledge of serious violations of mining safety laws and that the directors knowingly "caus[ed] [the company] to seek profit" through unlawful acts.[165] In *Westmoreland*, the United States Court of Appeals for the Seventh Circuit found that the plaintiffs pleaded particularized facts that the board "took no action to ensure the company's timely compliance **[*34]** with the law," despite the repeated warnings from the FDA—which were passed along to the board—that the company was in violation of FDA regulations.[166] And in *Abbott Labs*, the Seventh Circuit likewise found that a board's failure to rectify known, ongoing, and pervasive violations of FDA regulations could constitute bad faith and excuse demand.[167] The plaintiff in this action has not pleaded particularized facts that the Post-Acquisition Board knowingly permitted Marriott to violate the law.[168]

ii. *No conscious disregard of "red flags"*

---

162 Pl.'s Answering Br. 41 n.18.

163 Am. Compl. ¶¶ 57-59; Statement of the FTC, *FTC v. LifeLock* (Dec. 17, 2015) (explaining that "the reasonableness of security will depend on the facts and circumstances of each case").

164 *E.g.*, *Hays v. Almeida, 2019 Del. Ch. LEXIS 1485, 2019 WL 3389172, at *3 (Del. Ch. July 26, 2019)* (ORDER) (rejecting the argument that directors faced oversight liability where "the complaint [did] not allege that the directors knew that Walgreens was violating the law or even engaging in the conduct that risked violating the law"); *Teamsters Local 443 Health Servs. & Ins. Plan v. Chou, 2020 Del. Ch. LEXIS 274, 2020 WL 5028065, at *16 (Del. Ch. Aug. 24, 2020)* ("Because a *Caremark* claim must plead bad faith, 'a plaintiff must allege facts that allow a reasonable inference that the directors acted with scienter which, in turn, requires not only proof that a director acted inconsistently with his fiduciary duties, but also most importantly, that the director knew he was so acting.'" (quoting *Corbat, 2017 Del. Ch. LEXIS 848, 2017 WL 6452240, at *14*)).

165 *Massey, 2011 Del. Ch. LEXIS 83, 2011 WL 2176479, at *20*.

166 *Westmoreland Cty. Emp. Ret. Sys. v. Parkinson, 727 F.3d 719, 726-29 (7th Cir. 2013)*.

167 *In re Abbott Lab'ys Deriv. S'holders Litig., 325 F.3d 795, 808-09 (7th Cir. 2003)*.

168 In October 2020, the United Kingdom Information Commissioner's Office fined Marriott £18.4 million ($24.0 million) in connection with the cyberattack for violating the General Data Protection Regulation (GDPR). *See ICO Fines Marriott 18.4 Million Pounds for Failing to Secure Customer Data*, Reuters (Oct. 30, 2020); *see* Am. Compl. ¶¶ 164-65. The GDPR was adopted on April 14, 2016 and became enforceable on March 25, 2018. *See* GDPR, *supra* note 137. The GDPR requires, among other things, that customers handling European Union citizens' data implement reasonable data protection measures to protect consumers' personal data and privacy from loss or exposure. *See* GDPR Art. 5; Am. Compl. ¶ 62. The plaintiff alleges that "the defendants failed to comply with various provisions of the GDPR which required Marriott to implement appropriate technical and organizational measures to ensure a level of security appropriate to the risk." Am. Compl. ¶ 163. But the Complaint lacks any particularized facts suggesting that the Post-Acquisition Board intentionally violated the GDPR or knowingly permitted GDPR violations to continue unabated. There are no allegations suggesting that Marriott's directors "viewed themselves or [Marriott] as above the law." *Corbat, 2017 Del. Ch. LEXIS 848, 2017 WL 6452240, at *24* (explaining that alleged "failed" efforts "to comply with the wide range of laws and regulations that govern large financial institutions" are "not enough to support a plausible inference of bad faith" and that [b]ad results alone do not imply bad faith."); *In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 67 (Del. 2006)* (noting that "a failure to act in good faith may be shown . . . 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" (citation omitted)). Although not briefed by the parties in any event, the ICO fine is not a basis to find that the Post-Acquisition Board faces a substantial likelihood of liability for a bad faith oversight violation.

The plaintiff also contends that the Post-Acquisition Board faces a substantial risk of liability for ignoring several "red flags" about Starwood's inadequate data protection systems post-closing. Those "red flags" are not of illegality, as previously discussed.[169] The plaintiff does not allege that the directors were told, for example, that Starwood's standards ran afoul of regulatory or legal requirements. The so-called "red flags" were updates to the Board about aspects of Starwood's cybersecurity measures that needed improvement.[170]

The purported "red **[*35]** flags" the plaintiff focuses on are as follows. First, five members of the Demand Board learned at a February 8, 2017 Audit Committee meeting that Internal Audit rated Marriott as "Needs Improvement" for cybersecurity and that its "incident response plan [wa]s not up to date."[171] Second, the Board was told by Hoffmeister on February 10, 2017 that Starwood's data security standards did not mandate PCI compliance or tokenization.[172] And third, PwC told the Board that Starwood's "[d]ecentralized technology management model" created a "greater opportunity for deviation from the expected published standard."[173] These "red flags" were effectively ignored, the plaintiff asserts, because the Board waited a year before taking up Starwood's information protection systems again.[174]

Even if the gaps in Starwood's data security evidenced the sort of compliance failure that could support a viable claim under the second prong of *Caremark*, the Complaint lacks particularized allegations that the Board consciously overlooked or failed to address them.[175] As the defendants point out, no "red flags" were deliberately disregarded.[176] Rather, management told the Board that it was addressing or would address the issues **[*36]** presented.[177]

At the same February 10, 2017 meeting where the Board learned about Starwood's PCI non-compliance, Hoffmeister reported there "would be efforts made immediately to remedy" Starwood's lack of tokenization.[178] In addition, the presentation given to the Board confirmed that the Company had a plan in place to "consolidate Marriott + Starwood [s]ecurity."[179] The Board was also told about several recommendations that PwC had made to appropriately update Starwood's brand standards and detailed "Intended Actions" to address those recommendations.[180] These facts are not reflective of a board that has decided to turn a blind eye to potential corporate wrongdoing.[181]

Perhaps the entirety of Starwood's deficiencies were not addressed "immediately," as Hoffmeister told the Board they could be. And, with hindsight knowledge of the extent of the data breach, the implementation plan was probably too slow. It wasn't until the following year on February 9, 2018 that the Board was next updated about those migration efforts.[182] But, the plaintiff does not allege that the full Board had any reason to suspect

[169] *See supra* Section II.B.2.b.i.

[170] *See* ***Citigroup, 964 A.2d at 124-26***; *see infra* note 184.

[171] Am. Compl. ¶¶ 118-19.

[172] *Id.* ¶ 124.

[173] *Id.*

[174] *Id.* ¶ 130; Defs.' Ex. 15 at 1386.

[175] *See* *Desimone, 924 A.2d at 940* ("Delaware courts routinely reject the conclusory allegation that because illegal behavior occurred, internal controls must have been deficient, and the board must have known so.").

[176] Defs.' Opening Br. 39-40.

[177] Defs.' Reply Br. 15.

[178] Am. Compl. ¶ 126.

[179] *Id.* ¶¶ 122, 124; Defs.' Ex. 14 at 1284-85.

[180] Am. Compl. ¶ 125.

[181] *See* *Corbat, 2017 Del. Ch. LEXIS 848, 2017 WL 6452240 at *17* (finding no substantial likelihood of liability for bad faith failed oversight where the board was presented with an action plan by management and outside advisors); *2017 Del. Ch. LEXIS 848, [WL] at *22* (finding no particularized allegations of board inaction where the company "dealt with [a] red flag in a manner that cannot be said to reflect bad faith"); *Reiter, 2016 Del. Ch. LEXIS 158, 2016 WL 6081823, at *13* (declining to draw inference that directors knew they were breaching fiduciary duties by allowing corporate violations of law where "the same reports that described the Company's heightened compliance risk simultaneously explained to the directors in considerable detail on a regular basis the initiatives management was taking to address those problems and to ameliorate . . . compliance risk").

[182] *Id. at 1366, 1386* (Oberg's Enterprise Risk Assessment presentation, detailing a detailed "Cybersecurity Risk Scorecard" that described current risk mitigation efforts and tracked performance, including the anticipated "[m]igration of Starwood systems to the Marriott established technology standards" for end user devices by September 2019).

that management was not promptly acting on PwC's recommendations.[183] As the documents incorporated **[*37]** into the Complaint confirm, management had "enhance[ed] monitoring," "[e]xpand[ed] enterprise security logging and event management," and "[e]xpand[ed] the use of third party monitoring" among other numerous actions between February 2017 and 2018.[184] An attempted yet failed remediation effort generally cannot implicate bad faith.[185]

Finally, the plaintiff asserts that the Post-Acquisition Board is exposed to *Caremark* liability for its failure to immediately discontinue use of the Starwood guest reservation system after learning, in September 2018, that it was infected with malware that could allow attackers to access customer data.[186] The plaintiff does not allege that the Board learned on September 17, 2018 that an immediate shutdown of the system was necessary to protect consumer data but chose to continue its use nonetheless. According to the Complaint, Marriott did not learn about the extent of the breach and that customer data had been accessed until November 2018.[187] The Complaint and documents incorporated into it demonstrate that the Board continued to receive detailed updates on the "incredible amount of work" management and forensic specialists performed throughout **[*38]** November 2018 to investigate and address the problem.[188] There are no facts pleaded to suggest that the directors' ignorance on the extent of the breach in September 2018 is the result of a breach of fiduciary duty.[189] The plaintiff has therefore failed to demonstrate that a majority of the Demand Board faces a substantial likelihood of liability for consciously disregarding "red flags."

iii. *Notification Requirements Regarding the Breach*

The plaintiff's final theory of liability for the Demand Board is another variation of alleged failure to comply with positive law—this time, based on the timing of Marriott's disclosure of the data breach. The plaintiff contends that Marriott was "required by various state laws to expeditiously disclose the data breach" and that the Board "knew they were required by their fiduciary duties to cause Marriott to disclose this information" in compliance with those laws.[190] By not alerting the public about the incident until November 30, 2018—despite the Board first learning of malware on September 18, 2018—the plaintiff alleges that notification laws were violated.

The plaintiff's argument suffers from many of the same flaws as those regarding PCI DSS and tokenization. **[*39]** To start, the plaintiff does not allege that the directors were informed about the applicable notification laws. Directors cannot be liable under the second prong of *Caremark* for legal violations that they did not know about.[191]

Of the notification laws of 31 states and territories that the plaintiff asserts were violated by Marriott's "83-day delay" in notifying individuals affected by the breach,[192] only three statutes—of Delaware, Maryland, and Michigan—are addressed in the parties' briefs. Those

---

[183] *See* Horman, 2017 Del. Ch. LEXIS 13, 2017 WL 242571, at *13 ("Delaware courts have consistently rejected . . . the inference that directors must have known about a problem because someone was supposed to tell them about it." (quoting Cottrell v. Duke, 829 F.3d 983, 995 (8th Cir. 2016) (alteration in original))).

[184] Defs.' Ex. 30 at 1372.

[185] *See* Richardson v. Clark, 2020 Del. Ch. LEXIS 378, 2020 WL 7861335, at *11 (Del. Ch. Dec. 31, 2020); *see also* Jacobs, 2016 Del. Ch. LEXIS 114, 2016 WL 4076369, at *9 ("Simply alleging that a board incorrectly exercised its business judgment and made a 'wrong' decision in response to red flags . . . is not enough to plead bad faith."); Home Depot, 223 F. Supp. 3d at 1326-27 (finding no substantial likelihood of liability for *Caremark* violation based on allegation that implementation to remedy deficiency in company's data security was not completed fast enough where allegations did not demonstrate bad faith).

[186] Pl.'s Answering Br. 13-14, 37.

[187] Am. Compl. ¶¶ 139-41.

[188] Defs.' Ex. 21 at 1946-47; Defs.' Exs. 25-27.

[189] *See* Horman, 2017 Del. Ch. LEXIS 13, 2017 WL 242571, at *15 (explaining that the size of the ultimate harm is "not a sufficient basis on which to rest liability" absent facts showing a "board's ignorance can only be explained by a breach of fiduciary duty" (quoting *David B. Shaev Profit Sharing Account v. Armstrong*, 2006 Del. Ch. LEXIS 33, 2006 WL 391931, at *6 (Del. Ch. Feb. 13, 2006)).

[190] Pl.'s Answering Br. 55.

[191] *See* Horman, 2017 Del. Ch. LEXIS 13, 2017 WL 242571, at *11 (explaining that directors are liable if they "become aware of the red flags and do nothing in response").

[192] Am. Compl. ¶ 172.

laws each concern notification requirements in the event of the disclosure of personal data.[193] Maryland's Personal Information Privacy Act requires a business that has discovered or has been notified of a security breach to conduct a prompt investigation to determine if "Personal Information" has or will be misused.[194] If it has, the business is required to notify the affected individuals "as soon as reasonably practicable."[195] Michigan's notification law likewise defines a "security breach" as the "unauthorized access and acquisition of data that compromises the security or confidentiality of personal information."[196] Delaware's Consumer Security Breach Act also requires notification "without unreasonable **[*40]** delay" when a resident's "personal information was breached or is reasonably believed to have been breached."[197]

The plaintiff points to the fact that consumer class action claims based on the Maryland and Michigan **[*41]** notification statutes survived a motion to dismiss in the Federal Action as a basis for finding liability here.[198] Those claims were not, however, brought against the members of the Demand Board and cannot implicate their liability.[199] Under the heightened pleading standards of *Rule 23.1*, the lack of particularized allegations indicating that the directors consciously disregarded or intentionally violated positive law is dispositive.

Regardless, there are no allegations that the Board *knew* personal data was accessed such that the notification obligations had been triggered prior to November 2018.[200] The plaintiff suggests that it "strains credulity" to conclude the Board did not know personal information was accessed given the severity of the breach.[201] But as the defendants point out, discovering malware is not the same as discovering that personal information has been accessed.[202] The Complaint plainly states that Marriott first discovered that "customers' personal information" was potentially accessed on November 19, 2018.[203] Marriott's notification of interested parties 10 days later and public announcement of its investigatory findings on the eleventh day **[*42]** are not obvious violations of notification laws that suggest bad faith on the part of the Board.[204]

---

[193] At argument, the plaintiff explained that it focused on Maryland and Michigan because those states' notification laws were selected as bellwether claims in the Federal Action and on Delaware given the action in this court. *See* Reargument Hr'g Tr.; Pl.'s Answering Br. 56 n.26; Defs.' Opening Br. 49-50; Defs.' Reply Br. 21 n.8.

[194] *Md. Code Ann., Com. Law § 14-3504(b)(1)* (West 2021). "Personal Information" is defined to include:

> An individual's first name or first initial and last name in combination with any one or more of the following data elements, when the name or the data elements are not encrypted, redacted, or otherwise protected by another method that renders the information unreadable or unusable: . . . a passport number . . . [a]n account number, a credit card number, or a debit card number, in combination with any required security code, access code, or password, that permits access to an individual's financial account.

Id. § 14-3501(e)(1)(i).

[195] *Id. §§ 14-3504(b)(2)*, *14-3504(c)(2)*.

[196] *Mich. Comp. Laws Ann. § 445.63(b)* (West 2021). "Personal information" is defined to include:

> [T]he first name or first initial and last name linked to 1 or more of the following data elements of a resident of this state: (i) Social security number[;] (ii) Driver license number or state personal identification card number[;] (iii) Demand deposit or other financial account number, or credit card or debit card number, in combination with any required security code, access code, or password that would permit access to any of the resident's financial accounts.

Id. § 445.63(r).

[197] *6 Del. C. § 12B-102(a)*.

[198] *Marriott, 440 F. Supp. 3d at 487, 490*.

[199] *See generally id. Cf. Pfeiffer v. Toll, 989 A.2d 683, 690 (Del. Ch. 2010)*, *abrogated on other grounds by Kahn v. Kolberg Kravis Roberts & Co., L.P., 23 A.3d 831 (Del. 2011)* (finding demand futile based, in part, on federal court decision holding that the same individual defendants acted with scienter regarding "the same trades at issue" in the Delaware action).

[200] *See supra* note 164 (discussing the scienter requirement for an oversight claim).

[201] Pl.'s Answering Br. 57.

[202] Am. Compl. ¶¶ 140, 217; Defs.' Reply Br. 20.

[203] Am. Compl. ¶ 140.

[204] *Id.* ¶¶ 142-43. The plaintiff originally argued that the members of the Audit Committee face a substantial likelihood

* * *

The data breach that is at the center of this case was momentous in scale and put the data of hundreds of millions of people at risk. Critically, however, the corporate trauma that came to fruition was at the hands of a hacker. Marriott was the victim of an illegal act rather than the perpetrator. One could argue that the Complaint depicts a preventable scenario because the directors did not respond to internal reports about inadequate data security risks as swiftly as they might have. But the difference between a flawed effort and a deliberate failure to act is one of extent and intent. A *Caremark* violation requires a plaintiff to demonstrate the latter.

Here, the Complaint lacks particularized allegations demonstrating that the Post-Acquisition Board knew that the vulnerabilities in Starwood's data system ran afoul of the law, that it nonetheless chose not to address them, or that it scorned legal notification requirements. Having failed to show that those directors consciously disregarded positive law or acted in bad faith, the plaintiff has not impugned **[*43]** the ability of any member of the Demand Board to impartially consider a demand based on a substantial likelihood of liability for failed oversight.

III. CONCLUSION

The plaintiff failed to allege particularized facts that could support a finding that any member of the Demand Board faced a substantial likelihood of liability on a non-exculpated claim. Any claim based on pre-Acquisition due diligence is time barred. The remaining claims are unsupported by particularized allegations demonstrating that the Post-Acquisition Board acted in bad faith with regard to cybersecurity oversight, compliance, or notification of the data breach. As a result, a demand made on the Demand Board would not have been futile with respect to the plaintiff's breach of fiduciary duty claim. The defendants' Motion to Dismiss is granted and the Complaint is dismissed pursuant to Court of Chancery Rule 23.1.

End of Document

of liability for issuing a Form 10-Q on November 6, 2018 that "remained silent as to the Breach." *Id.* ¶¶ 139, 248; Pl.'s Answering Br. 56. After the District Court in the Federal Action dismissed securities law claims for allegedly false and misleading disclosures with prejudice, the plaintiff here determined not to press its disclosure claims. *See* Mot. to Dismiss Hr'g Tr. 59. Had they not, the claim likely would have failed because the plaintiff does not ascribe any bad faith actions or motives to the Audit Committee members who approved the Form 10-Q. The claim would, at most, implicate the directors' "'erroneous judgment' concerning the proper scope and content of the disclosure." Orman v. Cullman, 794 A.2d 5, 41 (Del. Ch. 2002) (quoting Crescent/Mach I P'rs, L.P. v. Turner, 846 A.2d 963, 987 (Del. Ch. 2000)); *see also* Morrison v. Berry, 2019 Del. Ch. LEXIS 1412, 2019 WL 7369431, at *18 (Del. Ch. Dec. 31, 2019) ("Bad faith, in the context of omissions, requires that the omission be intentional and constitute more than an error of judgment or gross negligence.").

Gottlieb v. Duskin

Court of Chancery of Delaware, New Castle

November 20, 2020, Decided

Civil Action No. 2019-0639-MTZ

Reporter

2020 Del. Ch. LEXIS 348 *

Mark Gottlieb, et al., v. Jonathan Duskin, et al.,

Notice: THIS OPINION HAS NOT BEEN RELEASED FOR PUBLICATION. UNTIL RELEASED, IT IS SUBJECT TO REVISION OR WITHDRAWAL.

Counsel: **[*1]** Blake A. Bennett, Esquire, Cooch & Taylor, P.A., Wilmington, DE.

Eric Lopez Schnabel, Esquire, Dorsey & Whitney (Delaware) LLP, Wilmington, DE.

Raymond J. DiCamillo, Esquire, Richards, Layton & Finger, P.A., Wilmington, DE.

Judges: Morgan T. Zurn, Vice Chancellor.

Opinion by: Morgan T. Zurn

Opinion

I write regarding the motion to dismiss the Verified Class Action Complaint[1] (the "Motion") filed by Defendants Jonathan Duskin, Seth R. Johnson, Keri L. Jones, Kent A. Kleeberger, William F. Sharpe, III, Joel Waller, and Laura Weil (collectively, the "Director Defendants").[2] I heard argument on the Motion on February 13, 2020.[3] On May 27, I issued a partial ruling, holding that Plaintiff Mark Gottlieb had pled facts sufficient to trigger enhanced scrutiny under *Unocal Corp. v. Mesa Petroleum Co.*[4] and that Plaintiff's claims, as pled, are derivative and not direct.[5]

To fully resolve the Motion, I asked the parties to submit supplemental briefing on two issues: (1) whether Plaintiff, having forwent demand, adequately pled facts demonstrating that demand is futile under *Court of Chancery Rule 23.1*, and (2) whether *Unocal* scrutiny is appropriate as Plaintiff primarily seeks money damages rather than injunctive relief.[6] The parties submitted supplemental **[*2]** briefing by August 24.[7] This letter completes my ruling on the Motion. I conclude that Plaintiff has failed to demonstrate that demand is futile under *Rule 23.1*. Therefore, the Complaint must be dismissed in its entirety, and I need not reach the question of whether *Unocal* scrutiny is appropriate for a post-closing damages action.

I. BACKGROUND[8]

The parties are familiar with the facts as alleged in the Complaint, which I related at length in my partial bench ruling.[9] Generally, the Complaint alleges that the

---

[1] Docket Item ("D.I.") 1 [hereinafter "Compl."].

[2] D.I. 17, 18.

[3] D.I. 42.

[4] *493 A.2d 946 (Del. 1985)*.

[5] *See* D.I. 47. Defendants B. Riley FBR, Inc. and B. Riley Financial, Inc. (together, the "B. Riley Defendants") also moved to dismiss pursuant to *Rule 12(b)(6)*. *See* D.I. 19, 20. Their motion was not the subject of my partial ruling and remained pending during the resolution of the Director Defendants' Motion. In view of my determination that Plaintiff's claims are derivative in nature, the B. Riley Defendants joined the Director Defendants' arguments set forth in supplemental briefing. *See* D.I. 49. Accordingly, this letter decision resolves the Director Defendants' Motion, as well as the B. Riley Defendants' motion to dismiss.

[6] *See* D.I. 47.

[7] *See* D.I. 48, 49, 51, 52.

[8] I draw the pertinent facts from the Complaint.

[9] *See* D.I. 47.

Director Defendants breached their fiduciary duties to Christopher & Banks (the "Company") "by engaging in [a] scheme to reject the $0.80 per share Offer for the Company by trying to bully the offeror to go away, and then when that failed[,] by commissioning the investment banker to prepare an analysis which was patently flawed and which made no sense, giving the Company values which it could not have had the analysis been done in good faith."[10] It also alleges that the Director Defendants "failed in bad faith to fully inform themselves, and then negotiate with the Offeror to obtain a better bid."[11] Plaintiff broadly contends that the Director Defendants did so to "entrench[] themselves at **[*3]** the expense of the Company's shareholders."[12]

Each of the Director Defendants served on the Board from the time of the transaction though the May 14, 2019 filing of the Complaint.[13] Assuming his claims were direct rather than derivative, Plaintiff did not make a pre-suit demand on the Company's board of directors (the "Board") prior to filing this action. Nor does the Complaint explicitly allege that demand is futile.

The Complaint provides a handful of allegations with respect to each of the Director Defendants.[14] Most of the Complaint's director-specific allegations are aimed at Jonathan Duskin.[15] Duskin has served on the Board since 2016. The Complaint describes Duskin's current and former roles in the industry and his allegedly "poor financial record" at other companies.[16] In addition, Duskin is the current CEO of Macellum Capital Management ("Macellum"). Macellum's "affiliate" is the Company's largest stockholder, owning 12.7% of its stock.[17]

Plaintiff alleges that Duskin "had been having conversations with" the offeror, Justin Yoshimura, "throughout th[e] year," was Yoshimura's first point of contact with respect to the bid,[18] and "arranged the retention of **[*4]** B. Riley, and was the initial contact with them."[19] Plaintiff further alleges that Yoshimura outbid the Company in a bankruptcy asset auction in 2018, which "may have created some ill will with defendant Duskin who is (as noted)" affiliated with "Christopher & Banks' largest shareholder."[20] Plaintiff stops short of alleging that Duskin was interested in the transaction or lacked independence with respect to it; rather, Count I requests that "[t]he Board should explore whether director Duskin has a conflict of interest and, if so, exclude him from further deliberations as to the Company's strategic alternatives."[21]

The Complaint's allegations with respect to the remaining Director Defendants are sparse. Plaintiff recites each director's Board tenure and general industry experience, but does not allege any interest in or connection to Duskin or the challenged transaction.

- Paragraph 23: Seth Johnson has served on the Board since 2016 as "Macellum's designated board nominee" and has current and former experience in the industry.[22] The Complaint does not allege any direct connection between Johnson and Duskin, nor does it allege if or how Macellum influenced the challenged Board actions. **[*5]**
- Paragraphs 24 and 37: Keri Jones has been the CEO of the Company since March 2018 and has held other positions in the industry. Yoshimura's email offering the $0.80 "stalking horse bid" indicated he was "bullish on [Jones] and her turnaround plans."[23]
- Paragraph 25: Kent Kleeberger has served on the Board since 2016 and as its Chair since January 2017. He has an extensive professional history including service as an "independent consultant to certain private equity firms."[24]
- Paragraph 26: William Sharpe has served on the Board since May 2012, and has extensive

[10] Compl. ¶ 71.

[11] *Id.* ¶ 72.

[12] *Id.* ¶ 64(a).

[13] *See id.* ¶¶ 22-28.

[14] *See id.*

[15] *See id.* ¶¶ 22, 37, 38, 76(d).

[16] *Id.* ¶ 22.

[17] *Id.*

[18] *Id.* ¶ 37.

[19] *Id.* ¶ 38.

[20] *Id.*

[21] *Id.* ¶ 76(d).

[22] *Id.* ¶ 23.

[23] *Id.* ¶ 37.

[24] *Id.* ¶ 25 (emphasis omitted).

experience, including serving as a partner at an investment banking firm and working for other entities that "provide[] advice on mergers and acquisitions, restructuring, and public and private capital raising to the middle market."[25] Plaintiff also alleges that "[t]he Company state[ed] in its 2019 Proxy: 'Mr. Sharpe brings considerable business, investment banking and corporate experience to our Board, given his more than 15 years as an investment banker.'"[26]

• Paragraphs 27, 33, and 35: Joel Waller served on the Board from January 2017 through June 2019. In addition to other industry experience, "Waller previously served as the Company's **[*6]** President, from December 2011 through November 2012, and as the Company's interim CEO from February 2012 through November 2012."[27] While serving as the Company's President and CEO in March 2017, he detailed the Company's struggle to successfully implement its long-term turnaround plan. And in March 2018, Waller stated that the Company was confident that it would realize the benefits of its turnaround plan that year.

• Paragraph 28: Laura Weil served on the Board from 2016 through June 2019, and has an extensive professional history, but has not been employed by the Company.

II. ANALYSIS

From these allegations, I assess whether Plaintiff has standing to pursue the derivative Complaint under *Court of Chancery Rule 23.1*. A stockholder's derivative claim may proceed only "if (i) the stockholder demanded that the directors pursue the corporate claim and they wrongfully refused to do so or (ii) demand is excused because the directors are incapable of making an impartial decision regarding the litigation."[28] *Rule 23.1* requires a stockholder asserting a derivative claim to "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable **[*7]** authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort."[29] It imposes "stringent requirements of factual particularity that differ substantially from . . . permissive notice pleadings,"[30] and the Court will not accept conclusory allegations as true.[31]

Where the plaintiff does not make a pre-suit demand, "the complaint must plead with particularity facts showing that a demand upon the board would have been futile."[32] The "operative question" is "whether demand is excused because the directors are incapable of making an impartial decision regarding whether to institute such litigation."[33] Viewing the constellation of allegations holistically, "the demand futility analysis asks whether the board of directors as constituted when the lawsuit was filed could exercise disinterested and independent judgment regarding a demand."[34] When making this assessment, "a court counts heads," and "[i]f the board lacks a majority of directors who could exercise independent and disinterested judgment regarding a demand, then demand is futile."[35]

The Delaware Supreme Court has established two tests for determining whether directors can exercise **[*8]** independent and disinterested judgment regarding a

[25] *Id.* ¶ 26 (emphasis omitted).

[26] *Id.* (emphasis omitted).

[27] *Id.* ¶ 27.

[28] *United Food & Com. Workers Union v. Zuckerberg, 2020 Del. Ch. LEXIS 319, 2020 WL 6266162, at *7 (Del. Ch. Oct. 26, 2020)* (citing *Ainscow v. Sanitary Co. of Am., 21 Del. Ch. 35, 180 A. 614, 615 (Del. Ch. 1935))*.

[29] *Ct. Ch. R. 23.1(a)*.

[30] *Brehm v. Eisner, 746 A.2d 244, 254 (Del. 2000)*.

[31] *Zuckerberg, 2020 Del. Ch. LEXIS 319, 2020 WL 6266162, at *8*.

[32] ***In re Citigroup Inc. S'holder Deriv. Litig., 964 A.2d 106, 120 (Del. Ch. 2009)*** (citing *Ch. Ct. R. 23.1(a)*, and also citing *Stone v. Ritter, 911 A.2d 362, 367 n.9*, and *Brehm, 746 A.2d at 254*); *see also* *Wood v. Baum, 953 A.2d 136, 140 (Del. 2008)* (noting that in the absence of a pre-suit demand "plaintiff must establish demand futility").

[33] *Zuckerberg, 2020 Del. Ch. LEXIS 319, 2020 WL 6266162, at *8* (internal quotation marks omitted) (quoting *Stone, 911 A.2d at 367*).

[34] *Id.* (citing *In re infoUSA, Inc. S'holders Litig., 953 A.2d 963, 985 (Del. Ch. 2007)*, and also citing *In re Oracle Corp. Deriv. Litig., 2018 Del. Ch. LEXIS 92, 2018 WL 1381331, at *18 (Del. Ch. Mar. 19, 2018))*.

[35] *Id.* (citing *In re EZCORP Inc. Consulting Agreement Deriv. Litig., 2016 Del. Ch. LEXIS 14, 2016 WL 301245, at *34 (Del. Ch. Jan. 25, 2016))*.

demand:[36] *Aronson v. Lewis*[37] and *Rales v. Blasband*.[38] "The crux of the Court's inquiry is that set out by our Supreme Court in *Rales v. Blasband*: whether the majority of the board, as it exists at the time the complaint is filed, is capable of considering the demand in light of the circumstances."[39] "The *Rales* test requires that the plaintiff allege particularized facts establishing a reason to doubt that the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."[40] Although preceded by *Aronson*, Delaware law has evolved to recognize *Rales* as the "general"[41] and "overarching test for futility."[42]

Aronson has been regarded as *Rales*'s narrower and circumstance-specific sister test, "appl[ying] to claims involving a contested transaction *i.e.*, where it is alleged that the directors made a conscious business decision in breach of their fiduciary duties"[43] and "[a]ddressing a situation in which the same directors who would consider a demand had made the challenged decision."[44] *Aronson* requires that the plaintiff allege particularized facts creating a reason to **[*9]** doubt that (1) the directors are disinterested and independent, or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.[45] In this case, all Director Defendants sat on the Board both at the time of the challenged transaction and when Plaintiff filed this action in May 2019. *Aronson*'s test is the traditional choice, as "the suit involves a challenge to action of the directors who themselves would evaluate the demand."[46]

Consistent with this Court's decision to "decline[] automatic excusal theories[] in favor of individual director-by-director analysis based on the particularized allegations of the Complaint,"[47] "demand is not futile simply because enhanced scrutiny applies."[48] As Vice Chancellor Glasscock stated in *Ryan v. Armstrong*, "the presence of a narrowly pled *Unocal* claim . . . does not operate to excuse demand *per se*," "although of course *specific* pleadings that a majority of directors were motivated primarily by entrenchment or other non-corporate considerations will show demand futility."[49] The plaintiff's claims must be dismissed under *Rule 23.1* "unless the Complaint demonstrates demand would be futile, consistent with the analyses **[*10]** set out in *Rales* and *Aronson v. Lewis*, regardless of whether the underlying facts state a claim under *Unocal*."[50]

That said, where, as here, the complaint "alleges entrenchment as the Defendants['] motive in the challenged transaction," "[a]ddressing such an allegation under *Aronson* is a rather awkward fit."[51] And *Aronson*'s continued viability in view of *Rales*'s more streamlined inquiry and intervening developments in the law has recently been called into question.[52] "The

[36] *See* *Wood, 953 A.2d at 140*.

[37] *473 A.2d 805 (Del. 1984)*.

[38] *634 A.2d 927 (Del. 1993)*.

[39] *Ryan v. Armstrong, 2017 Del. Ch. LEXIS 80, 2017 WL 2062902, at *10 (Del. Ch. May 15, 2017)* (footnote omitted) (citing *Rales, 634 A.2d at 934*, and also citing *In re infoUSA, Inc., 953 A.2d at 985-90*), *aff'd*, ***176 A.3d 1274 (Del. 2017)***.

[40] *Wood, 953 A.2d at 140* (internal quotation marks omitted) (quoting *Rales, 634 A.2d at 934*).

[41] *Zuckerberg, 2020 Del. Ch. LEXIS 319, 2020 WL 6266162, at *18 & n.20* (collecting cases).

[42] *Ryan, 2017 Del. Ch. LEXIS 80, 2017 WL 2062902, at *11*.

[43] *Wood, 953 A.2d at 140*.

[44] *Zuckerberg, 2020 Del. Ch. LEXIS 319, 2020 WL 6266162, at *11*.

[45] *Wood, 953 A.2d at 140* (citing *Aronson, 473 A.2d at 814*).

[46] *Ryan, 2017 Del. Ch. LEXIS 80, 2017 WL 2062902, at *14* (citing *Aronson, 473 A.2d at 814*, and also citing *In re infoUSA, Inc., 953 A.2d at 986*).

[47] *2017 Del. Ch. LEXIS 80, [WL] at *13 & n.138* (collecting cases).

[48] *Zuckerberg, 2020 Del. Ch. LEXIS 319, 2020 WL 6266162, at *12* (citing *Ryan, 2017 Del. Ch. LEXIS 80, 2017 WL 2062902, at *13-14)*.

[49] *2017 Del. Ch. LEXIS 80, 2017 WL 2062902, at *13* (emphasis added).

[50] *2017 Del. Ch. LEXIS 80, [WL] at *14* (footnote omitted).

[51] *Id.*

[52] *See* *Zuckerberg, 2020 Del. Ch. LEXIS 319, 2020 WL 6266162, at *16* ("Viewed on its own terms, *Aronson* is no longer a functional test. Delaware decisions have managed to continue applying it only by emphasizing the overarching question of a substantial likelihood of liability, incorporating the

Aronson test must be understood in the context of the overarching test for demand futility laid out in *Rales*: could the directors bring business judgment to bear on the demand?"[53] Because both tests fundamentally address this question, *Aronson* and *Rales* inform each other and will almost certainly yield the same outcome when applied, and in fact, this Court has recognized the significant analytical overlap of these tests.[54]

Accordingly, I look to general principles of demand futility articulated by this Court under *Aronson* and its progeny, while keeping in mind *Rales*'s broader inquiry: I consider whether Plaintiff pled particularized facts showing **[*11]** that the Director Defendants face a substantial likelihood of liability such that they would have been incapable of exercising their independent business judgment in considering a demand.[55]

A. Plaintiff Has Failed To Show Futility Under ***Aronson*** Prong One.

Under *Aronson*'s first prong, the Court considers "director compliance with the duty of loyalty: if the directors made the underlying decision under the influence of self-interest, or dependent on a third party, they have breached a duty of loyalty, and are liable for loss caused thereby."[56] Thus, I assess whether the Complaint pleads particularized facts sufficient to raise a reasonable doubt as to the disinterestedness or independence of at least half of the Director Defendants, such that the Director Defendants would face a substantial likelihood of liability.[57] Thus, on a "director-by-director basis" the Court asks

> (i) whether the director received a material personal benefit from the alleged misconduct that is the subject of the litigation demand, (ii) whether the director would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand, and (iii) whether the director **[*12]** lacks independence from someone who received a material personal benefit from the alleged misconduct that is the subject of the litigation demand or who would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand.[58]

If the Complaint adequately alleges that the Director Defendants were conflicted with respect to Yoshimura's bid, "there is a reasonable doubt whether those directors can exercise their business judgment on a demand to sue themselves."[59]

The allegations with respect to each of the Director Defendants are scant at best. Drawing all inferences in Plaintiff's favor, the Complaint only alleges that Duskin might have a conflict of interest because of a prior experience that "may have created some ill will" with

implications of exculpation, and de-emphasizing the role of the standard of review. The foundational premise of the decision, which relied on the standard of review for the challenged decision as a proxy for whether directors face a substantial likelihood of liability, no longer endures. Fortunately, a viable alternative [, *Rales*,] exists.").

[53] Ryan, 2017 Del. Ch. LEXIS 80, 2017 WL 2062902, at *14 (footnote omitted) (collecting cases).

[54] *See, e.g.,* Guttman v. Huang, 823 A.2d 492, 500 (Del. Ch. 2003) ("[T]he differences between the *Rales* and the *Aronson* tests in the circumstances of this case are only subtly different, because the policy justification for each test points the court toward a similar analysis."); *see also* Zuckerberg, 2020 Del. Ch. LEXIS 319, 2020 WL 6266162, at *18-19 & n.20 (recognizing that general principles of demand futility set forth in *Aronson* are considered and applied, perhaps more efficiently, under *Rales*); Ryan, 2017 Del. Ch. LEXIS 80, 2017 WL 2062902, at *14 & n.143 (stating that *Aronson* is contextualized by *Rales* and collecting cases); 2017 Del. Ch. LEXIS 80, [WL] at *10-18 (specifically applying *Aronson* to determine whether demand was futile in an entrenchment case, but doing so in view of *Rales*'s broader question and principles).

[55] *See, e.g.,* Zuckerberg, 2020 Del. Ch. LEXIS 319, 2020 WL 6266162, at *18-19 & n.20; Ryan, 2017 Del. Ch. LEXIS 80, 2017 WL 2062902, at *10-18; Guttman, 823 A.2d at 500. Even if *Aronson* is no longer viable, my analysis would be nearly identical to, and bear the same outcome as, a futility analysis under *Rales*.

[56] Ryan, 2017 Del. Ch. LEXIS 80, 2017 WL 2062902, at *14.

[57] 2017 Del. Ch. LEXIS 80, [WL] at *15; *see also* Zuckerberg, 2020 Del. Ch. LEXIS 319, 2020 WL 6266162, at *15 ("[A] plaintiff seeking to show that a director faces a substantial likelihood of liability for having approved a transaction, no matter what standard of review applies, must plead particularized facts providing a reason to believe that the individual director was self-interested, beholden to an interested party, or acted in bad faith.").

[58] Zuckerberg, 2020 Del. Ch. LEXIS 319, 2020 WL 6266162, at *19.

[59] Ryan, 2017 Del. Ch. LEXIS 80, 2017 WL 2062902, at *14.

Yoshimura.[60] The Complaint does not explain how this potential ill will renders Duskin incapable of acting in accordance with his fiduciary duties.

Plaintiff offers no particularized allegations to establish that any other Director Defendant, let alone the majority, was interested in the transaction or beholden to Duskin. Instead, Plaintiff offers a conclusory and collective entrenchment theory, contending **[*13]** that the Director Defendants fended off the Yoshimura bid to preserve their positions, in view of Yoshimura's harsh words about the Board and management.[61] Plaintiff does not allege the Director Defendants' positions were material to them; does not allege any Director except Duskin had any animus towards Yoshimura; and does not allege their discretion was sterilized by Duskin's potential interest in fending off the bid.[62]

"This is quintessential conclusive pleading of a mere threat of liability."[63] "The Complaint is bare of the type of director-specific pleading" that shows a breach of loyalty and that "if true, create[s] a reasonable doubt that a substantial likelihood of liability would cause a majority of directors to face liability, disabling their exercise of business judgment and excusing demand."[64] Because I cannot find from the facts alleged that the majority of the Director Defendants faces a disabling interest or lacks independence with respect to the demand eschewed by Plaintiff, Plaintiff has failed to plead facts demonstrating futility under *Aronson*'s first prong.[65]

B. Plaintiff Has Failed To Show Futility Under *Aronson* Prong Two.

Plaintiff's futility arguments **[*14]** focus on *Aronson* prong two: a "safety valve to permit suit where the majority of directors are otherwise disinterested and independent but the complaint meets a heightened pleading standard of particularity and the threat of liability to the directors required to act on the demand is sufficiently substantial to cast a reasonable doubt over their impartiality."[66] I must assess whether the pleadings create a reasonable doubt that the decision was otherwise not the product of business judgment, such that it is reasonable to infer that the Director Defendants acted in bad faith and would therefore face a substantial likelihood of liability,[67] and "excuses demand where the facts pled disclose that rare case where a transaction may be so egregious on its face that board approval cannot meet the test of business judgment."[68] "[A] plaintiff carries a heavy burden in satisfying the second prong of *Aronson*,"[69] and must plead "particularized facts . . . such that it is difficult to conceive that a director could have satisfied his or her fiduciary duties."[70] If the Complaint demonstrates that Plaintiff has met this heavy burden with respect to at least half of the Director Defendants, "[s]uch directors **[*15]** are disabled from considering a demand to sue themselves, and demand would be futile."[71]

Plaintiff's allegations are insufficient to demonstrate that at least half of the Director Defendants could be found to have acted in bad faith and face a substantial likelihood of liability. "This is simply a mirror image of the contentions addressed with respect to *Aronson*'s first

[60] Compl. ¶ 38; *see also id.* ¶ 76(d).

[61] *See id.* ¶ 37 ("From our conversations throughout this year, I think we are in agreement that CBK possesses many underutilized assets, ranging from a loyal and engaged customer base to a platform that is able to succeed in tertiary malls. However[,] it goes without being said that under the current Board of Directors, the company has underperformed even its peers in every metric.").

[62] *See* *Ryan, 2017 Del. Ch. LEXIS 80, 2017 WL 2062902, at *15*.

[63] *Id.*

[64] *Id.*

[65] *See* *2017 Del. Ch. LEXIS 80, [WL] at *15-16*.

[66] *2017 Del. Ch. LEXIS 80, [WL] at *17* (internal quotation marks omitted) (quoting *Guttman, 823 A.2d at 500*).

[67] *See id.* ("In order for demand to be excused under the second prong of *Aronson* where, as here, the Defendants are exculpated from liability for the duty of care, the Plaintiff must plead facts raising an inference that the action complained of was taken in bad faith.").

[68] *Id.* (internal quotation marks omitted) (quoting *Aronson, 473 A.2d at 815*).

[69] *Id.* (internal quotation marks omitted) (quoting *White v. Panic, 783 A.2d 543, 551 (Del. 2001)*).

[70] *Id.* (internal quotation marks omitted) (quoting *Chester Cty. Empls.' Ret. Fund v. New Residential Inv. Corp., 2016 Del. Ch. LEXIS 153, 2016 WL 5865004, at *9 (Del. Ch. Oct. 7, 2016)*).

[71] *2016 Del. Ch. LEXIS 153, [WL] at *14*.

prong."[72] Plaintiff only alleges that Duskin may have harbored some animus toward Yoshimura that impacted his decision to reject the bid. And reading the Complaint in the light most favorable to Plaintiff, he suggests, but does not explicitly claim, that the remaining Director Defendants followed Duskin's lead by approving defensive measures and likewise rejecting the bid. Plaintiff offers no allegations regarding the Director Defendants' compensation and financial circumstances, or anything else to suggest that the Director Defendants, other than Duskin, would have a non-corporate motive in approving the transaction. Nor does the Complaint give rise to the reasonable inference that Duskin's influence "was so powerful as to sterilize the other directors' discretion or that such directors were beholden **[*16]** to him."[73] In view of these shortcomings, the Complaint fails to allege particularized facts to permit an inference that the majority of the Director Defendants acted with bad faith such that they face a substantial likelihood of liability.[74]

In the absence of particularized pleadings for each Director Defendant, Plaintiff alleges generally that the Director Defendants took defensive measures to fend off an allegedly hostile bid, not for the benefit of the Company, but for entrenchment. But Plaintiff's conclusory allegation that the Director Defendants were collectively motivated by entrenchment is insufficient "to excuse demand *per se*."[75] Plaintiff must offer "specific pleadings that a majority of directors were motivated primarily by entrenchment or other non-corporate considerations."[76]

I previously held that "[a]s in *Ryan*, Plaintiff's allegations of an entrenchment motive are thin:" "Plaintiff conclusorily alleges that the director defendants entrenched themselves at the expense of the company shareholders."[77] However, the Complaint is silent as to each individual Director Defendant's "motivations, interests, and actions beyond its broad conclusory allegations" and **[*17]** "lacks particularized factual allegations to permit me to infer that the majority of the Board acted solely or primarily to entrench themselves."[78]

In the absence of particularized allegations that entrenchment primarily motived the decisionmakers such they acted in bad faith, Plaintiff contends that the transaction itself is so disloyal and in bad faith that it satisfies *Aronson*'s second prong.[79] Plaintiff asserts this case "smack[s]" of disloyalty,[80] such that this is a "rare case" where the challenged decisions are "so egregious"[81] that they are "inexplicable other than bad faith" and therefore it is "difficult to conceive that a director could have satisfied his or her fiduciary duties."[82] But Plaintiff's allegations do not support this conclusion.

In fact, although the challenged actions can be fairly characterized as defensive, the Complaint also repeatedly references the Company's long-term adherence to its turnaround plan.[83] Plaintiff alleges that the plan failed time and again, but the Board and management nonetheless remained optimistic about its promise.[84] And in March 2018, Waller announced the Director Defendants' belief that they "expect[d] the benefit of [the turnaround plan] to **[*18]** be largely realized in 2018."[85]

In November, Yoshimura approached Duskin with an

---

[72] *2016 Del. Ch. LEXIS 153, [WL] at *18*.

[73] *Id.*

[74] *Id.*

[75] *2016 Del. Ch. LEXIS 153, [WL] at *13*; *see also* *2016 Del. Ch. LEXIS 153, [WL] at *17* (finding that a "conclusory pleading" of an entrenchment motive "is insufficient under *Rule 23.1*").

[76] *2016 Del. Ch. LEXIS 153, [WL] at *13*; *see also* *2016 Del. Ch. LEXIS 153, [WL] at *17* (applying this principle).

[77] D.I. 47 at 21-22.

[78] *Ryan, 2017 Del. Ch. LEXIS 80, 2017 WL 2062902, at *17*.

[79] *See* D.I. 51 at 13-15.

[80] *Id.* at 13.

[81] *Ryan, 2017 Del. Ch. LEXIS 80, 2017 WL 2062902, at *17* (quoting *Aronson, 473 A.2d at 815*).

[82] *2017 Del. Ch. LEXIS 80, [WL] at *17* (internal quotation marks omitted) (quoting *Chester Cty. Empls.' Ret. Fund, 2016 Del. Ch. LEXIS 153, 2016 WL 5865004, at *9)*; *2016 Del. Ch. LEXIS 153, [WL] at *18* ("An action inexplicable other than bad faith is sufficiently likely to imply liability that demand on directors taking such action is futile.").

[83] *See* Compl. ¶¶ 4, 7, 35, 37, 39.

[84] *See id.* ¶¶ 7, 35, 37, 39.

[85] *Id.* ¶ 35.

"overture"[86] to "a stalking horse bid to acquire the company for at least ~$.80, which represents a ~33% premium to today's closing price."[87] Yoshimura ultimately engaged Duskin, his alleged foe, to kick off a sales process. Yoshimura and the Director Defendants reacted by enacting a number of defensive measures. Those included allegedly inflating projections and commissioning a "sham" report from B. Riley in order to fend off and rationalize rejecting the premium bid.[88] In doing so, the Director Defendants—who have not been alleged to be interested or lack independence in this transaction—opted to stay the course in favor of the turnaround plan.

Even if the Director Defendants defended and rejected the bid for entrenchment purposes such that those actions (if supported by sufficient pleadings) would give rise to liability, the decision to reject the bid and stay the course on the turnaround plan is not so egregious as to be inexplicable other than by bad faith. To the contrary, staying the course could likely have had a legitimate business purpose.[89] As *Aronson* teaches, absent "rare" and "egregious" **[*19]** circumstances, "the mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient."[90]

In defending his scant allegations, Plaintiff contends that the fact that they have triggered *Unocal* enhanced scrutiny means they are sufficient to excuse demand under *Aronson*'s second prong.[91] Boiled down, Plaintiff believes the standard of review, set on notice pleading standards, should dictate the outcome of the futility analysis under *Rule 23.1*'s more onerous pleading standard.

The challenged conduct narrowly creates an inference sufficient to trigger *Unocal*'s enhanced scrutiny, but as explained, those are "not the only reasonable inferences that may be drawn from the timeline present here."[92] Plaintiff's bare-bones *Unocal* claim does not automatically translate into a non-exculpated duty of loyalty claim, and is not enough to satisfy the second prong of *Aronson*. The fact that a plaintiff has alleged the existence of defensive measures triggering *Unocal* enhanced scrutiny does not amount to a *per se* determination that the transaction is inexplicable other than by bad faith.[93]

In conclusion, the facts as pled do not support "an inference **[*20]** that the actions taken by the directors, even if defensive, are inexplicable other than as bad faith."[94] Accordingly, the Complaint does not give rise to a reasonable inference that the Defendant Directors face a substantial likelihood of bad-faith liability. Plaintiff has failed to satisfy the second prong of *Aronson*.

III. CONCLUSION

The Director Defendants' Motion, joined by the B. Riley Defendants, is **GRANTED**, and the Complaint is **DISMISSED** in its entirety for failure to satisfy *Rule 23.1*.[95] The parties shall submit an implementing order within twenty days of this decision.

Sincerely,

/s/ Morgan T. Zurn

Vice Chancellor

End of Document

[86] *Id.* ¶ 39.

[87] *Id.* ¶ 37.

[88] *Id.* ¶¶ 12, 39, 43.

[89] *See Ryan, 2017 Del. Ch. LEXIS 80, 2017 WL 2062902, at *18* ("It is a truism that defensive actions may be loyal actions if reasonable. They *may* also be loyal—although subject to injunctive relief—if unreasonable. They may be loyal even though adopted in a grossly negligent way." (emphasis in original)).

[90] *Aronson, 473 A.2d at 815*.

[91] *See* D.I. 51 at 12-16.

[92] D.I. 47 at 27-28; *see Ryan, 2017 Del. Ch. LEXIS 80, 2017 WL 2062902, at *18 n.180* (considering in an *Aronson* prong two analysis that, although the challenged action triggered *Unocal* scrutiny, "the rationale of the [challenged action] was not completely devoid of support," as plaintiff alleged facts that also suggested a rational business purpose).

[93] *See Ryan, 2017 Del. Ch. LEXIS 80, 2017 WL 2062902, at *17-18*; *accord Zuckerberg, 2020 Del. Ch. LEXIS 319, 2020 WL 6266162, at *15, *16* (noting that the applicable standard of review is not outcome-determinative for purposes of a futility analysis).

[94] *Ryan, 2017 Del. Ch. LEXIS 80, 2017 WL 2062902, at *18*.

[95] *See 2017 Del. Ch. LEXIS 80, [WL] at *2*.

In re Boeing Co. Derivative Litig.

Court of Chancery of Delaware

June 25, 2021, Submitted; September 7, 2021, Decided

C.A. No. 2019-0907-MTZ

Reporter
2021 Del. Ch. LEXIS 197 *; 2021 WL 4059934

IN RE THE BOEING COMPANY DERIVATIVE LITIGATION

Notice: THIS OPINION HAS NOT BEEN RELEASED FOR PUBLICATION. UNTIL RELEASED, IT IS SUBJECT TO REVISION OR WITHDRAWAL.

Prior History: *In re Boeing Co. Derivative Litig., 2021 Del. Ch. LEXIS 22, 2021 WL 392851 (Del. Ch., Feb. 1, 2021)*

Counsel: **[*1]** Joel Friedlander, Jeffrey M. Gorris, and Christopher M. Foulds, FRIEDLANDER & GORRIS, P.A., Wilmington, Delaware; Richard M. Heimann and Katherine Lubin Benson, LIEFF CABRASER HEIMANN & BERNSTEIN, LLP, San Francisco, California; Steven E. Fineman, Nicholas Diamond, Sean Petterson, Rhea Ghosh, and Kartik S. Madiraju, LIEFF CABRASER HEIMANN & BERNSTEIN, LLP, New York, New York, Attorneys for Co-Lead Plaintiffs.

Blake Rohrbacher, Kevin M. Gallagher, and Ryan D. Konstanzer, RICHARDS, LAYTON & FINGER, P.A., Wilmington, Delaware; Joshua Z. Rabinovitz, KIRKLAND & ELLIS LLP, Chicago, Illinois, Attorneys for Defendants and Nominal Defendant The Boeing Company.

Judges: ZURN, Vice Chancellor.

Opinion by: ZURN

Opinion

MEMORANDUM OPINION

ZURN, Vice Chancellor.

A 737 MAX airplane manufactured by The Boeing Company ("Boeing" or the "Company") crashed in October 2018, killing everyone onboard; a second one crashed in March 2019, to the same result. Those tragedies have led to numerous investigations and proceedings in multiple regulatory and judicial arenas to find out what went wrong and who is responsible. Those investigations have revealed that the 737 MAX tended to pitch up due to its engine placement; that a new software program **[*2]** designed to adjust the plane downward depended on a single faulty sensor and therefore activated too readily; and that the software program was insufficiently explained to pilots and regulators. In both crashes, the software directed the plane down.

The primary victims of the crashes are, of course, the deceased, their families, and their loved ones. While it may seem callous in the face of their losses, corporate law recognizes another set of victims: Boeing as an enterprise, and its stockholders. The crashes caused the Company and its investors to lose billions of dollars in value. Stockholders have come to this Court claiming Boeing's directors and officers failed them in overseeing mission-critical airplane safety to protect enterprise and stockholder value.

Because the crashes' second wave of harm affected Boeing as a company, the claim against its leadership belongs to the Company. In order for the stockholders to pursue the claim, they must plead with particularity that the board cannot be entrusted with the claim because a majority of the directors may be liable for oversight failures. This is extremely difficult to do. The defendants have moved to dismiss this action, arguing **[*3]** the stockholders have failed to clear this high hurdle.

The narrow question before this Court today is whether Boeing's stockholders have alleged that a majority of the Company's directors face a substantial likelihood of liability for Boeing's losses. This may be based on the directors' complete failure to establish a reporting system for airplane safety, or on their turning a blind eye to a red flag representing airplane safety problems. I conclude the stockholders have pled both sources of board liability. The stockholders may pursue the Company's oversight claim against the board. But the stockholders have failed to allege the board is incapable of maintaining a claim against Boeing's officers. The stockholders' other claim against the board, regarding their handling of the chief executive officer's retirement and compensation, is also dismissed.

I. BACKGROUND

I draw the following facts from the Verified Amended Consolidated Complaint, as well as the documents attached and integral to it.[1]

Co-Lead Plaintiffs are Boeing stockholders. Co-Lead Plaintiff Thomas P. DiNapoli is Comptroller of the State of New York, Administrative Head of the New York State and **[*4]** Local Retirement System, and Trustee of the New York State Common Retirement Fund ("NYSCRF"). NYSCRF is a public pension fund for New York State and local government employees. Co-Lead Plaintiff Fire and Police Pension Association of Colorado ("FPPA") is the Trustee for the Fire and Police Members' Benefit Investment Fund, which contains assets of governmental defined benefit pension plans for Colorado firefighters, police officers, and their beneficiaries. As of June 8, 2020, FPPA held approximately 9,165 shares of Boeing stock, and NYSCRF held approximately 1,186,627 shares of Boeing stock.

Nominal Defendant Boeing is a global aerospace corporation that designs, manufactures, and sells commercial airplanes and other aviation equipment for the airline, aerospace, and defense industries. Boeing conducts its business in four segments. Its Boeing Commercial Airplanes ("BCA" or "Commercial Airplanes") segment is by far the most lucrative, generating approximately 61.7% of the Company's revenue in 2017 and 45% of its revenue in 2019. That decrease resulted from two fatal crashes involving Boeing's 737 MAX airplanes in 2018 (the "Lion Air Crash") and 2019 (the "Ethiopian Airlines Crash"). **[*5]** Those tragedies caused preventable loss of life, as well as the grounding of Boeing's entire 737 MAX fleet in

---

[1] Docket Item ("D.I.") 131 [hereinafter "Am. Compl]. *See, e.g.*, *Himawan v. Cephalon, Inc., 2018 Del. Ch. LEXIS 585, 2018 WL 6822708, at *2 (Del. Ch. Dec. 28, 2018)*; *In re Gardner Denver, Inc. S'holders Litig., 2014 Del. Ch. LEXIS 27, 2014 WL 715705, at *2 (Del. Ch. Feb. 21, 2014)*. Citations in the form of "Defs.' Ex. —" refer to the exhibits in support of Defendants' Motion, available at D.I. 147 through D.I. 152 and D.I. 160. Citations in the form of "Pls.' Ex. —" refer to exhibits in support of Plaintiffs' opposition to the Motion, available at D.I. 155. And citations in the form of "Hr'g Tr. —" refer to the transcript of the June 25, 2021 oral argument on Defendants' Motion, available at D.I. 169.

Prior to filing this action, Plaintiffs pursued and received books and records pursuant to *8 Del. C. § 220*. Plaintiffs received over 44,100 documents totaling over 630,000 pages. It is reasonable to infer that exculpatory information not reflected in the document production does not exist. *See* *Teamsters Local 443 Health Servs. & Ins. Plan v. Chou, 2020 Del. Ch. LEXIS 274, 2020 WL 5028065, at *24 & n.314 (Del. Ch. Aug. 24, 2020)*.

The Amended Complaint cites documents Plaintiffs obtained under *Section 220*. The parties do not contest that under the incorporation by reference doctrine, I may consider those documents and Defendants' exhibits in support of the Motion to determine whether the Amended Complaint has accurately referenced their contents in support of its claims and in pleading demand futility. *Reiter on Behalf of Cap. One Fin. Corp. v. Fairbank, 2016 Del. Ch. LEXIS 158, 2016 WL 6081823, at *5-6 (Del. Ch. Oct. 18, 2016)*.

In briefing, Plaintiffs did not assert that any of the exhibits Defendants submitted would be improper to consider on the Motion. *See* D.I. 155 at 1 n.1 & 42-44. At argument, Plaintiffs' counsel suggested that the Court should not consider Dennis Muilenburg's "Lion Air Talking Points" for the Board's November 23, 2018 call, submitted as Defendants' Exhibit 86. *See* Hr'g Tr. 125-27. Specifically, Plaintiffs' counsel argued that "it is on its face a draft set of talking points that Mr. Muilenburg had"; and that "it's not incorporated by reference" because Plaintiffs "didn't plead that they were recited . . . to the board," "it's not a board meeting," and "[i]t's not a presentation," but "could have been." *Id.* 125. But Plaintiffs pled that "[t]alking points for the call circulated among Muilenburg and other executives expressed skepticism about media accounts of MCAS's role in the crash." Am. Compl. ¶ 224. Plaintiffs' brief in opposition to the Motion also relied on the talking points. *See* D.I. 155 at 26. Defendants submitted Exhibit 86 in reply. *See* Defs.' Ex. 86. I therefore consider Defendants' Exhibit 86 on the Motion.

At Defendants' urging, I have considered their proffered exhibits to determine if they show that Plaintiffs "misrepresented their contents" or if any inference that Plaintiffs seek is unreasonable. *Flannery v. Genomic Health, Inc., 2021 Del. Ch. LEXIS 175, 2021 WL 3615540, at *8 (Del. Ch. Aug. 16, 2021)* (citing *Voigt v. Metcalf, 2020 Del. Ch. LEXIS 55, 2020 WL 614999, at *9 (Del. Ch. Feb. 10, 2020)*). Through that lens, I find they do no such work for Defendants; in fact, Defendants' exhibits support Plaintiffs' allegations.

March 2019 (the "737 MAX Grounding") and attendant financial and reputational harm to the Company. Plaintiffs seek to hold the defendants in this action accountable for those harms under the principles articulated in *In re Caremark International Inc. Derivative Litigation*[2] and *Marchand v. Barnhill*.[3]

The defendants are current and former Boeing officers (the "Officer Defendants") and members of Boing's Board of Directors (the "Board") (the "Director Defendants," and together with the Officer Defendants, "Defendants"), who allegedly failed to oversee and monitor airplane safety. The Director Defendants include Dennis A. Muilenburg, W. James McNerney Jr., Kenneth M. Duberstein, David L. Calhoun, Mike S. Zafirovski, Admiral Edmund P. Giambastiani Jr., Susan C. Schwab, Caroline B. Kennedy, Arthur D. Collins Jr., Edward M. Liddy, Ronald A. Williams, Lynn J. Good, Randall L. Stephenson, Robert A. Bradway, and Lawrence W. Kellner.[4]

Many of Boeing's Board seats were long-term and awarded to political insiders or executives with financial expertise. For example, Duberstein, the longest-tenured **[*6]** Defendant and a lobbyist with "ultimate insider status," served as a McDonnell Douglas director from 1989 to 1997, and then as a Boeing director from 1997 through April 2019, including as Lead Director from 2005 through April 2018.[5] Duberstein was succeeded in that role by Defendant David L. Calhoun, a private equity executive, who has been a Boeing director since 2009; was appointed Board Chairman in October 2019 in the wake of the 737 MAX crashes; and was appointed Boeing's President and CEO in January 2020.

The Officer Defendants have also had extensive tenures at Boeing. They include the following:

• McNerney has been with Boeing since at least 2001. He served as Boeing's CEO, President, and Chairman of the Board from 2005 until February 2016.

• Muilenburg is a career Boeing executive who started with the Company in 1985. He became Boeing's Vice Chairman, President, and COO in December 2013; CEO in July 2015; and CEO and Chairman of the Board in March 2016, succeeding McNerney. After the 737 MAX crashes, in October 2019, Muilenburg was removed as Chairman and ultimately retired from the Company in December 2019.

• Defendant J. Michael Luttig served as Boeing's EVP and General Counsel **[*7]** from May 2006 to May 2019. In May 2019, following the grounding of the 737 MAX, Luttig was named Counselor and Senior Advisor to CEO Muilenburg and the Board, but left the Company in December 2019.

• Defendant Raymond L. Conner joined Boeing in 1977. He served as Boeing's Vice Chairman from 2014 until his retirement in 2017, and President and CEO of BCA from 2014 until November 2016.

• Defendant Kevin G. McAllister was Boeing's Executive Vice President and President and CEO of BCA from November 2016 (succeeding Conner) until his ouster in October 2019, following the Ethiopian Airlines Crash.

• Defendant Greg Hyslop has been Boeing's chief engineer since July 2016, overseeing all aspects of safety and technical integrity of Boeing products and services. Hyslop is also a member of Boeing's Executive Council and reports to the Company's President and CEO.

• Defendant Diana L. Sands is a member of Boeing's Executive Council and has served as Senior Vice President of Boeing's Office of Internal Governance and Administration since April 2014. As Boeing's chief ethics and compliance officer, she leads Boeing's ethics, compliance, corporate audit and trade controls activities, and reports to Boeing's **[*8]** President and CEO and to Boeing's Audit Committee, discussed *infra*.

• Defendant Greg Smith has served as Boeing's CFO since 2011.

In these roles, Defendants allegedly failed to carry out their respective duties to monitor the safety and airworthiness of Boeing's aircraft, and the extent of those alleged failures only surfaced in the wake of corporate trauma. Rather than prioritizing safety, Defendants lent their oversight authority to Boeing's agenda of rapid production and profit maximization. That misplaced Board focus caused Boeing to bleed millions of dollars in fees, fines, and lost revenue, yet the Company rewarded several of the Defendants with

---

[2] *698 A.2d 959 (Del. Ch. 1996)*.

[3] ***212 A.3d 805 (Del. 2019)***.

[4] Plaintiffs allege Defendant Raymond L. Conner was "vice chairman of Boeing" from 2014 to 2017. Am. Compl. ¶ 39. It is unclear whether Conner was vice chairman of the Board. If he was a director, he is included as a "Director Defendant."

[5] Am. Compl. ¶ 23.

hefty compensation and retirement packages.

A. Boeing Shifts Its Focus From Engineering And Safety To Profits And Rapid Production.

Founded in 1916, Boeing thrived as "an association of engineers."[6] Its executives were "conversant in engineering requirements."[7] As a result, Boeing's culture emphasized engineering and safety, and Boeing emerged as a leading global aerospace manufacturer.

As the Company grew, its focus on safety and engineering fell away. In 1997, Boeing acquired McDonnell Douglas, another airplane manufacturer with a long **[*9]** history of pushing profits, shirking quality control, and designing products involved in numerous safety incidents. With former McDonnell Douglas leaders at the helm, Boeing's corporate culture shifted from "safety to profits-first" and "focusing on costs-cutting rather than designing airplanes."[8] As observed by a longtime Boeing physicist:

> If your business model emphasizes productivity, employee engagement, and process improvement, costs go down faster. This was the essence of the "quality" business model Boeing followed in the mid-90s.
>
> The 777 had the best "learning curve" in the business. On the other hand, if your industry is mature, and your products are commodity-like, business school theory says a cost-cutting model is appropriate.
>
> Wal-Mart perfected its particular version of the cost-cutting business model. Amazon adapted that model to its industry. Boeing has adapted it to high-end manufacturing.[9]

As a result, many of Boeing's engineers felt disenchanted, and in 2000 they staged a forty-day strike to improve Company culture and regain a voice in decision making. By 2001, Boeing relocated its headquarters from Seattle to Chicago in order "to escape the influence of the resident flight **[*10]** engineers."[10]

The internal shift to focus on cost-cutting exacerbated the inherent risks associated with Boeing's business. In the early 2000s, Boeing saw a sharp rise in safety violations imposed by the Federal Aviation Administration (the "FAA"). Between 2000 and 2020, the FAA flagged twenty airplane safety violations for poor quality control, poor maintenance, and noncompliant parts, as well as the Company's failure to provide its airline clients with crucial safety information.[11] Consequently, Boeing faced fines ranging between $6,000 and $13 million.

Quality suffered, and the Company was widely criticized, with prosecutors asking, "Where was the leadership?"[12] Management scandals ultimately led to the ouster of two successive CEOs. Then, in 2005, McNerney was named CEO. McNerney did not have a technical background, and after his appointment, Boeing was described as a "weird combination of a distant building with a few hundred people in it and a non-engineer with no technical skills whatsoever at the helm."[13]

The Company's safety record in the years that followed was spotty. In 2013, the new 787 Dreamliner suffered a series of lithium-ion battery fires **[*11]** and was grounded by the FAA. In 2014, the National Transportation Safety Board ("NTSB") directed Boeing to modify its process for developing safety assessments for designs incorporating new technology, after having determined that (1) Boeing had made misleading and unfounded claims about the lithium-ion battery system in its safety assessment reports to the FAA; (2) Boeing's certification engineers had not properly tested the lithium-ion battery system; and (3) Boeing's safety assessment was insufficient. *Al Jazeera* also conducted and released an investigative report that detailed employee reports of ineffective quality control at a

---

[6] Am. Compl. ¶ 44.

[7] *Id.*

[8] *Id.* ¶ 47.

[9] *Id.* ¶ 55 (quoting Stan Sorscher, a longtime Boeing physicist and negotiator for the Society for Professional Engineering Employees in Aerospace).

[10] *Id.* ¶ 5; *see also id.* ¶ 50. As Boeing's then-CEO Phil Condit explained, "When the headquarters is located in proximity to a principal business—as ours was in Seattle—the corporate center is inevitably drawn into day-to-day business operations." *Id.*

[11] *See id.* ¶ 49. In comparison, the FAA cited Boeing's competitor, Airbus, for only three safety violations during the same period. *Id.*

[12] *Id.* ¶ 52.

[13] *Id.* ¶ 53.

Dreamliner plant that resulted in "foreign object debris" being left in the aircraft, and disclosed that a Boeing customer was refusing to accept Dreamliners manufactured in that plant due to quality concerns.[14]

In addition to the Dreamliner issues, in July 2013, one of Boeing's 777 airplanes crashed, killing three and seriously injuring dozens. An NTSB report concluded that the crash was caused, at least in part, by inadequate plane documentation and training manuals, and recommended improvements in those areas.

Boeing's safety woes continued into 2015 **[*12]** as reflected in thirteen separate pending or potential civil enforcement cases relating to quality control, safety protocol violations, and manufacturing errors in production lines. The FAA investigated these claims and Boeing's failure to take appropriate corrective actions. In December 2015, Boeing entered into an unprecedented settlement with the FAA (the "FAA Settlement") and agreed to pay historic fines of $12 million, with up to $24 million in additional fines deferred pending Boeing acting on a five-year implementation of "additional significant systemic initiatives, to strengthen its regulatory compliance processes and practices."[15] On February 25, 2021, the FAA announced in a press release it had assessed an additional $6.6 million in deferred civil penalties and settlement costs against Boeing.[16]

B. Boeing Lacked Any Formal, Board-Level Process To Oversee Airplane Safety.

Boeing did not implement or prioritize safety oversight at the highest level of the corporate pyramid. None of Boeing's Board committees were specifically tasked with overseeing airplane safety, and every committee charter was silent as to airplane safety. The Board recognized as much: former director John **[*13]** H. Briggs, who retired in 2011, observed that the "board doesn't have any tools to oversee" safety.[17] This stood in contrast to many other companies in the aviation space whose business relies on the safety and flightworthiness of airplanes.[18]

From 2011 until August 2019, the Board had five standing Committees to monitor and oversee specific aspects of the Company's business: (1) Audit, (2) Finance, (3) Compensation, (4) Special Programs, and (5) Governance, Organization and Nominating. The Audit Committee was Boeing's primary arbiter for risk and compliance. Specifically, it "evaluat[ed] overall risk assessment and risk management practices"; "perform[ed a] central oversight role with respect to financial statement, disclosure, and compliance risks"; and "receiv[ed] regular reports from [Boeing's] Senior Vice President, Office of Internal Governance and Administration with respect to compliance with our ethics and risk management policies."[19]

The Audit Committee's charter identifies its responsibilities as

- "[o]btain[ing] and review[ing], on an annual basis, a formal written report prepared by the independent auditor describing [Boeing's] internal quality-control procedures";

- reviewing **[*14]** "[a]ny material issues raised by the most recent internal quality-control review, or peer review, of [Boeing], or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by [Boeing]";
- "[d]iscuss[ing] with management the Company's policies, practices and guidelines with respect to risk assessment and risk management";
- "[a]t least annually receiv[ing] reporting by the [Senior Vice President, Office of Internal Governance and Administration] on the Company's compliance with its risk management processes, and by the General Counsel on pending Law Department investigations of alleged or potentially significant violations of laws, regulations, or Company policies"; and
- "[m]eet[ing] with the [Senior Vice President, Office of Internal Governance and Administration] to review the Company's ethics and business conduct programs and the Company's compliance with

[14] *Id.* ¶¶ 118-21.

[15] *Id.* ¶ 123.

[16] Pls.' Ex 1.

[17] Am. Compl. ¶ 57.

[18] *Id.* ¶ 67 (identifying board-level safety committees and control at Southwest Airlines, Delta Airlines, United Airlines, JetBlue, Spirit Airlines, and Alaska Airlines).

[19] *Id.* ¶ 59.

related laws and regulations."[20]

The Audit Committee was obligated to regularly report to the Board regarding those topics, including "the Company's compliance with legal or regulatory requirements," and "the implementation and effectiveness **[*15]** of the Company's ethics and compliance programs to support the Board's oversight responsibility."[21]

Although the Audit Committee was tasked with handling risk generally, it did not take on airplane safety specifically. Its yearly updates regarding the Company's compliance risk management process did not address airplane safety. For example, when the Board discussed audit plans in 2014 and 2017, respectively, it did not mention or address airplane safety. Specifically as to the 737 MAX, from its development through its grounding in 2019, the Audit Committee never mentioned "safety."[22] Nor did it address product safety issues related to the design, development, or production of the 737 MAX, or ask for presentations on the topic.

Rather, consistent with Boeing's emphasis on rapid production and revenue, the Audit Committee primarily focused on financial risks to the Company. For example, its February 2011 audit plan focused on "production rate readiness activities" and "supplier management rate readiness."[23] Its presentations centered on whether Boeing had liquidity, capital, and supply chain resources sufficient to fund aggressive production of the 737 MAX.[24] Even after the Lion Air Crash **[*16]** in 2018, chief compliance officer Sands's risk management update to the Audit Committee in December 2018 did not identify product safety as a "compliance risk" for 2018.[25]

The Audit Committee also oversaw an Enterprise Risk Visibility ("ERV") process.[26] The ERV process annually provided senior management and the Board with a "comprehensive view of key Boeing Risks and the actions taken to address them," as curated from "[a]ll business units, major functions, and risk and compliance disciplines."[27] The Audit Committee annually reviewed the top strategic, operational, and compliance risks the ERV process identified, and subsequently reported those risks to the Board, which in turn reviewed management's mitigation of those risks.[28] The ERV process also played an important role in Boeing's internal Corporate Audit group, which evaluated priority risk areas within the Company.[29] Based on the results of annual ERV risk assessments, the Corporate Audit group annually submitted an audit plan to review top risks.[30] But neither the Corporate Audit group nor the ERV process specifically emphasized airplane safety; they primarily focused on production and financial risks.[31]

Airplane safety was not a regular set agenda item or topic at Board meetings. Audit Committee and ERV materials reveal that airplane safety risks were not discussed.[32] While the Board sometimes discussed production line safety, the Board often met without mentioning or discussing safety at all.[33] The Board did

[20] *Id.* ¶ 61.

[21] *Id.* ¶ 62.

[22] *Id.* ¶¶ 60, 62-64.

[23] *Id.* ¶ 64.

[24] *See* Defs.' Ex. 6; Defs.' Ex. 10; Am. Compl. ¶¶ 60, 63; *see also infra* note 32.

[25] Am. Compl. ¶ 65.

[26] Defs.' Ex. 7 at - 14500; Hr'g Tr. 9.

[27] Defs.' Ex. 7 at - 14501.

[28] *Id.* at - 14502-04.

[29] Defs.' Ex. 9 at - 14488; Defs.' Ex. 10 at - 17591; Hr'g Tr. 9.

[30] Defs.' Ex. 9 at - 14488-89.

[31] *See* Defs.' Ex. 7; Defs.' Ex. 8 at - 11183-84; Defs.' Ex. 9; Defs.' Ex. 10 at - 17575-92; Defs.' Ex. 23; Defs.' Ex. 24 at - 16424, -16426; Defs.' Ex. 25 at - 16997; *see also* ***[*17]*** *infra* note 32.

[32] Defs.' Ex. 6; Defs.' Ex. 7 at - 14501-04; Defs.' Ex. 9 at - 14489-90, -14495; Defs.' Ex. 10; Defs.' Ex. 13; Defs.' Ex. 23; Defs.' Ex. 24 at - 16424, -16426; Defs.' Ex. 25 at - 16981; *see also* Am. Compl. ¶¶ 64-66. Discussions or mentions of "safety" are similarly absent from the Audit Committee Report and Enterprise Risk Visibility Review sections of the Board meeting minutes Defendants submitted. Ex. 8 at - 11183-84, -11187; Defs.' Ex. 11 at - 12506; Defs.' Ex. 12 at - 12648-49; Defs.' Ex. 19 at - 11606; Defs.' Ex. 26 at - 13570, -13573; Defs.' Ex. 27 at - 11921-23; Defs.' Ex. 28; Defs.' Ex. 29; Defs.' Ex. 34 at - 12382-83; Defs.' Ex. 37 at - 12972; Defs.' Ex. 39 at - 8135; Defs.' Ex. 44; *see also* Am. Compl. ¶ 64. Defendants' Exhibits 28, 29, 39, and 44 were largely redacted in Defendants' *Section 220* production.

[33] Defs.' Ex. 11; Defs.' Ex. 12; Defs.' Ex. 18; Defs.' Ex. 37; Defs.' Ex. 38; Defs.' Ex. 40; Defs.' Ex. 42; Defs.' Ex. 43; Defs.' Ex. 44; Defs.' Ex. 46; Defs.' Ex. 50; Defs.' Ex. 51; Defs.' Ex.

hear presentations discussing "Environment, Health & Safety,"[34] including regarding the workplace safety program "Go4Zero."[35] Communications mentioning "safety," "quality," or "risk" do not reflect substantive discussion related to airplane safety.[36]

Management's periodic reports to the Board did not include safety information. Muilenburg sent the Board a monthly business summary and competitor dashboard, and management made occasional presentations at Board meetings.[37] Those management communications focused primarily on the business impact of airplane safety crises and risks.[38]

Further, the Board did not have a means of receiving internal complaints about airplane safety. Before 2019, Boeing's principal internal safety reporting process was the Safety Review Board ("SRB"). The SRB was Boeing's principal internal **[*18]** safety reporting process, but it had no link to the Board and no Board reporting mechanism.[39] The SRB operated below the level of the most senior officers; the complaints and concerns fielded by the SRB were handled by Boeing's mid-level management like the Program Functional Chief Design Engineer, the Chief Pilot, the Chief Project Engineer, and the Product Safety Chief Engineer and factory leaders. Without a Board-level reporting mechanism, safety issues and whistleblower complaints reported to the SRB did not come to the Board's attention. Neither the Audit Committee, nor any other Board committee, reviewed whistleblower complaints related to product safety.

C. Boeing Develops The 737 MAX In An Effort To Outpace Its Competitors.

With the Board so distanced from safety information, and on the heels of recent safety incidents and inquiries, Boeing continued to push production and forego implementing meaningful systems to monitor airplane safety. Boeing's primary production focus was on its "blockbuster" 737 MAX, which became one of the Company's key revenue sources.[40]

By 2008, Boeing was falling behind on production and sales as compared to its primary competitor, Airbus. In 2010, Airbus **[*19]** announced its fuel-efficient A320neo, which sold well and quickly gained ground on Boeing's 737, which had not been updated since the late 1990s. As Boeing clients began considering Airbus's fuel-efficient jets, Boeing felt production and sales pressure.

In 2010 and early 2011, Boeing considered two options for updating its existing 737 Next Generation ("737 NG") model: either develop an entirely new airplane, which could take a decade, or redesign the current model with

---

52. These documents do not support Defendants' argument that the Board had a reporting structure and processes to oversee airplane safety and the 737 MAX. *See* Hr'g Tr. 8.

[34] *See, e.g.*, Defs.' Ex. 9 at - 14495 (listing "safety" within "Environment, Health & Safety" in the Appendix D Risk Universe); Defs.' Ex. 10 at - 17589 ("Supply Chain Operations (SCO) Environment, Health & Safety, Safety Management System Renton 737 Programs Governance" and "Evaluate processes for Renton site safety oversight related to 'Go for Zero' execution to achieve overall relevant Enterprise Safety objectives"); *see also* Defs.' Ex. 7; Defs.' Ex. 10 at - 17572-73, -17583, -17587; Defs.' Ex. 20 at - 13047, -13066; Defs.' Ex. 23 at - 15866; Defs.' Ex. 24 at - 16426; Defs.' Ex. 25 at - 16981; Defs.' Ex. 84 at - 618225, -618235, -618240, -618242, -618248.

[35] *See, e.g.*, Defs.' Ex. 19 at - 11603 ("Mr. Shanahan then provided a Safety Update. He began by reviewing the evolution of the 'Go for Zero' safety program since 2007. He next reviewed safety performance and workplace injury statistics for operations and non-operations activities. Mr. Shanahan then reviewed safety focus areas, including improvements in final assembly and structures manufacturing, ongoing prevention activities and the roles of data analytics in improving safety performance."); *see also* Defs.' Ex. 10 at - 17589; Defs.' Ex. 16 at - 11076; -11078; Defs.' Ex. 17 at - 11646.

[36] Defs.' Ex. 6 at - 20519; Defs.; Ex. 8 at - 11183; Defs.' Ex. 16 at - 11073, -11077-80; Defs.' Ex. 17 at - 11646; Defs.' Ex. 20 at - 13057; Defs.' Ex. 21 at - 2692; Defs.' Ex. 22 at - 18837-38 ("Model-Based Engineering (MBE) - Progress . . . Improve safety, quality, productivity, cost"); Defs.' Ex. 25 at - 16997; Defs.' Ex. 37 at - 12967; Defs.' Ex. 39 at - 8133, -8135; Defs.' Ex. 40 at - 8086; Defs.' Ex. 41 at - 8315; Defs.' Ex. 42 at - 12481; Defs.' Ex. 43 at - 12842; Defs.' Ex. 44 at - 2501; Defs.' Ex. 45 at - 1960; Defs.' Ex. 50 at - 2711; Defs.' Ex. 52 at - 11401; Defs.' Ex. 62 at - 13680-81; Defs.' Ex. 63 at - 13682; Defs.' Ex. 70 at - 13684.

[37] *See, e.g.*, Defs.' Ex. 62.

[38] Am. Compl. ¶¶ 7, 8, 14, 17, 18, 57-76; *see* Defs.' Ex. 60 at - 13677; Defs.' Ex. 73 at - 2944; Defs.' Ex. 74 at - 2947; *see also supra* notes 34-36 and accompanying text.

[39] Hr'g Tr. 30-33; Am. Compl. ¶¶ 74-76.

[40] *See* Am. Compl. ¶ 6.

larger, more efficient engines in six years. In an effort to regain competitive ground, and amid concerns about production cost and timing, Boeing elected to update the 737 NG. If developed as a "derivative plane," Boeing would only need to secure FAA certification for those changes between the 737 NG and the new plane.[41] The FAA assesses the minimum level of "differences training" required for a pilot to fly a new airplane by evaluating the similarity between the new and prior versions of the airplane.[42]

At a June 2011 Board meeting, the Board and senior management considered the potential redesign of the 737 NG. Jim Albaugh, Head of BCA, pressed the production and sales benefits of the 737 NG's potential "re-engine": **[*20]** gains in fuel efficiency, non-recurring investment costs, capital costs, and expedited re-design schedules.[43] The Board concluded the reconfigured airplane would have larger and more fuel-efficient engines intended to "restore[] competitive advantage over [Airbus's] NEO."[44]

So at an August 2011 Board meeting, the Board approved development of Boeing's next generation of narrow-body commercial aircraft: the 737 MAX, which would be a reconfigured version of the 737 NG that "incorporat[ed] new engine technology and such other modifications and upgrades as are deemed appropriate in light of prevailing market conditions."[45] The August 2011 Board minutes describe the "strategy and objectives associated with a re-designed 737 airplane, including increasing customer value, maintaining market share and a competitive advantage over the Airbus 320neo, reducing risk and enabling wide body product investment."[46] According to three people present at the August Board meeting, no Board member asked about the safety implications of reconfiguring the 737 NG with larger engines. Rather, the Board inquired about engine options, program personnel, development schedule contingencies, and customer contract **[*21]** provisions regarding performance and penalties; the Board's primary concern was "how quickly and inexpensively the Company could develop the 737 MAX model to compete with Airbus's A320neo."[47] The Board delegated to McNerney all authority over the multi-year effort to approve the 737 MAX's final specifications, and deliver and build it, without having to return to the Board.

1. Boeing Implements The "MCAS" System In The 737 MAX.

In developing and marketing the 737 MAX, Boeing prioritized (1) expediting regulatory approval and (2) limiting expensive pilot training required to fly the new model. As explained by a former Boeing engineer who worked on the 737 MAX's flight controls, Boeing "wanted to A, save money and B, to minimize the certification and flight-test costs."[48]

Because the Company was months behind Airbus in developing a new airplane, Boeing set a "frenetic" pace for the 737 MAX program, resulting in hastily delivered technical drawings and sloppy, deficient blueprints.[49] Boeing's engineers were instructed to maintain "commonality" with the 737 NG in order to expedite FAA certification.[50] But maintaining commonality posed unique design issues.

In particular, the **[*22]** 737 MAX's larger engine needed to be situated differently on the airplane's wings, shifting its center of gravity. Because of that engine placement, the 737 MAX tended to tilt too far upwards, or "pitch up," in flight.[51] Initial attempts to resolve the issue with aerodynamic solutions failed. So Boeing addressed the issue with new software: the Maneuvering Characteristics Augmentation System, or "MCAS."[52] MCAS moved the leading edge of the plane's entire horizontal tail, known as the "horizontal stabilizer," to

[41] *Id.* ¶ 138.

[42] *Id.* ¶ 163.

[43] *Id.* ¶ 133.

[44] *Id.*

[45] *Id.* ¶ 135; *see id.* ¶¶ 6, 133-34.

[46] *Id.* ¶ 267.

[47] *Id.* ¶ 134.

[48] *Id.* ¶ 138.

[49] *Id.* ¶ 137.

[50] *Id.* ¶ 138 (explaining that "commonality" is "an industry term that evaluates how similar one model is to its predecessor").

[51] *Id.* ¶ 150.

[52] *Id.* ¶¶ 9, 152-53, 155.

push the airplane's tail up and its nose down.[53]

As originally designed, MCAS would activate only if the plane pitched up at both a high angle of attack (or "AOA") and a high G-force (the plane's acceleration in a vertical direction). During 2016 flight testing, Boeing changed MCAS to allow it to activate at low speeds; as such, it "could be automatically triggered simply by a high AOA."[54]

The external sensor for AOA was highly vulnerable to false readings or failure for numerous reasons, such as general weather, lightning, freezing temperatures, software malfunctions, or birds. The AOA's sensor's vulnerability was well-known: between 2004 and 2019, failed AOA sensors were **[*23]** flagged to the FAA in more than 216 incident reports, including instances that required emergency landings. MCAS had only one AOA sensor, creating a "single point of failure" that violated the fundamental engineering principle requiring redundancy "so that one single error in a complex system does not cause total system failure."[55] If the single AOA sensor was triggered, even for a flawed reason unrelated to the plane's pitch, MCAS would "correct" the aircraft by pushing its nose down.[56]

In 2013, Boeing engineers proposed that the 737 MAX implement a Dreamliner safety feature called "synthetic airspeed" to detect a false AOA signal.[57] Managers rejected that proposal due to additional cost and pilot training, and MCAS remained dependent on a single fickle AOA sensor. Engineers remained skeptical; in late 2015, one queried: "[a]re we vulnerable to single AOA sensor failures with the MCAS implementation or is there some checking that occurs?"[58]

Boeing's analyses and FAA disclosures about MCAS underestimated its lethality. In 2014, Boeing submitted a System Safety Assessment (an "Assessment") to the FAA calculating the effect of possible MCAS failures. The Assessment did not consider **[*24]** the possibility that MCAS could trigger repeatedly, effectively giving the software unlimited authority over the plane. Boeing concluded MCAS was not a "safety-critical system."[59] After MCAS was revised to rely on the single AOA sensor, internal safety analyses concluded that MCAS could cause "catastrophic" failures if it took a pilot more than ten seconds to identify and respond to the software's activation.[60] But the analyses assumed the pilot would react within four seconds, and so concluded that the likelihood of a "hazardous event" due to an MCAS failure was nearly inconceivable.[61] It would later be revealed that Boeing's four-second reaction time assumption was a "gross underestimate."[62]

Boeing did not update the 2014 FAA Assessment for MCAS as revised. Boeing's technical pilots deceived the FAA by failing to disclose that MCAS as revised activated only upon the AOA sensor signal, regardless of speed, increasing the likelihood that MCAS would activate.

2. Boeing Pushes Expedited Certification And Rapid Production.

Based on purported commonality with the 737 NG, Boeing sought "Level B" pilot training for the 737 MAX, which can be done on a tablet computer without costly flight **[*25]** simulator training.[63] More extensive training would incur additional costs, defeat the economies from commonality with the 737 NG, and make the 737 MAX less competitive with the Airbus 320neo. Between 2014 and 2017, Boeing touted that flight simulator training would not be necessary on the 737 MAX.

[53] *Id.* ¶ 152.

[54] *Id.* ¶ 155.

[55] *Id.* ¶¶ 159-60. A 2011 FAA Advisory Circular warned that "[h]azards identified and found to result from probable failures are not acceptable in multiengine airplanes," and that "[i]n these situations, a design change may be required . . . such as increasing redundancy." *Id.* ¶ 159.

[56] *Id.* ¶ 190 ("[A]n analysis performed by the manufacturer showing that if an erroneously high single [AOA] sensor input is received by the flight control system, there is a potential for repeated nose-down trim commands of the horizontal stabilizer.").

[57] *Id.* ¶ 161.

[58] *Id.* ¶ 160.

[59] *Id.* ¶ 154.

[60] *Id.* ¶ 156.

[61] *Id.*

[62] *Id.*

[63] *Id.* ¶ 164.

Boeing and its well-connected leadership had significant sway over the FAA, and the FAA often permitted Boeing to self-regulate. Boeing put "tremendous pressure" on its Chief Technical Pilot Mark Forkner to obtain Level B pilot training for the 737 MAX.[64]

In August 2016, the FAA issued a provisional report establishing Level B training for the 737 MAX. In November, after Boeing had revised MCAS, Forkner texted a colleague that MCAS was "running rampant" on a flight simulator when operating at a low speed and then texted: "so basically I lied to the regulators (unknowingly)."[65] Still, Forkner stressed to the FAA that it should not reference MCAS in its report because it was "outside the normal operating envelop[e]."[66]

In July 2017, the FAA published **[*26]** the final 737 MAX report providing for Level B differences training determination. Based on Boeing's failure to submit a new Assessment on the revised MCAS and misrepresentation of MCAS's safety risks, the FAA deleted all information about MCAS from the July 2017 report.[67] Forkner emailed a Boeing colleague bragging that his "jedi mind tricks" had worked on the FAA.[68]

As a result of the FAA's decision, the 737 MAX airplane manuals and pilot training materials for U.S.-based airlines lacked specific information about MCAS.[69] Specifically, no substantive description of MCAS appeared in Boeing's three documents for pilots flying new models: (1) the Flight Crew Operations Manual ("FCOM"), the primary pilot reference; (2) the Quick Reference Handbook, a shorter emergency manual for abnormal flight situations; and (3) the Flight Crew Training Manual, which provides general recommendations on flying maneuvers and techniques. After the Lion Air and Ethiopian Airlines Crashes, senior FAA officials testified before Congress that MCAS should have been explained in those manuals.

After securing Level B training, Boeing continued to conceal issues with the 737 MAX. The airplane was supposed **[*27]** to have an "AOA disagree alert" to identify malfunction in the airplane's AOA sensor and prevent it from triggering MCAS's "repeated nose-down trim commands of the horizontal stabilizer."[70] That alert was a standard feature of the 737 NG.[71] Boeing included the alert in the March 2017 "type certificate" submitted to the FAA, so the alert was required in all planes produced.[72] But in August 2017, Boeing learned the alert did not function due to a software issue; to make it work, customers needed to purchase an optional "add-on" feature for $80,000 called an "AOA indicator display."[73] The AOA disagree alerts did not work in at least 80% of the 737 MAX planes Boeing delivered—including the Lion Air and Ethiopian Airlines planes that crashed. Boeing did not tell the FAA or its customers that the majority of its planes had inoperable AOA disagree alerts until after the Lion Air Crash in 2018. And even after the 2019 Ethiopian Airlines Crash, Boeing continued to insist that the AOA indicator display was not a "required" safety feature and that it was appropriate to offer it as an optional "add on."[74] Boeing decided to repair the AOA disagree alert via a software update that was not scheduled to roll **[*28]** out until 2020.

3. Boeing Successfully Markets The 737 MAX In Emerging Markets And Presses The Board's Business Objectives; Boeing's Employees Question The 737 MAX's Safety, But Those Concerns Never Reach The Board.

Four months after announcing the 737 MAX in 2011, Boeing had logged more than 1,000 orders and commitments for the airplane from airlines and leasing customers worldwide. By 2014, Boeing had over 2,700 737 MAX orders from fifty-seven customers. And by the end of 2016, Boeing had 4,300 orders from ninety-two

[64] *Id.* ¶ 105.

[65] *Id.* ¶ 169; *see id.* Ex. A; *id.* Ex. B at A-10.

[66] *Id.* ¶ 170 ("[O]ne of the Program Directives we were given was to not create any differences . . . That is what we sold to the regulators who have already granted us the Level B differences determination. *To go back to them now, and tell them there is in fact a difference . . . would be a huge threat to that differences training determination*.").

[67] *Id.* ¶ 106; *id.* Ex. B.

[68] *Id.* ¶ 171.

[69] *Id.* ¶¶ 106, 173; *id.* Ex. B.

[70] *Id.* ¶¶ 175, 190.

[71] *Id.* ¶ 175.

[72] *Id.* ¶ 177.

[73] *Id.* ¶ 176.

[74] *Id.* ¶ 180.

customers. The 737 MAX had become the fastest-selling airplane in Boeing's history.

Many of those sales originated from Boeing's target customers in emerging markets. Boeing pursued those customers in a cost-saving and revenue-enhancing strategy, knowing that in many countries with expanding fleets of low-cost airlines, the quality of pilot training was not consistently as high as in the United States. Those countries took their safety cues from the FAA. Although Lion Air and Garuda Indonesia Airlines both initially requested simulator training on their newly purchased 737 MAX airplanes, Boeing pressed that computer-based training was sufficient.[75] Boeing never **[*29]** required or provided simulator training. By December 2017, Boeing had sold numerous 737 MAX airplanes to airlines in Southeast Asia, including Lion Air.

Boeing began fulfilling customer orders in May 2017.[76] By 2018, Boeing's profits from the 737 MAX skyrocketed.[77] The BCA accounted for approximately 60% of the Company's record $101.1 billion in annual revenue and approximately $8 billion, or 80%, of the Company's annual net earnings.[78] By the end of 2018, the value of Boeing's total backlog of orders—a measure of financial health for an airplane manufacturer—had risen to $490 billion, with the BCA accounting for $412 billion and nearly 5,900 jetliners, more than 4,000 of which were 737 MAX airplanes.

Boeing struggled to keep up with demand and customer expectations and to meet the Board's production and delivery target of fifty-seven airplanes per month. In July and August 2018, deliveries averaged approximately thirty-nine airplanes per month. Falling behind, Boeing employees worked in a "factory in chaos," facing intense pressure to maintain production schedules.[79]

As Boeing's 737 MAX's sales accelerated, its employees grew concerned about the airplane's safety. For example, **[*30]** in summer 2018, a longtime general manager and engineer at the 737 MAX plant in Renton, Washington, tried to raise "Recovery Operations & Safety Concerns" with the 737 program's general manager and factory leader, writing, "[R]ight now all my internal warning bells are going off. . . . And for the first time in my life, I'm sorry to say that I'm hesitant about putting my family on a Boeing airplane."[80] At a meeting, the engineer expressed that he had "seen larger operations shut down for far less safety issues . . . in the military and those organizations have national security responsibilities."[81] The manager responded, "The military isn't a profit making organization."[82] The engineer retired from Boeing soon thereafter. Before and after the Lion Air Crash, similar concerns came in from other employees regarding unrelenting and dangerous economic pressure from senior management to produce the 737 MAX rapidly and cheaply.[83]

---

[75] *Id.* ¶ 143 (explaining that "rather than provide costly simulator training, Boeing employees emphasized that the 'FAA, [European regulators], Transport Canada, China, Malaysia, and Argentinia [*sic*] authorities have all accepted the [computer-based training] requirement'").

[76] *Id.* ¶ 144.

[77] *Id.* ¶ 146.

[78] *Id.*

[79] *Id.* ¶ 148.

[80] *Id.* ¶ 87.

[81] *Id.* ¶ 89.

[82] *Id.*

[83] *See id.* ¶ 90 ("Separately, in 2018, . . . a Boeing engineering manager working on the 737 MAX, expressed frustration to Director of Global Operations . . . that Boeing had selected 'the lowest cost supplier and sign[ed] up to impossible schedules,' which reflected unrelenting and dangerous economic pressure from senior management: [']*I don't know how to fix these things* . . . it's systemic. It's culture. It's the fact that we have a senior leadership team that understand very little about the business and yet are driving us to certain objectives. . . . *Sometimes you just have to let things fail big so that everyone can identify a problem* . . . maybe that's what needs to happen rather than just continuing to scrape by.[']"); *id.* ¶ 91 ("In July 2018, Boeing's Test and Evaluation department voiced concerns to 'Boeing Executive Leadership' regarding the 'considerable pressure' the 737 MAX program faced over production schedules. The department's letter identifies the 'ero[sion of] safety margins' due to the declining average experience among senior production pilots. [Boeing's] Employee Relations Director . . . forwarded the communication to defendant Hyslop, Boeing's chief engineer, but . . . mischaracterized the letter as seeking mainly compensation and additional benefits, without flagging the safety concerns of overworked employees."); *id.* ¶ 92 ("[I]n November 2018, after the Lion Air Crash, . . . a Quality Assurance Inspector and nearly 30-year Boeing veteran, recounted mistreatment 'for reporting serious quality problems,' explaining that '[n]o one should have to go through this when trying to do what is right — to assure the quality of our product.' He added, 'I have stood alone during these past months trying to assure that we have addressed these quality issues. I had only hoped that

While some of these complaints made their way to senior management, none made it to the Board. The Board was unaware of whistleblower **[*31]** complaints regarding airplane safety, compliance, workforce exhaustion, and production schedule pressure at the 737 MAX facility.

D. Undisclosed Issues With The 737 MAX Ultimately Cause The Lion Air and Ethiopian Airlines Crashes; The Board Continues To Shirk Safety Oversight, Receiving Only Sporadic Updates About The 737 MAX From Management.

On October 29, 2018, a new 737 MAX flying as Lion Air Flight 610 crashed in the Java Sea minutes after taking off from Jakarta, Indonesia, killing all 189 passengers and crew. Satellite data show the plane rising and falling repeatedly, as MCAS continually activated to force the airplane's nose downwards. The plane's black box data revealed that the pilots searched the Quick Reference Handbook's checklist for abnormal flight events, but it said nothing about MCAS, which was later identified as the cause of the tragedy. Within days of recovering the black box, Boeing started revising MCAS.

The FAA quickly conducted a risk assessment analysis and concluded what many at Boeing already knew: that there was an unacceptably high risk of catastrophic failure if MCAS was not changed, estimating that the then-existing fleet of Boeing 737 MAX planes would **[*32]** average one fatal crash stemming from MCAS every two to three years if the software was not corrected. Boeing then conducted its own risk assessment and reached a conclusion consistent with the FAA's. On November 6, Boeing issued an Operations Manual Bulletin to the airlines (the "Manual Bulletin"), stating, "[i]n the event of erroneous AOA sensor data, the pitch trim system can trim the stabilizer nose down in increments lasting up to 10 seconds."[84] It did not name MCAS.

The next day, November 7, the FAA issued an Emergency Airworthiness Directive (the "Emergency Directive"), indicating that "an unsafe condition exists that requires immediate action by an owner/operator."[85] The Emergency Directive described "an analysis performed by the manufacturer showing that if an erroneously high single [AOA] sensor input is received by the flight control system, there is a potential for repeated nose-down trim commands of the horizontal stabilizer."[86] The FAA mandated that Boeing revise its flight manuals "to provide the flight crew horizontal stabilizer trim procedures to follow under certain conditions."[87] In response, Muilenburg emailed Greg Smith warning the mandate might harm productivity: "[w]e **[*33]** need to be careful that the [airplane flight manual] doesn't turn into a compliance item that restricts near-term deliveries."[88]

On November 12, *The Wall Street Journal* published an article entitled "Boeing Withheld Information on 737 Model, According to Safety Experts and Others" (the "*WSJ* Article").[89] It reported that "neither airline managers nor pilots had been told such a[n MCAS] system had been added to the latest 737 variant—and therefore aviators typically weren't prepared to cope with the possible risks."[90] It reported disdain by pilots who questioned why they were not properly trained on the MCAS system.[91] Finally, the *WSJ* Article reported that the FAA learned the new flight control systems "were not highlighted in any training materials or during lengthy discussions between carriers and regulators about phasing in the latest 737 derivatives" and that Boeing purposefully withheld that critical information.[92]

1. The Board Passively Receives Lion Air Crash Updates From Muilenburg, But Does Not Initiate Action.

management would have stood with me.' [The employee] identified another whistleblower . . . a former quality specialist and compliance monitor, whom he said was also harassed in retaliation for reporting of 'quality concerns' related to the 737 MAX.").

[84] *Id.* ¶ 188.

[85] *Id.* ¶ 189.

[86] *Id.* ¶ 190.

[87] *Id.* ¶ 191.

[88] *Id.* ¶ 211.

[89] *Id.* ¶¶ 195-98; *id.* Ex. D.

[90] *id.* Ex D; *id.* ¶ 198.

[91] *Id.* Ex. D ("It's pretty asinine for them to put a system on an airplane and not tell pilots who are operating the airplane, especially when it deals with flight controls . . . . Why weren't they trained on it?"); *id.* ¶ 198.

[92] *id.* Ex. D; *id.* ¶ 197.

Management did not bring the Lion Air Crash to the Board's attention for over a week. Muilenburg first contacted the Board, Smith, and McAllister **[*34]** regarding the Lion Air Crash on November 5.[93] His half-page email identified the players in the investigation, reported that the Indonesian investigator "publicly said today that the airspeed indicator on the airplane that crashed was damaged during the last four flights of the airplane," and concluded, "We believe the 737 MAX fleet is safe."[94] It did not mention MCAS, the lack of redundancy for a faulty sensor, or the missing sensor alert or specific pilot instructions.

Muilenburg updated the Board again between November 8 and 23, spurred by unfavorable information about the 737 MAX and Lion Air Crash becoming public.[95] On November 13, Director Arthur Collins forwarded Muilenburg a news summary: "I am sure you have already read [the *WSJ* Article] and will brief the [B]oard on this topic."[96] Muilenburg consulted with then-current and former Lead Directors Calhoun and Duberstein about the *WSJ* Article and its fallout.[97] Calhoun advised Muilenburg to contact the Board. And so on November 13, Muilenburg sent a memo to the Board regarding the Lion Air Crash.[98] He told the Board the *WSJ* Article was "categorically false" and "wrongly claims Boeing withheld from customers and flight crews information **[*35]** related to a pitch augmentation system that's unique to the 737 MAX."[99] And he blamed the Lion Air flight crew for the crash.[100] He did not explain that Boeing knew MCAS was vulnerable and susceptible to failure, nor that pilots were not informed about or trained on MCAS.

The next day, Muilenburg informed Duberstein that Calhoun "suggested that my note to the Board focus solely on the Lion Air matter given the importance and visibility," and that he would update the Board on Lion Air the following weekend.[101] Duberstein's response focused on the negative public reaction to the Lion Air Crash and its impact on production: "Press is terrible. Very tough. Lots of negative chatter I'm picking up. Not pleasant. We need to address more aggressively concerns merging re 737 line, deliveries, and Lion Air."[102] Muilenburg responded that he was "working all angles" on public relations, government relations, and investor relations, including "working airline operations leaders to get messages and counter pilot comments (who are motivated to get separate type rating for MAX — equals more pay)."[103]

On November 17, Boeing executives, including Muilenburg, Smith, McAllister, Hyslop, **[*36]** and Luttig, discussed a *Bloomberg* article that Muilenburg characterized as "filled with misleading statements and inaccuracies — implying that we hid MCAS from operators and that procedures were not covered in training/manuals."[104]

On November 18, after *The New York Times* published an article addressing MCAS's role in the Lion Air crash, Muilenburg sent the Board another letter.[105] He bemoaned "a steady drumbeat of media coverage—and continued speculation—on what may have caused the accident" and again falsely suggested that the 737 MAX was safe.[106] Muilenburg took the same position in November 19 and 20 internal messages to Boeing employees and executives.

Then, on November 21, Muilenburg emailed the Board to invite them to an "optional" November 23 Board call for an update on the Lion Air Crash from Muilenburg, Luttig, and Smith.[107] This was the first time the Board convened after the crash. There are no minutes. Management's talking points for the call explained that erroneous AOA data "contributed to the mishap," and that the Lion Air repair shop may not have followed the

93 *id.* ¶¶ 208-09; Defs.' Ex. 55.

94 Defs.' Ex. 55.

95 *See* Defs.' Ex. 53; Defs.' Ex. 56; Defs.' Ex. 57; Defs.' Ex. 58.

96 Am. Compl. ¶ 212.

97 *See id.* Ex. E.

98 *See id.* Ex. D.

99 *Id.*; Defs.' Ex. 57.

100 Am. Compl. Ex. D.

101 *See id.* Ex. E.

102 *Id.*

103 *Id.*; *id.* ¶ 214.

104 *Id.* ¶ 217.

105 Defs.' Ex. 58; Am. Compl. ¶ 218.

106 Defs.' Ex. 58.

107 Am. Compl. ¶¶ 223-24; Defs.' Ex. 59 ("Consider this phone call 'optional', understanding that many of you have family and friend activities planned for this coming weekend.").

approved repair process on the sensor.[108] The talking points included an explanation of MCAS, and described Boeing's post-Lion **[*37]** Air Crash updates to operators regarding erroneous AOA sensors and MCAS. They also explained the "further safety enhancement" of a software update "that will limit the airplane's response in case of erroneous AOA sensor data" and "further reduce the risk associated with a discrepant AOA sensor and help reduce pilot workload."[109] The talking points also provided that "the function performed by MCAS" was referenced in the FCOM, that the "appropriate flight crew response to uncommanded trim, regardless of cause, is contained in existing procedures," and that "any suggestion that we intentionally withheld information about airplane functionality from our customers simply isn't true."[110] They disclosed a meeting the week before with the acting FAA Administrator, who "understood how MCAS works and believes the 737 MAX is a safe airplane," and who knew about the repair shop investigation. Finally, the talking points expressed frustration with people "commenting freely, including customers, pilot unions, media, and aerospace industry punditry," and addressed Lion Air's orders, other customers' orders, and Boeing's stock price.[111]

Muilenburg's subsequent written communications to the Board again **[*38]** blamed Lion Air's crew, and stressed that Boeing's external statement denying its fault was "showing up in the initial media coverage, which has focused largely on Lion Air's operations, maintenance practices and decision to fly with malfunctioning angle of attack sensors."[112] Muilenburg encouraged Boeing's public relations team to maintain that the 737 MAX was safe, and on December 13, he reported to the Board that "members of our Communications team met with *Wall Street Journal* editors in New York to further discuss ongoing coverage and restate our expectation for fair and fact-based reporting."[113]

2. The Board Formally Addresses The Lion Air Crash For The First Time In December 2018, But Does Not Focus On The 737 MAX's Safety Then Or Thereafter.

After the November 23 optional update, the Board did not formally convene and address the Lion Air Crash until its regularly scheduled Board meetings on December 16 and 17. Consistent with the fact that safety was not a regular topic of Board discussion, the minutes reflect that the Board's primary focus relating to the 737 MAX and Lion Air Crash was on restoring profitability and efficiency in light of longstanding supply chain issues. Over **[*39]** the course of two days, the Board allocated five total minutes to eight different "Watch Items," one of which was "progress working through supply chain and factory disruption affecting MAX deliveries."[114] The Board allocated another five minutes to reviewing a four-page legal memo "including matters related to the Lion Air incident."[115] And it allocated ten minutes to Compliance Risk Management.[116] The associated risk management report contained one page on the FAA Settlement, which said nothing about the 737 MAX or airplane safety generally.[117] In the Executive Session presentation, the "Lion Air incident" was listed as a "Hot Topic."[118]

The Audit Committee met, too. The material it intended to present to the full Board included an "Ethics and Compliance Update," but did not contain any meaningful information about the 737 MAX's safety or safety generally.[119] An Ethics and Compliance Update presentation dated December 17, 2018, included a chart summarizing "Substantiated Cases" of eight categories of "Inquiries and Investigations," including "Safety, Health & Environmental" alongside "Sexual Harassment," "Proper Use of Co. Time or Resources," and "Information Integrity."[120] The agendas for the Audit **[*40]** Committee's forthcoming 2019 meetings did

[108] Defs.' Ex. 86.

[109] *Id.*

[110] *Id.*

[111] Am. Compl. ¶ 224; Defs.' Ex. 86.

[112] Am. Compl. ¶ 226.

[113] Defs.' Ex. 60; *see* Am. Compl. ¶ 227.

[114] Defs.' Ex. 61 at 2; Defs.' Ex. 84 at - 618197, -618203.

[115] Defs.' Ex. 14; Defs.' Ex. 61 at 2; Defs.' Ex. 84 at - 618197, - 618204-07. That memo was wholly redacted in Defendants' *Section 220* production.

[116] Defs.' Ex. 84 at - 618197.

[117] *Id.* at - 618233.

[118] Am. Compl. ¶ 231.

[119] Defs.' Ex. 84 at - 618218-28.

[120] *Id.* at - 618225.

not indicate any focus on airplane safety.[121] The December 16 and 17 Board meeting did not result in any meaningful action to address airplane safety by either the full Board or the Audit Committee.

The Board next received information about the Lion Air Crash on January 16, 2019, when Muilenburg sent his monthly business summary and competitor dashboard.[122] It began with a one-paragraph "brief update on the ongoing Lion Air flight 610 accident investigation" that was proceeding with Boeing's "full support."[123] Muilenburg also noted that Boeing is "exploring potential 737 MAX software enhancements that, if made, would further improve the safety systems," and maintained that "airlines around the world continue to operate the MAX safely" and were "ma[king] significant new orders and commitments, expressing strong confidence in the airplane."[124] After mentioning safety in passing, Muilenburg moved on to a detailed discussion of the market's confidence in the 737 MAX, and Boeing's "financials" and "strong operating performance and solid cash generation," which were "driven by solid commercial . . . deliveries . . . as well as continued focus on productivity." **[*41]** [125] He expressed that Boeing had "set a new industry and company record and validated our team's 737 recovery efforts," and noted that 2019 was "already off to a strong start," as the Company was "focus[ed]" on "driving 737 production line stability and preparation for the 57 aircraft per month rate decision."[126] The dashboard concluded with an overview of political issues affecting the Company.[127]

Muilenburg sent his next monthly business summary and competitor dashboard to the Board on February 13.[128] It did not mention the Lion Air Crash.[129] Muilenburg wrote that Boeing would continue to work with the FAA on a "737 MAX software enhancement that, when implemented, will further improve system safety;" that "[d]espite recent media speculation," nothing had been decided about the "software update and its timing;" and that "[w]e'll keep engaging media and other stakeholders on the merits of the airplane, our processes and our people."[130] It went on:

> And on 737, we're driving production line stability and engaging key suppliers, with a particular focus on CFM engines, as we prepare for a decision later this year on increasing rate to 57 airplanes per month. . . . We remain on track to achieve **[*42]** our quarterly delivery target of 206 planes (including 147 737s), and ramp-up of 737 deliveries in February and March remains an intense focus area.[131]

And it highlighted financials, noting that "Boeing stock [recently] closed at an all-time high."[132]

One week later, on February 20, Executive Vice President and General Counsel Michael Luttig provided a report to the Audit Committee summarizing significant legal matters, including the "Lion Air Accident."[133]

3. The Board Decides To Forego Investigation, And Boeing Belatedly Admits It Deceived The FAA.

The Board next met formally on February 24 and 25. As reflected in the Executive Session presentation, two of the "Other Updates" on "Key Topics" were "737 Production" and "Lion Air Accident."[134] On February 25, the Board issued an addendum to its meeting minutes summarizing a legal update from Luttig.[135] The addendum states that the Board "decided to delay any investigation until the conclusion of the regulatory investigations or until such time as the Board determines that an internal investigation would be appropriate."[136]

---

[121] *Id.* at - 618301.

[122] Am. Compl. ¶ 233; Defs.' Ex. 62.

[123] Defs.' Ex. 62.

[124] *Id.*

[125] *Id.*

[126] *Id.*

[127] *Id.*

[128] Am. Compl. ¶ 234; Defs.' Ex. 63.

[129] *See generally* Defs.' Ex. 63.

[130] *Id.* at - 13683.

[131] *Id.* at - 13862.

[132] *Id.*

[133] Defs.' Ex. 15. The remainder of that report was redacted in the *Section 220* production.

[134] Defs.' Ex. 64 at - 575.

[135] Pls.' Ex. 4; Am. Compl. ¶ 238.

[136] Pls.' Ex. 4.

By January 2019, the Department of Justice ("DOJ") had opened a criminal investigation into whether Boeing had defrauded **[*43]** the FAA when obtaining certification of the 737 MAX. In February 2019, Boeing gave the DOJ Forkner's November 2016 text messages admitting he had lied to the FAA.[137] Muilenburg and Luttig were aware of the text messages in the first couple of months of 2019. Muilenburg, Luttig, and Boeing did not provide those text messages to the FAA until October 2019. The FAA demanded an explanation for Forkner's remarks and "Boeing's delay in disclosing the document to its safety regulator."[138]

As stated in Boeing's eventual 2021 agreement with the DOJ, Boeing "did not timely and voluntarily disclose to the Fraud Section the offense conduct described in the Statement of Facts" and Boeing's cooperation "was delayed and only began after the first six months of the Fraud Section's investigation, during which time the Company's response frustrated the Fraud Section's investigation."[139] As a result, Boeing agreed to pay a "Total U.S. Criminal Monetary Amount" of $2.513 billion, composed of a criminal monetary penalty of $243.6 million, compensation payments to Boeing's 737 MAX airline customers of $1.77 billion, and the establishment of a $500 million crash-victim beneficiaries fund.[140]

4. MCAS Causes [*44] The Ethiopian Airlines Crash.

On March 10, less than one month after the Board declined to pursue an internal investigation, another 737 MAX crashed. Ethiopian Airlines Flight ET 302 went down shortly after taking off, killing all 157 passengers and crew. The pilots followed Boeing's recommended emergency procedures, but could not regain control of the plane because MCAS repeatedly activated.

5. Muilenburg Does Damage Control, But The Board Does Not Assess The Safety Of Boeing's Airplanes.

Boeing quickly issued a public statement before authorities released any details about the Ethiopian Airlines Crash. On March 11, the Company emphasized that if the Ethiopian Airlines pilot followed the checklist of procedures in the flight manual, he "[would] always be able to override the flight control using electric trim or manual trim."[141] But by that time, one-third of the world's fleet of in-service 737 MAX aircraft had been grounded, and several United States Senators called for the FAA to ground the 737 MAX.

That same day, Muilenburg emailed the Board. While stating that "[o]ur objective is to ensure our teams are centered on our priorities, including safety, quality and stability,"[142] Muilenburg's **[*45]** comments were not geared toward taking action to address and improve the 737 MAX's safety. Nor were they made in response to any Board inquiry as to the airplane's safety. Instead, Muilenburg addressed the Board's objectives for the 737 MAX: "ongoing production operations," revenue, and reputational achievement.[143] He advised the Board that management was engaging in extensive outreach with Boeing's customers and regulators to "reinforce our confidence in the 737 MAX."[144] He touted that the FAA had issued a notification reinforcing the 737 MAX's airworthiness, and "mentioned the pending MAX software enhancement with the expectation it will mandate upgrade in April."[145] He concluded by addressing how Boeing intended to handle the Ethiopian Airlines Crash in the media and internal communications, and directed inquiries to Boeing's media relations team.

Thereafter, Muilenburg reviewed and responded to an all-employee email prepared by that team. He thought the note was "solid," but "lack[ed] a statement about our confidence in the fundamental safety of the MAX."[146]

> This goes back to our discussion last night on answering two basic questions: *is the MAX safe? And was MCAS involved? We need* ***[*46]*** *to make a strong statement on the first, and be clear that there are no supporting facts on the second*.[147]

Muilenburg emailed the Board again on March 12,

[137] Am. Compl. ¶¶ 10, 235, 290; *id.* Ex. A; *id.* Ex. B.

[138] Pls.' Ex. 5; Am. Compl. ¶ 278.

[139] Am. Compl. Ex. B ¶¶ 4(b)-(c); *id.* ¶¶ 13, 106, 123, 239, 290.

[140] *Id.* ¶ 296; *id.* Ex. B.

[141] *Id.* ¶ 248.

[142] Defs.' Ex. 66 at - 620851.

[143] *Id.*

[144] *Id.*

[145] *Id.*

[146] Am. Compl. ¶ 243.

[147] *Id.*

providing a "quick interim update" before a formal Board call the following day.[148] Muilenburg stated that "[a]s you've seen in the news flow today, additional international authorities have grounded the 737 MAX," but assured the Board that those decisions were driven solely by "public/political pressure, not by any new facts."[149]

During this pivotal period, Boeing was engaged in continuous conversations with the FAA, and Muilenburg spoke with Department of Transportation Secretary Elaine Chao and President Donald Trump in an attempt to keep the 737 MAX flying. On March 12, FAA officials reiterated their position that domestic flights of the 737 MAX would continue. At least one director, Liddy, praised Muilenburg's efforts during this period.[150]

6. The FAA Grounds The 737 MAX, But The Board's Focus Remains On Restoring Boeing's Reputation And Sales.

On March 13, the FAA's investigation of the Ethiopian Airline Crash indicated that the plane experienced the same pattern of repeated steep dives and climbs caused by MCAS that preceded the Lion **[*47]** Air Crash. The FAA grounded the 737 MAX, becoming the final major aviation regulator to do so.

After the FAA grounded the planes, the Board held a call with management regarding the Ethiopian Airlines Crash and whether Boeing should itself ground the fleet.[151] The Board did not consider, deliberate, or decide on grounding the plane or other immediate remedial measures until after the second crash and the FAA's grounding over Boeing's objection. No Board minutes or agendas between November 2018 and March 2019 reference a discussion about grounding the 737 MAX.

Nonetheless, Boeing jumped at the opportunity to claim credit for the grounding. Later on March 13, Muilenburg told the Board that Boeing had managed to get its own messaging out about the grounding before the FAA released its statement.[152]

That evening, Muilenburg followed up with his monthly business update, which began with his efforts to rehabilitate Boeing's image.[153] In particular, he shared that "Kevin McAllister and I spent time walking the 737 production line in Renton, where we filmed a joint video for team members."[154] With the comment that "safety . . . is our top priority," Muilenburg disclosed that for the first time, he "added **[*48]** safety metrics to our monthly report."[155] This marked one of the first formal implementations of safety reporting to the Board. Muilenburg initiated this update. His addition continued to focus on production, including "year-to-date targets and actuals for lost workday cases, recordable injuries and near misses."[156] His March business summary then turned to the 737 MAX's business performance and ability to meet delivery targets.[157]

Over the next six weeks, Muilenburg's communications to the Board focused on restoring Boeing's reputation and returning the 737 MAX to service. And some Directors' messages to Muilenburg echoed his focus on reputational and production triage. For example, on March 21, Giambastiani emailed Muilenburg to direct him to an article from *Aviation Week* and emphasized a comment suggesting the pilots were at fault for the two crashes.[158] And on March 26, Duberstein emailed Muilenburg to inquire about the reputational impact of an emergency landing of a Southwest 737 MAX due to engine problems, complaining that the report "[l]ed the network news" and was "[a]nother reputational hit at us and no comment from us."[159]

On April 4, a preliminary report on the Ethiopian **[*49]** Airlines Crash identified MCAS as a contributing cause for the accident. After sending a draft to the full Board, Boeing issued a press release maintaining that most

---

[148] Defs.' Ex. 68.

[149] *Id.*

[150] Am. Compl. ¶ 252 ("I, for one, really appreciate the strong leadership you're demonstrating in a very challenging situation. Your leadership will prevail.").

[151] *See* Defs.' Ex. 69; Am. Compl. ¶¶ 255-56.

[152] Defs.' Ex. 69.

[153] Defs.' Ex. 70.

[154] *Id.*

[155] *Id.*

[156] *Id.*

[157] *Id.*

[158] Am. Compl. ¶ 259 ("More importantly for the pilot . . . FLY THE PLANE.").

[159] *Id.* ¶ 260.

"accidents are caused by a chain of events" and that was the case for the two crashes.[160]

E. In April 2019, The Board Adopts Safety Oversight Measures.

Some directors questioned Boeing's approach. On March 15, Arthur Collins and then-Lead Director David Calhoun recommended a Board meeting devoted to product safety. As Collins explained to Calhoun,

> In light of the two 737 MAX 8 crashes and subsequent global fleet grounding, the previous grounding of Air Force KC-46 tankers, and the Amazon 767 cargo plane crash, I believe we should devote the entire board meeting (other than required committee meetings and reports) to a review of quality within Boeing. This would start with an update on what we know about each of the three previously mentioned situations, but then include a review of quality metrics and actions that are either currently in place or planned to assure that the highest level of quality is designed into all Boeing products or incorporated into all manufacturing, customer training, and service support activities. **[*50]** In addition to providing necessary information for the Board, this type of agenda would underscore the board's (and management's) unwavering commitment to quality and safety above all other performance criteria. I recognize that this type of approach needs to be communicated carefully so as not to give the impression that the board has lost confidence in management (which we haven't) or that there is a systemic problem with quality throughout the corporation (which I don't believe there is), but I'm sure this can be done. . . . I'll leave the decision in your hands with Dennis [Muilenburg].[161]

Collins followed up on the "category of 'lessons learned,'" reminding Calhoun that, at Medtronic (on whose board they both had served), Collins "began each board meeting, executive committee meeting, and operating review with a review of product quality/safety—before any discussion of financial performance, market share/competitive activities, new product development timetables, and certainly stock price."[162] He stressed that people "paid close attention to the priorities of senior management, and everyone in the corporation understood that nothing was more important to the CEO and the board than quality/safety," **[*51]** and that "[i]t's hard to quantify the impact of this approach, but it certainly was important."[163]

Calhoun forwarded Collins's messages to Muilenburg, who responded that it was "[g]ood input"; that he "added Safety data to the Board lead-off briefing, and just added it to my monthly Board note too"; and that "just so you know, Safety data is the first data we look at during our internal ExCo reviews."[164] Thereafter, Muilenburg and Calhoun held a call regarding Collins's suggestions for making safety a Board priority.[165]

At the Board's next regularly scheduled meeting on April 28 and 29, the Board focused on the Ethiopian Airlines Crash and its implications for the Company. In contrast to prior Board meetings, the Board dedicated approximately two hours and fifteen minutes to discussing the 737 MAX. For the first time, the Board critically assessed MCAS, the FAA certification process, and pilot training requirements.

The Board also initiated Board-level safety reporting for the first time. On April 4, the Board established the Committee on Airplane Policies and Processes (the "Airplane Committee"). Even then, the Airplane Committee's fact-finding sessions intended to inform the **[*52]** Committee's conclusions and recommendations were sparsely attended: Giambastiani was the sole Board attendee at more than half of the Committee's eighteen fact-finding sessions with internal and external experts, including on topics such as airline training requirements and an overview of BCA's safety process.

Between April and August 2019, the Airplane Committee entertained presentations on seven new topics—including "[c]ommercial airplane design and manufacturing and policies and processes," "aircrew training requirements," and "engineering and safety

[160] *Id.* ¶ 262.

[161] *Id.* Ex. C.

[162] *Id.*

[163] *Id.*

[164] *Id.* I infer "ExCo" refers to management's Executive Council.

[165] *See id.*

organizational structures in related industries"—none of which had been the subject of previous Board briefings.[166] For example, in April 2019, Lynne Hopper, Boeing's Vice President of BCA Engineering, and Beth Pasztor, BCA's Vice President of Safety, Security & Compliance, presented to the Board for the first time.

On May 6, for the first time, the Airplane Committee formally requested information about the cause of the crashes. As Committee chair, Giambastiani asked Hyslop to provide information about pilot training requirements, Boeing's "Quick Action" checklists for emergencies, and airlines that had purchased an AOA disagree alert. **[*53]** [167] And in late June, Giambastiani proposed that product safety reports evaluated by the SRB "should feed to [A]udit [C]ommittee" and "should go to CTO/CFO and [be] shared with Board"; that the Audit Committee should have "visibility of high risk issues"; and that "the entire list of safety issues on the MAX [should be] reported to Dennis [Muilenburg]/Greg [Hyslop]."[168]

The Airplane Committee also recommended that the Board establish another committee dedicated to safety. And so on August 26, the Board established the Aerospace Safety Committee "for the purpose of assisting the Board in the oversight of the safe design, development, manufacture, production, operations, maintenance, and delivery of the aerospace products and services of the Company."[169] It was also responsible for overseeing the airplane certification process and Company protocols for engaging with the FAA. In turn, the Aerospace Safety Committee quickly recommended that the Board create yet another oversight committee. On September 30, the Board created a Product and Services Safety Organization that was responsible for, among other things, investigating "cases of undue pressure and anonymous product and service safety **[*54]** concerns raised by employees," and represented Boeing's first mechanism or reporting line to convey employee complaints to the Board.[170]

Product safety reporting processes up to executives and the Board were operational by October 20. And at the December 15 Board meeting, the Audit Committee received a compliance risk management report from chief compliance and ethics officer Sands that, for the first time, included a category for "Safety." In comparison, Sands's report from the December 2018 Board meeting following the Lion Air Crash had not covered product safety at all.

Muilenburg also embraced the new focus on safety. In an email to McAllister, Hyslop, Smith, and other senior Boeing officials, he wrote,

> As *part of our lessons learned from the MAX, we need to have a clear understanding of how safety risk is being assessed*, and appropriately "test" those items that are assessed as "medium" or at a "minor" or "major" hazard level to ensure the right visibility/action/communication. . . . This is an exceptionally important process improvement area for us all.[171]

By late 2019, Muilenburg began receiving "granular weekly reports of potential safety issues discussed at meetings of rank-and-file **[*55]** engineers - something that did not happen in the past."[172] And Muilenburg eventually acknowledged that access to better information would have supported grounding the 737 MAX fleet shortly after the Lion Air Crash.[173]

F. The Board Attempts To Preserve Its Image, Despite Eschewing Safety Oversight Initiatives Until April 2019.

The Board publicly lied about if and how it monitored the 737 MAX's safety. As the Board was establishing formal safety monitoring processes, then-Lead Director Calhoun held a series of interviews with major newspapers with the following corporate objective: "Position the Boeing Board of Directors as an independent body that has exercised appropriate oversight."[174] As to the Lion Air Crash, Calhoun represented that the Board had been "notified immediately, as a board broadly," after the Lion Air

[166] *Id.* ¶ 70.

[167] *Id.* ¶ 72.

[168] *Id.* ¶ 81 (alteration in original).

[169] *Id.* ¶ 73.

[170] *Id.* ¶ 93.

[171] *Id.* ¶ 82.

[172] *Id.* ¶ 83.

[173] *Id.* ¶ 84 ("[I]f we knew back then what we know now, we would have grounded right after the first accident.").

[174] *Id.* ¶ 263.

crash and met "very, very quickly" thereafter;[175] participated in evaluating the safety risk associated with the 737 MAX; and considered grounding the 737 MAX after the Lion Air Crash, but concluded the crash "was an anomaly" that did not warrant grounding the airplane.[176] As to the Ethiopian Airlines Crash, Calhoun represented that the Board met within twenty-four hours of the **[*56]** crash to discuss potential grounding of the 737 MAX and recommended that the 737 MAX be grounded. Each of Calhoun's representations was false.

In addition, Calhoun and the Board would publicly denounce Muilenburg. Muilenburg had come under fire from the FAA, but as of November 5, 2019, Calhoun maintained that, "[f]rom the vantage point of our board, Dennis has done everything right."[177] With additional scrutiny, regulators learned the extent of Boeing's deceit under Muilenburg's leadership, and the FAA came down on him. On December 22, after learning that the FAA had reprimanded Muilenburg and after *The New York Times* published an article reporting on his deficiencies, the Board called a meeting and voted to terminate Muilenburg and replace him with Calhoun, "to restore confidence in the Company moving forward as it works to repair relationships with regulators, customers, and all other stockholders."[178]

The Board did not terminate Muilenburg for cause, and publicly characterized his departure as his "resignation," and later as his "retirement."[179] In doing so, the Board enabled Muilenburg to retain unvested equity awards worth approximately $38,642,304.[180] The Board also announced **[*57]** that Luttig would "retire," allowing him to keep his unvested equity awards as well.[181] As alleged, the Board chose this path because "[a]ny public dispute between Boeing and Muilenburg would have exposed the Board's prolonged support of Muilenburg and lack of safety oversight."[182]

Calhoun became CEO in January 2020. In that role, he publicly questioned Muilenburg's leadership, shifting blame away from the Board. Calhoun stated that the Board "never seriously questioned [Muilenburg's] strategy, in part because before the first MAX crash off the coast of Indonesia in October 2018, the company was enjoying its best run in years," and painted Muilenburg as a money-hungry leader that was willing to prioritize profits over quality and safety.[183] In Calhoun's words, "If [the Board] w[as] complacent in any way, maybe, maybe not, I don't know. . . . We supported a C.E.O. who was willing and whose history would suggest that he might be really good at taking a few more risks."[184]

G. Corporate Trauma Inspires This Suit.

The 737 MAX fleet was grounded for twenty months, until November 18, 2020. During that period, Boeing was federally mandated to cure the defects in the 737 MAX's **[*58]** MCAS system and AOA sensor and to revamp pilot training. But these measures did not rectify the significant damage the Lion Air and Ethiopian Airlines Crashes and the 737 MAX Grounding caused to Boeing's profitability, credibility, reputation, and business prospects. Nor did they unwind Boeing's exposure to substantial criminal, regulatory, and civil liability. In 2020, Boeing estimated that it had incurred non-litigation costs of $20 billion, and litigation-related costs in excess of $2.5 billion. Litigation continues on multiple fronts, and customers cancelled orders. And in January 2021, Boeing consented to the filing of a criminal information charging the Company with conspiracy to defraud the United States and thereby incurring billions of dollars in penalties.[185]

The corporate harm Boeing suffered inspired numerous books and records requests and derivative actions filed in this Court in 2019. The Court consolidated the plenary actions and appointed NYSCRF and FPPA as

---

175 *Id.* ¶¶ 268-69.

176 *Id.* ¶ 271.

177 *Id.* ¶ 280.

178 *Id.* ¶¶ 284-85.

179 *Id.* ¶¶ 288-89.

180 *Id.* ¶ 286.

181 *Id.* ¶ 289.

182 *Id.* ¶ 287.

183 *Id.* ¶ 291 (quoting a *New York Times* article as stating, "[Calhoun had] never be able to judge what motivated [Muilenburg], whether it was a stock price that was going to continue to go up and up, or whether it was just beating the other guy to the next rate increase," and that "[i]f anybody ran over the rainbow for the pot of gold on stock, it would have been [Muilenburg]").

184 *Id.* (alterations in original).

185 *Id.* ¶ 11; Am. Compl. Ex. B.

Co-Lead Plaintiffs on August 3, 2020.[186] Plaintiffs filed the Verified Amended Consolidated Complaint on January 29, 2021 (the "Amended Complaint"), addressing the DOJ's criminal penalties.[187] Count I asserts a derivative **[*59]** claim for breach of fiduciary duty against the Director Defendants, alleging they consciously breached their fiduciary duties and violated their corporate responsibilities by (1) before the Lion Air Crash, failing to implement any reasonable information and reporting system to monitor and oversee the safety of Boeing's airplanes; (2) after the Lion Air Crash, despite being made aware of red flags concerning the operation, development, and nondisclosure of MCAS, consciously disregarding their duty to investigate and to remedy any misconduct uncovered; and (3) after the Ethiopian Airlines Crash, falsely assuring the public about the safety of the 737 MAX and MCAS and deciding to cash out Muilenburg's unvested equity-based compensation.[188] Count II asserts a derivative claim for breach of fiduciary duty against the Officer Defendants, alleging they consciously breached their fiduciary duties or, at a minimum, acted with gross negligence by (1) consciously and repeatedly failing to implement and actively monitor or oversee a compliance and safety program; (2) consciously disregarding their duty to investigate red flags and to remedy any misconduct uncovered; and (3) covering up the extreme **[*60]** safety risks of Boeing's aircraft.

On March 19, Defendants moved to dismiss pursuant to [Court of Chancery Rules 12(b)(6)]() and [23.1]() (the "Motion").[189] Defendants submitted eighty-eight exhibits in support of the Motion.[190] The parties briefed the Motion as of June 4.[191] I heard argument on June 25 and took the Motion under advisement.[192]

II. ANALYSIS

Defendants have moved to dismiss all claims against them pursuant to [Court of Chancery Rule 23.1]() for failure to plead that demand is futile.

Plaintiffs assert Defendants' breaches of fiduciary duty harmed Boeing. Thus, the claims belong to Boeing and the decision whether to pursue the claim presumptively lies with the Board.[193] But our law recognizes that, "[i]n certain circumstances, stockholders may pursue litigation derivatively on behalf of the corporation as a matter of equity to redress the conduct of a torpid or unfaithful management . . . where those in control of the company refuse to assert (or are unfit to consider) a claim belonging to it."[194] "Because stockholder derivative suits by [their] very nature . . . impinge on the managerial freedom of directors, our law requires that a stockholder satisfy the threshold demand requirements of [Court of Chancery Rule 23.1]() before he is **[*61]** permitted to assume control of a claim belonging to the

---

[186] D.I. 88.

[187] *See generally* Am. Compl.

[188] *Id.* ¶ 305. Plaintiffs originally alleged that the Director Defendants breached their fiduciary duties before the Lion Air Crash by ignoring several red flags concerning airplane safety. *Id.* At oral argument, Plaintiffs shifted this theory. *See* Hr'g Tr. 135-36 ("MR. FRIEDLANDER: Frankly, Your Honor, I think it's better not to think of those as red flags for *Marchand* in the sense of that -- like *Marchand* never uses the concept of red flags. . . . I would say these are points of emphasis to illustrate the problems that the reporting system had . . . because there's an affirmative obligation to create a reporting system of the type described in *Marchand*. We're saying they didn't do it, and then we said which *Marchand* requires. And as a second argument, and they had red flags and nonetheless they still didn't do it. But really it's all incorporated under the affirmative obligation of *Marchand* to create it. THE COURT: So you would like me to look at those more under prong one as a deficient reporting system [rather] than under prong two, red flags? MR. FRIEDLANDER: Yeah. But I think they're important . . . .").

[189] D.I. 145; D.I. 146.

[190] D.I. 147; D.I. 148; D.I. 149; D.I. 150; D.I. 151; D.I. 152; D.I. 160.

[191] D.I. 146; D.I. 155; D.I. 159.

[192] D.I. 167; Hr'g Tr.

[193] *[White v. Panic, 783 A.2d 543, 550 (Del. 2001)]()* ("In most situations, the board of directors has sole authority to initiate or to refrain from initiating legal actions asserting rights held by the corporation."); *see [Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984)]()* ("A cardinal precept of the General Corporation Law of the state of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation."), *overruled on other grounds by [Brehm v. Eisner, 746 A.2d 244 (Del. 2000)]()*.

[194] *[In re CBS Corp. S'holder Class Action & Deriv. Litig., 2021 Del. Ch. LEXIS 12, 2021 WL 268779, at *27 (Del. Ch. Jan. 27, 2021)]()*, *as corrected* (Feb. 4, 2021) (quoting *[Cumming v. Edens, 2018 Del. Ch. LEXIS 54, 2018 WL 992877, at *11 (Del. Ch. Feb. 20, 2018)]()* (internal quotation marks omitted)).

corporation."[195]

Rule 23.1 requires pleadings to "comply with stringent requirements of factual particularity that differ substantially from the permissive notice pleadings governed solely by *Chancery Rule 8(a)*."[196] To satisfy *Rule 23.1*, the stockholder must plead with particularity either that she made a demand on the company's board of directors to pursue particular claims and was refused, or why any such demand would be futile, thereby excusing the need to make a demand altogether.[197] Where, as here, the stockholder plaintiff foregoes a demand on the board, she "must plead particularized facts creating a reasonable doubt concerning the Board's ability to consider the demand."[198]

Demand futility turns on "whether the board that would be addressing the demand can impartially consider [the demand's] merits without being influenced by improper considerations."[199] While the continued utility of a binary approach to demand futility has been called into question, for now, Delaware still applies one of two tests when deciding whether demand upon the board would be futile.[200] The first, established in *Aronson v. Lewis*, "applies to claims **[*62]** involving a contested transaction i.e., where it is alleged that the directors made a conscious business decision in breach of their fiduciary duties."[201] The second, established in *Rales v. Blasband*,[202] applies where a majority of the current members of the board "had not participated in the challenged decision,"[203] or "where the subject of a derivative suit is not a business decision . . . [such as when the board is alleged to have violated its] oversight duties."[204]

Here, the parties agree that *Rales* governs.[205] "The central question of a *Rales* inquiry, no matter the context, is the same: 'whether the board can exercise its business judgment on the corporate behalf in considering demand.'"[206] In refining that question, *Rales* instructs that a director cannot objectively exercise her business judgment in considering a demand if she is either (1) "interested," meaning, among other things, that she faces a "substantial likelihood of liability" for her role in the alleged corporate wrongdoing; or (2) not

---

[195] *Horman v. Abney, 2017 Del. Ch. LEXIS 13, 2017 WL 242571, at *6 (Del. Ch. Jan. 19, 2017)* (quoting *Aronson, 473 A.2d at 811*) (internal quotation marks omitted).

[196] *Brehm, 746 A.2d at 254*; *accord* ***In re Citigroup Inc. S'holder Deriv. Litig., 964 A.2d 106, 120-21 (Del. Ch. 2009)***.

[197] *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1044 (Del. 2004)*; *Wood v. Baum, 953 A.2d 136, 140 (Del. 2008)*.

[198] *CBS, 2021 Del. Ch. LEXIS 12, 2021 WL 268779, at *28*; ***Citigroup, 964 A.2d at 121*** ("Demand is not excused solely because the directors would be deciding to sue themselves. Rather, demand will be excused based on a possibility of personal director liability only in the rare case when a plaintiff is able to show director conduct that is so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists." (footnotes and internal quotation marks omitted)).

[199] *Rales v. Blasband, 634 A.2d 927, 934 (Del. 1993)*.

[200] *See* *UFCW & Participating Food Indus. Empls Tri-State Pension Fund v. Zuckerberg, 250 A.3d 862, 877 (Del. Ch. 2020)* (observing that "the *Aronson* test has proved to be comparatively narrow and inflexible in its application, and its formulation has not fared well in the face of subsequent judicial developments").

[201] *Wood, 953 A.2d at 140* (citing *Aronson, 473 A.2d at 814*) (explaining the two demand futility tests). Under *Aronson*, the plaintiff must plead particularized facts that create a reasonable doubt that (i) the directors are disinterested and independent or (ii) the challenged transaction was otherwise the product of a valid exercise of business judgment. *Id.*

[202] *634 A.2d at 927*.

[203] *Zuckerberg, 250 A.3d at 887*.

[204] *Wood, 953 A.2d at 140*; *see also* *Horman, 2017 Del. Ch. LEXIS 13, 2017 WL 242571, at *6* (holding that *Rales* applies "when a plaintiff challenges board inaction such as when a board is alleged to have consciously disregarded its oversight duties").

[205] *See* D.I. 146 at 58 ("Whether the Board's decision to terminate Muilenburg is considered under *Aronson* or *Rales*, . . . Plaintiffs fail to establish demand futility." (citing *Zuckerberg, 250 A.3d 862, 2020 WL 6266162, at *9-18*)); *id.* at 60 (assessing Plaintiffs' claims under *Rales*); D.I. 155 at 38 (citing and applying *Rales*).

[206] *McElrath ex rel. Uber Techs. v. Kalanick, 2019 Del. Ch. LEXIS 107, 2019 WL 1430210, at *8 (Del. Ch. Apr. 1, 2019)* (quoting *Inter-Marketing Grp. USA, Inc. v. Armstrong, 2019 Del. Ch. LEXIS 40, 2019 WL 417849, at *4 (Del. Ch. Jan. 31, 2019)*), *aff'd sub nom.* *McElrath v. Kalanick, 224 A.3d 982 (Del. 2020)*.

independent of another interested fiduciary.[207]

"On a motion to dismiss pursuant to *Rule 23.1*, the Court considers the same documents, similarly **[*63]** accepts well-pled allegations as true, and makes reasonable inferences in favor of the plaintiff—all as it does in considering a motion to dismiss under *Rule 12(b)(6)*."[208] Given the heightened pleading requirements of *Rule 23.1*, however, "conclusory allegations of fact or law not supported by allegations of specific fact may not be taken as true."[209] "Because of the absence of a precise formula in the Rule for pleading compliance with the demand requirement, the sufficiency of a complaint under *Rule 23.1* is determined on the basis of the facts of each case."[210]

"*Rule 23.1* does not abrogate *Rule 12(b)(6)*."[211] But because "the standard under *Rule 12(b)(6)* is less stringent than the standard under *Rule 23.1*, a complaint that survives a *Rule 23.1* motion to dismiss generally will also survive a *Rule 12(b)(6)* motion to dismiss, assuming that it otherwise contains sufficient facts to state a cognizable claim."[212] The standards governing a motion to dismiss under *Court of Chancery Rule 12(b)(6)* for failure to state a claim for relief are well settled:

> (i) all well-pleaded factual allegations are accepted as true; (ii) even vague allegations are "well-pleaded" if they give the opposing party notice of the claim; (iii) the Court must draw all reasonable inferences in favor of the non-moving party; and **[*64]** ([iv]) dismissal is inappropriate unless the "plaintiff would not be entitled to recover under any reasonably conceivable set of circumstances susceptible to proof."[213]

Thus, the touchstone "to survive a motion to dismiss is reasonable 'conceivability.'"[214] This standard is "minimal"[215] and plaintiff-friendly.[216] "Indeed, it may, as a factual matter, ultimately prove impossible for the plaintiff to prove his claims at a later stage of a proceeding, but that is not the test to survive a motion to dismiss."[217] Despite this forgiving standard, the Court need not "accept conclusory allegations unsupported by specific facts" or "draw unreasonable inferences in favor of the non-moving party."[218] "Moreover, the court is not required to accept every strained interpretation of the allegations proposed by the plaintiff."[219]

I conclude that (1) Plaintiffs have pled facts sufficient to render demand futile for claims against the Director Defendants, with one carveout, but (2) Plaintiffs have failed to plead demand futility for the claims against the Officer Defendants. Accordingly, the Motion is granted

---

207 *Rales, 634 A.2d at 934, 936* (noting that, at bottom, the 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"); *CBS, 2021 Del. Ch. LEXIS 12, 2021 WL 268779, at *28* (same); *In re Clovis Oncology, Inc. Deriv. Litig., 2019 Del. Ch. LEXIS 1293, 2019 WL 4850188, at *11 (Del. Ch. Oct. 1, 2019)* (stating that when board oversight is challenged, "such improper influence arises if a majority of the board's members are compromised because [] they face a substantial likelihood of personal liability with respect to at least one of the alleged claims" (internal quotation marks omitted)).

208 *Beam, 833 A.2d at 976 (Del. Ch. 2003)* (citing *White, 783 A.2d at 549*), *aff'd*, *845 A.2d 1040 (Del. 2004)*.

209 *Grobow v. Perot, 539 A.2d 180, 187 (Del. 1988)*, *overruled on other grounds by* *Brehm, 746 A.2d at 244*.

210 *Brehm, 746 A.2d at 268* (Hartnett, J. concurring).

211 *Id.*

212 *In re Walt Disney Co. Deriv. Litig., 825 A.2d 275, 285 (Del. Ch. 2003)*.

213 *Savor, Inc. v. FMR Corp., 812 A.2d 894, 896-97 (Del. 2002)* (citations omitted).

214 *Cent. Mortg. Co. v. Morgan Stanley Mortg. Cap. Hldgs. LLC, 27 A.3d 531, 537 (Del. 2011)*.

215 *Id. at 536* (citing *Savor, 812 A.2d at 896*).

216 *See, e.g.*, ***Clouser v. Doherty, 175 A.3d 86 (Del. 2017)*** (TABLE); *In re USG Corp. Stockholder Litig., 2021 Del. Ch. LEXIS 45, 2021 WL 930620, at *3-4 (Del. Ch. Mar. 11, 2021)*.

217 *Cent. Mortg. Co., 27 A.3d at 536*.

218 *Price v. E.I. du Pont de Nemours & Co., 26 A.3d 162, 166 (Del. 2011)*, (citing *Clinton v. Enter. Rent-A-Car Co., 977 A.2d 892, 895 (Del. 2009)*), *overruled on other grounds by* ***Ramsey v Ga. S. Univ. Advanced Dev. Ctr., 189 A.3d 1255 (Del. 2018)***.

219 *In re Trados Inc. S'holder Litig., 2009 Del. Ch. LEXIS 128, 2009 WL 2225958, at *4 (Del. Ch. July 24, 2009)* (internal quotation marks omitted) (quoting *In re Gen. Motors (Hughes) S'holder Litig., 897 A.2d 162, 168 (Del. 2006)*).

and denied in part as to Count I, and granted as to Count II.

A. With One [*65] Exception, Plaintiffs Have Pled That Demand Is Futile For Claims Against The Director Defendants.

For Count I, Plaintiffs assert demand is futile because "from at least November 18, 2019 (the date of filing of the first derivative complaint alleging demand futility) through and including today, a majority of the members of the Board have faced a substantial likelihood of liability for failing to make any good faith effort to implement and oversee a board-level system to monitor and report on safety."[220] At bottom, Plaintiffs' position is that nine of the twelve board members at the time the original complaint was filed[221] face a substantial likelihood of liability for failure to fulfill their oversight duties under the standards set forth in *Caremark*,[222] as applied by the Delaware Supreme Court in *Marchand*.[223]

As Chancellor Allen first observed in *Caremark*, and as since emphasized by this Court many times, perhaps to redundance,[224] the claim that corporate fiduciaries have breached their duties to stockholders by failing to monitor corporate affairs is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[225] A decade after *Caremark*, our **[*66]** Supreme Court affirmed the doctrine Chancellor Allen announced there and clarified that our law will hold directors personally liable only where, in failing to oversee the operations of the company, "the directors knew that they were not discharging their fiduciary obligations."[226] At the pleading stage, a plaintiff must allege particularized facts that satisfy one of the necessary conditions for director oversight liability articulated in *Caremark*: either that (1) "the directors utterly failed to implement any reporting or information system or controls"; or (2) "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."[227] I respectfully refer to these conditions as *Caremark* "prong one" and "prong two."

"Delaware courts routinely reject the conclusory allegation that because illegal behavior occurred, internal controls must have been deficient, and the board must have known so."[228] Rather, the plaintiff must plead with particularity "a sufficient connection between the corporate trauma and the board."[229] "To be sure, even in this **[*67]** context, *Caremark* does not demand omniscience."[230] But it does mandate that "to satisfy their duty of loyalty, directors must make a good faith effort to implement an oversight system and then monitor it."[231]

The *Caremark* standard "draws heavily upon the concept of director failure to act in good faith,"[232] and does not constitute a freestanding fiduciary duty that could independently give rise to liability.[233] Because "[t]he test is rooted in concepts of bad faith," "a showing of bad faith is a *necessary condition* to director oversight

---

[220] Am. Compl. ¶ 299.

[221] *Id.* ¶¶ 22-43; *see id.* ¶ 301 (alleging that when the original complaint was filed, six of the twelve Board members had served for at least five years before the 2019 Ethiopian Airlines Crash); D.I. 146 at 6 n.2 (detailing changes on the Board since the original complaint was filed).

[222] 698 A.2d 959.

[223] ***212 A.3d 805***.

[224] *See* Chou, 2020 Del. Ch. LEXIS 274, 2020 WL 5028065, at *1 ("It has become among the hoariest of Chancery clichés for an opinion to note that a derivative claim against a company's directors, on the grounds that they have failed to comply with oversight duties under *Caremark*, is among the most difficult of claims in this Court to plead successfully.").

[225] Caremark, 698 A.2d at 967; Globis P'rs, L.P. v. Plumtree Software, Inc., 2007 Del. Ch. LEXIS 169, 2007 WL4292024, at *7 (Del. Ch. Nov. 30, 2007) (same); Desimone v. Barrows, 924 A.2d 908, 939 (Del. Ch. 2007) (same); Guttman v. Huang, 823 A.2d 492, 506 n.33 (Del. Ch. 2003) (same).

[226] Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006).

[227] *Id.*

[228] Desimone, 924 A.2d at 940.

[229] La. Mun. Police Emps.' Ret. Sys. v. Pyott, 46 A.3d 313, 340 (Del. Ch. 2012), *rev'd on other grounds*, 74 A.3d 612 (Del. 2013).

[230] *Clovis*, 2019 Del. Ch. LEXIS 1293, 2019 WL 4850188, at *13.

[231] ***Marchand, 212 A.3d at 821***.

[232] Stone, 911 A.2d at 369.

[233] ***Citigroup, 964 A.2d at 122-23***.

liability."[234] As our Supreme Court explained in *In re Walt Disney Co. Derivative Litigation*, the "intentional dereliction of duty" or "conscious disregard for one's responsibilities," which "is more culpable than simple inattention or failure to be informed of all facts material to the decision," reflects that directors have acted in bad faith and cannot avail themselves of defenses grounded in a presumption of good faith.[235] In order to plead a derivative claim under *Caremark*, therefore, a plaintiff must plead particularized facts that allow a reasonable inference the directors acted with scienter which in turn "requires [not only] proof that a **[*68]** director acted inconsistent[ly] with his fiduciary duties," but also "most importantly, that the director knew he was so acting."[236]

1. The Motion Is Denied In Part As To Count I; Plaintiffs Have Pled Particularized Facts Demonstrating A Majority Of The Director Defendants Face A Substantial Likelihood Of *Caremark* Liability.

Plaintiffs' *Caremark* theory breaks the Company's 737 MAX trauma into three periods of time: before the first crash, between the two crashes, and after the second crash. As crystallized at argument, Plaintiffs' theory before the Lion Air Crash maps onto *Caremark*'s first prong, asserting the Board utterly failed to implement any reporting or information systems or controls.[237] Plaintiffs further assert the first Lion Air Crash was a red flag the Board ignored under prong two, while continuing to fall short under prong one. Plaintiffs contend the Board's prong two deficiencies culminated in the Ethiopian Airlines Crash. And after both crashes, Plaintiffs assert the Director Defendants breached their fiduciary duties by allowing Muilenburg to retire with his unvested equity compensation. Plaintiffs have sufficiently alleged the Director Defendants **[*69]** face a substantial likelihood of liability under their *Caremark* theories, but not with regard to Muilenburg's compensation.

a. Plaintiffs Have Stated A Claim Under *Caremark* Prong One.

Directors may use their business judgment to "design context-and industry-specific approaches tailored to their companies' businesses and resources. But *Caremark* does have a bottom-line requirement that is important: the board must make a good faith effort—*i.e.*, try—to put in place a reasonable board-level system of monitoring and reporting."[238] This oversight obligation is "designed to ensure reasonable reporting and information systems exist that would allow directors to know about and prevent wrongdoing that could cause losses for the Company."[239] "[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."[240]

Our Supreme Court's recent decision in *Marchand* addressed the contours of a *Caremark* prong one claim when the company is operating in the shadow of "essential and mission critical" regulatory compliance risk. **[*70]** [241] Distinct from many *Caremark* cases evaluating the company's systems to monitor financial

---

[234] ***Id. at 123***.

[235] *906 A.2d 27, 66 (Del. 2006)*; ***Citigroup, 964 A.2d at 125*** ("[O]ne can see a similarity between the standard for assessing oversight liability and the standard for assessing a disinterested director's decision under the duty of care when the company has adopted an exculpatory provision pursuant to *§ 102(b)(7)*. In either case, a plaintiff can show that the director defendants will be liable if their acts or omissions constitute bad faith. A plaintiff can show bad faith conduct by, for example, properly alleging particularized facts that show that a director *consciously* disregarded an obligation to be reasonably informed about the business and its risks or *consciously* disregarded the duty to monitor and oversee the business.").

[236] *In re Massey Energy Co., 2011 Del. Ch. LEXIS 83, 2011 WL 2176479, at *22 (Del. Ch. May 31, 2011)* (emphasis omitted); ***Citigroup, 964 A.2d at 123*** ("[T]o establish oversight liability a plaintiff must show that the directors *knew* they were not discharging their fiduciary obligations or that the directors demonstrated a *conscious* disregard for their responsibilities such as by failing to act in the face of a known duty to act.").

[237] *See* Hr'g Tr. 135-36.

[238] ***Marchand, 212 A.3d at 821*** (footnote omitted).

[239] ***Citigroup, 964 A.2d at 131***.

[240] ***Id. at 122*** (internal quotation marks omitted).

[241] ***Marchand, 212 A.3d at 824***; *see Clovis*, 2019 Del. Ch. LEXIS 1293, 2019 WL 4850188, at *12.

wrongdoing like accounting fraud,[242] *Marchand* addressed the regulatory compliance risk of food safety and the failure to manage it at the board level, which allegedly allowed the company to distribute mass quantities of ice cream tainted by *listeria*. Food safety was the "most central safety and legal compliance issue facing the company."[243] In the face of risk pertaining to that issue, *Marchand* noted the board's oversight function "must be more rigorously exercised."[244] This "entails a sensitivity to compliance issues intrinsically critical to the company."[245]

Marchand held the board had not made a "good faith effort to put in place a reasonable system of monitoring and reporting" when it left compliance with food safety mandates to management's discretion, rather than implementing and then overseeing a more structured compliance system.[246] The Court considered the absence of various board-level structures "before the *listeria* outbreak engulfed the company."[247] The Court concluded that the complaint fairly alleged several dispositive deficiencies:

- no board committee that addressed food safety **[*71]** existed;
- no regular process or protocols that required management to keep the board apprised of food safety compliance practices, risks, or reports existed;
- no schedule for the board to consider on a regular basis, such as quarterly or biannually, any key food safety risks existed;
- during a key period leading up to the deaths of three customers, management received reports that contained what could be considered red, or at least yellow, flags, and the board minutes of the relevant period revealed no evidence that these were disclosed to the board;
- the board was given certain favorable information about food safety by management, but was not given important reports that presented a much different picture; and
- the board meetings are devoid of any suggestion that there was any regular discussion of food safety issues.[248]

Like food safety in *Marchand*, airplane safety "was essential and mission critical" to Boeing's business,[249] and externally regulated.[250] Considering *Marchand*'s mandate that the board rigorously exercise its oversight function with respect to mission critical aspects of the company's business, such as the safety of its products that are widely distributed and used by consumers, **[*72]** as well as the failings *Marchand* identified as giving rise to the reasonable inference that the board faced a substantial likelihood of liability under prong one, I conclude that Plaintiffs have carried their burden under *Rule 23.1* for their prong one claim. To be clear, I do not track the deficiencies *Marchand* identified because they are any sort of prescriptive list; "[a]s with any other disinterested business judgment, directors have great discretion to design context-and industry-specific approaches tailored to their companies' businesses and resources."[251] I echo *Marchand* because it is dispositive in view of Plaintiffs' remarkably similar factual allegations.

***i. The Board had no committee charged with direct responsibility to monitor airplane safety*.**

---

[242] *E.g.*, *Stone, 911 A.2d 362*; *Hughes, 897 A.2d 162*; ***Citigroup, 964 A.2d 106***.

[243] ***Marchand, 212 A.3d at 824*** (stating "food safety was essential and mission critical"); *see also* ***id. at 822*** (observing that food safety "has to be one of the most central issues at the company" and "a compliance issue intrinsically critical to the company's [monoline] business operation").

[244] *Clovis*, 2019 Del. Ch. LEXIS 1293, 2019 WL 4850188, at *13 (citing ***Marchand, 212 A.3d at 824***).

[245] *Id.* (alterations, footnotes, internal quotation marks omitted) (quoting ***Marchand, 212 A.3d at 822***).

[246] ***Marchand, 212 A.3d at 821-24***.

[247] ***Id. at 822***.

[248] *Id.*

[249] ***Id. at 824***.

[250] *See* *Chou, 2020 Del. Ch. LEXIS 274, 2020 WL 5028065, at *18* ("[W]hen regulations governing drug health and safety are at issue, ABC's Board must actively exercise its oversight duties in order to properly discharge its duties in good faith. The allegations here are a prime example: flouting laws meant to ensure the safety and purity of drugs destined for patients suffering from cancer is directly inimical to the central purpose of ABC's business."); *Clovis*, 2019 Del. Ch. LEXIS 1293, 2019 WL 4850188, at *13 ("[W]hen a company operates in an environment where externally imposed regulations govern its 'mission critical' operations, the board's oversight function must be more rigorously exercised.").

[251] ***Marchand, 212 A.3d at 821***.

The Amended Complaint alleges the Board had no committee charged with direct responsibility to monitor airplane safety. While the Audit Committee was charged with "risk oversight," safety does not appear in its charter. Rather, its oversight function was primarily geared toward monitoring Boeing's financial risks.[252]

Perhaps because the Audit Committee was not asked to do so, the pleading stage record indicates the Audit Committee did not regularly **[*73]** or meaningfully address or discuss airplane safety. The yearly report the Audit Committee received on Boeing's compliance risk management process did not include oversight of airplane safety.[253] Specifically as to the 737 MAX, the Audit Committee never assessed its safety risks, including those regarding MCAS and the AOA sensor, during its development before the Lion Air Crash or after; nor did the Audit Committee ask for presentations or information on the topic.[254] Similarly, the ERV process and Corporate Audit group did not address airplane safety.[255]

Defendants press that the Audit Committee addressed "risk" broadly, pointing to one-off instances like when it responded to FAA questions about the Dreamliner battery incident, or when it referred to "quality" or "safety" in passing. But those occasional occurrences fail to dislodge Plaintiffs' allegations that the Board did not specifically charge the Audit Committee with monitoring airplane safety. And to the extent Defendants point to risk analysis mechanisms and reports, like the ERV process and the Corporate Audit group,[256] in the absence of any allegation or indication that they were devoted to airplane safety, the reasonable **[*74]** inference is that they fall within the Audit Committee's financial and regulatory risk mandate.

At the pleading stage, the existence of the Audit Committee, Corporate Audit group, and ERV process cannot support the conclusion that the Board established any committee or process charged with direct responsibility to monitor airplane safety. To the contrary, the Board did not establish the Airplane Committee, which was explicitly tasked with overseeing airplane safety, until April 2019; the Airplane Committee was the first Board committee to formally request information about the cause of the crashes.

The lack of Board-level safety monitoring was compounded by Boeing's lack of an internal reporting system by which whistleblowers and employees could bring their safety concerns to the Board's attention. More than three months after the Ethiopian Airlines Crash, Giambastiani proposed that once safety concerns were evaluated by the SRB, they should be elevated to the Audit Committee, CTO, and CFO, and thereafter be shared with the Board.

ii. The Board did not monitor, discuss, or address airplane safety on a regular basis.

Zooming out from the committee level, Plaintiffs have alleged specific **[*75]** facts supporting the conclusion that the Board writ large did not formally address or monitor safety. The Board did not regularly allocate meeting time or devote discussion to airplane safety and quality control until after the second crash. Nor did the Board establish a schedule under which it would regularly assess airplane safety to determine whether legitimate safety risks existed.

The period after the Lion Air Crash is emblematic of these deficiencies. The Board's first call on November 23 was explicitly optional. The crash did not appear on the Board's formal agenda until the Board's regularly scheduled December meeting; those board materials reflect discussion of restoration of profitability and efficiency, but not product safety, MCAS, or the AOA sensor.[257] The Audit Committee devoted slices of five-minute blocks to the crash, through the lens of supply chain, factory disruption, and legal issues—not safety.[258]

The next board meeting, in February 2019, addressed factory production recovery and a rate increase, but not product safety or MCAS.[259] At that meeting, the Board affirmatively decided to delay its investigation into the

[252] *See* Hr'g Tr. 30-33.

[253] Hr'g Tr. 20-23.

[254] *Id.* 32.

[255] *See supra* notes 31-32.

[256] *See* Defs.' Ex. 7; Defs.' Ex. 9; Defs.' Ex. 10; Defs.' Ex. 23; Defs.' Ex. 24; Defs.' Ex. 25.

[257] *See id.* ¶¶ 230-31; Defs.' Ex. 61; *see also* Defs.' Ex. 64 at -575 (identifying the Lion Air Crash as a "key topic" with no mention of safety).

[258] Defs.'Ex. 14; Defs' Ex. 61 at 2; Defs'. Ex. 84 at - 618197, -618203-07.

[259] Am. Compl. ¶ 237; Defs.' Ex. 64 at - 575.

737 MAX, notwithstanding publicly reported **[*76]** concerns about the airplane's safety. Weeks later, after the Ethiopian Airlines Crash,[260] the Board still did not consider the 737 MAX's safety. It was not until April 2019—after the FAA grounded the 737 MAX fleet—that the Board built in time to address airplane safety.[261]

Defendants argue the Board "regularly discussed" safety as part of its strategic initiatives, pointing to slide decks that nod to "safety" as an "enduring value"[262] and as part of a "production system" that was simultaneously focused on "[a]ccelerating productivity."[263] They also point out that the Board was updated on the 737 MAX's development, production, and certification,[264] and that the Board inspected the plants where the 737 MAX was assembled, including on a June 2018 inspection of the Everett production site.[265] Defendants stress that the Board "oversaw the quality and safety of the 737 MAX program through monitoring the progress of the FAA's extensive certification review of the 737 MAX."[266]

But the invocations of safety Defendants highlight must be considered in the broader context Plaintiffs plead. The Board focused on the 737 MAX's production, development, and certification in order to assess production timelines and **[*77]** revenue expectations, and to strengthen the Company's relationships with FAA officials—not to consider customer safety.[267] The Board and management's passive invocations of quality and safety, and use of safety taglines, fall short of the rigorous oversight *Marchand* contemplates.

[260] Am. Compl. ¶ 248; Defs.' Ex. 66 at - 620851.

[261] Am. Compl. ¶ 79; Defs.' Ex. 75; Defs.' Ex. 77.

[262] Defs.' Ex. 16 at - 11080, -13052.

[263] Defs.' Ex. 17 at - 11645; *see also* Defs.' Ex. 20 at - 13057 (including the tagline "[e]nsuring the safety, integrity and quality of Boeing products" in a test evaluation update).

[264] D.I. 146 at 19-22; Defs.' Ex. 8 at - 11183; Defs.' Ex. 28; Defs.' Ex. 29; Defs.' Ex. 39 at - 8133; Defs.' Ex. -8086; Defs.' Ex. 41-8314; Defs.' Ex. 52 at - 11403.

[265] Defs.' Ex. 26; Defs.' Ex. 27; Defs.' Ex. 28; Defs.' Ex. 29.

[266] D.I. 146 at 20.

[267] Am. Compl. ¶¶ 127-28 (addressing board presentations containing taglines such as "*Performance, schedule, and cost certain . . . Stingy with a purpose*" and "*Transforming production system to support market demand*," and "Imperatives" such as "Break Cost Curve," "Faster to Market," and "Affordability Culture").

And under *Marchand*, minimal regulatory compliance and oversight do not equate to a *per se* indicator of a reasonable reporting system. "[T]he fact that [Boeing] nominally complied with F[A]A regulations does not imply that the *board* implemented a system to monitor [airplane] safety *at the board level*. Indeed, these types of routine regulatory requirements, although important, are not typically directed at the board."[268] The fact that Boeing's management was seeking minimal regulatory certification and periodically informing the Board of its progress in pursuit of production-based business objectives "does not rationally suggest that the board implemented a reporting system to monitor [airplane] safety or [Boeing's] operational performance," as "[t]he mundane reality that [Boeing] is in a highly **[*78]** regulated industry and complied with some of the applicable regulations does not foreclose any pleading-stage inference that the directors' lack of attentiveness rose to the level of bad faith indifference required to state a *Caremark* claim."[269] As *Marchand* made plain, the fact that the company's product facially satisfies regulatory requirements does not mean that the board has fulfilled its oversight obligations to prevent corporate trauma.

iii. The Board had no regular process or protocols requiring management to apprise the Board of airplane safety; instead, the Board only received ad hoc *management reports that conveyed only favorable or strategic information*.

As alleged, the Board did not simply fail to assess safety itself; it also failed to expect or demand that management would deliver safety reports or summaries to the Board on a consistent and mandatory basis. The Amended Complaint's allegations and exhibits incorporated by reference show that the Board received intermittent, management-initiated communications that mentioned safety in name, but were not safety-centric and instead focused on the Company's production and revenue strategy. And when safety was mentioned to the **[*79]** Board, it did not press for further information, but rather passively accepted management's assurances and opinions.[270]

[268] ***Marchand, 212 A.3d at 823***.

[269] *Id.*

[270] *See* Defs. Ex. 53; Defs.' Ex. 56; Defs.' Ex. 58; Defs.' Ex. 59; Defs.' Exs. 62-63; Defs.' Ex. 86; Am. Compl. ¶¶ 214, 224, 225, 227, 228.

For mission-critical safety, discretionary management reports that mention safety as part of the Company's overall operations are insufficient to support the inference that the Board expected and received regular reports on product safety.[271] Boeing's Board cannot leave "compliance with [airplane] safety mandates to management's discretion rather than implementing and then overseeing a more structured compliance system."[272] An effective safety monitoring system is what allows directors to believe that, unless issues or "red flags" make it to the board through that system, corporate officers and employees are exercising their delegated powers in the corporation's best interest.[273]

Here, the reports the Board received throughout the 737 MAX's development and FAA certification were high-level reports focused on the Company's operations and business strategy; the Board did not expect any safety content.[274] After the Lion Air Crash, management's communications to the Board demonstrate the lack of a Board process or protocol governing such communications.[275] None of Muilenburg's **[*80]** communications in the weeks following the Lion Air Crash were initiated by a Board request, either as a one-off or as part of a standing protocol. Muilenburg sent them at his discretion.[276] In the absence of a safety mandate, Muilenburg's self-directed communications to the Board focused on discrediting media reports faulting MCAS, and on blaming Lion Air repair shops and crew. Muilenburg did not send any communication to the Board about the Lion Air Crash until November 5, 2018, roughly one week after it happened.[277] In that email, he disclosed that an airspeed indicator was damaged, but treated the Lion Air crash as a public relations problem and maintained to the Board that the "737 MAX fleet is safe."[278] Muilenburg contacted the Board again after the *WSJ* Article was printed: he gave lip service to the idea that "[t]he safety of our planes is our top priority," but claimed the references to withholding information "are categorically false," that existing flight crew procedures were adequate, and that the 737 MAX was safe.[279] Muilenburg's assurances to the Board that the 737 MAX was safe were based on unreliable information, as he emphasized the "rigorous test program" Boeing endured **[*81]** "[t]o earn FAA certification."[280] His primary focus was the restoration of Boeing's public image.[281]

In the months that followed, Muilenburg's updates focused on Boeing's image and the accident's impact on the 737 MAX's production and delivery schedule, not product safety.[282] His monthly dashboard reports to the Board and regular updates on Company engineering initiatives addressed production and cost expectation and challenges, but not safety.[283] He repeatedly told the Board the 737 MAX was safe and blamed pilot and maintenance error.[284] Nothing indicates that the Board pressed him for more information about the cause of the

[271] *See* ***Marchand, 212 A.3d at 823-24***.

[272] *Clovis*, 2019 Del. Ch. LEXIS 1293, 2019 WL 4850188, at *12 (describing *Marchand*).

[273] *See* *Forsythe v. ESC Fund Mgmt. Co. (U.S.), 2007 Del. Ch. LEXIS 140, 2007 WL 2982247, at *7 (Del. Ch. Oct. 9, 2007)*.

[274] *See* Defs.' Ex. 40 at - 8086; Defs.' Ex. 41.

[275] *See, e.g.*, Am. Compl. ¶ 91("In July 2018, Boeing's Test and Evaluation department voiced concerns to 'Boeing Executive Leadership' regarding the 'considerable pressure' the 737 MAX program faced over production schedules. The department's letter identifies the 'ero[sion of] safety margins' due to the declining average experience among senior production pilots. [Boeing's] Employee Relations Director . . . . forwarded the communication to defendant Hyslop, Boeing's chief engineer, but . . . mischaracterized the letter as seeking mainly compensation and additional benefits, without flagging the safety concerns of overworked employees.").

[276] *See* Defs.' Ex. 53; Defs.' Ex. 56; Defs.' Ex. 57; Defs.' Ex. 58; Am. Compl. ¶¶ 206, 229.

[277] At argument, Boeing's counsel explained this was so because the crash occurred overseas and in the water. *See* Hr'g Tr. 27.

[278] Defs.' Ex. 55.

[279] Am. Compl. Ex. D.

[280] *Id.*; *accord* Defs.' Ex. 57.

[281] Am. Compl. Ex. D; *accord* Defs.' Ex. 57.

[282] *See, e.g.*, Defs.' Ex. 56 (focusing on "our strong performance [a]s supported by our continued 737 recovery); Defs.' Ex. 58 (stating that Boeing "must allow [the investigation] to run its course," maintaining the "[b]ottom line" that "the 737 MAX is safe," and ultimately concluding with an update on "737 production" and touting that the Company completed "43 deliveries for October," "an all-time high for the month and a positive sign or production recovery plane and supplier management efforts are working"); Defs.' Ex. 60.

[283] *See* Defs.' Ex. 21; Defs.' Ex. 22 at - 18838.

[284] *See, e.g.*, Am. Compl. ¶¶ 218, 225; Defs.' Ex. 58.

accident or questioned management's conclusion.[285]

Muilenburg's notes did not reference any Board-level directives for reporting or on investigating the Lion Air Crash.[286] Rather, they indicated that Boeing's management was taking charge while the Board remained a passive recipient of updates: management would "determine whether any action is required," and Muilenburg would "share additional details, if available, in [his] monthly update."[287] Those updates, too, were discretionary and not Board-ordered safety reports.

The Board's reliance **[*82]** on management-directed intermittent safety reporting continued after the Ethiopian Airline Crash. The Board passively accepted Muilenburg's assurances that Boeing's "teams are centered on our priorities, including safety, quality and stability,"[288] as an "ongoing" component of its "production operations";[289] and that public and regulatory backlash was driven solely by "public/political pressure, not by any new facts" about the 737 MAX's safety.[290] The Board did not press for more information. On March 12, Muilenburg emailed the Board about engagement with high federal executive branch officials to keep the 737 MAX flying.[291] One outside director praised Muilenburg's "strong leadership."[292]

It was not until April 2019, the month following the Ethiopian Airline Crash, that Boeing's Vice President of BCA Engineering and BCA's Vice President of Safety, Security & Compliance presented to the Board. This was the first time that the Board or any of its committees heard a presentation from either member of management, "despite their roles leading engineering and safety, respectively, for Boeing's largest segment."[293]

The nature and content of management's *ad hoc* reports to the Board indicate that the **[*83]** Board had no regular process or protocols requiring management to apprise the Board of airplane safety.[294] Nothing in the Amended Complaint or documents submitted supports the inference that the Board requested those reports or expected those reports to contain safety information.[295]

Management's *ad hoc* reports were also one-sided at best and false at worst, conveying only favorable and optimistic safety updates and assurances that the quality of Boeing's aircraft would drive production and revenue. Management reported its unsupported conclusion that MCAS and the AOA sensor did not cause the crashes and that the 737 MAX remained airworthy and able to meet production goals. Management told the Board that "the function performed by MCAS" was referenced in the Flight Crew Operations Manual, and expressed frustration with public commentary.[296] Muilenburg also told the Board that Boeing was developing a "737 MAX software enhancement that, when implemented, will further improve system safety," and that "[d]espite recent media speculation," nothing had been decided about the "software update and its timing"—understating that "enhancement['s]" lifesaving importance.[297]

285 While Muilenburg himself was Chairman of the Board at this time, Defendants have not attempted to impute his knowledge to the Board as a whole. *See* Am. Compl. ¶ 37.

286 *See* Defs.' Ex. 57.

287 *E.g.*, Defs.' Ex. 55.

288 Defs.' Ex. 66 at - 620851.

289 *Id.*

290 Defs.' Ex. 68.

291 *Id.*

292 Am. Compl. ¶ 252.

293 *Id.* ¶ 71.

294 Hr'g Tr. 14-16 ("THE COURT: Where can I see that expectation and practice from the board's side rather than management coming forward and — you've pointed me to some examples of management coming forward to the board. Can you point me to any examples of where the board has expressed its expectation that management do so? MR. RABINOVITZ: I can't point you to a written protocol, Your Honor . . . [But] the fact that this practice existed is a meaningful indication of the protocol that did exist between management and the board. The board doesn't need to say so. The proof is in the pudding, as it were. . . . THE COURT: Just before you do that, just to put a bit of a finer point on it, the protocol that you're offering is manifested only when management chose to elevate issues to the board? MR. RABINOVITZ: This specific part, right. Elevating specific safety issues when management believed they warranted board attention. I cannot point to that in writing.").

295 *See id.* 14-16, 19-21, 32, 47-48.

296 Am. Compl. ¶ 224.

297 *Id.* ¶ 234; Defs.' Ex. 63 at - 13683.

Because the Board did not **[*84]** have any formal procedures in place to monitor the safety of Boeing's airplanes, the Board was not privy to the truth about MCAS, AOA sensor vulnerabilities, or how those issues were handled in FAA certification and pilot training.[298] It accepted Muilenburg's denials, deflections, and repeated insistence that the 737 MAX was safe, even after the press faulted MCAS and insufficient training for the Lion Air Crash.

The fact that management only communicated with the Board regarding safety on an *ad hoc* basis as necessary to further business strategy, and the fact that management only gave the board "certain favorable information" but not "important reports that presented a much different picture," indicate that the Board failed to implement a reasonable reporting system to monitor the safety of Boeing's airplanes.[299]

iv. Management saw red, or at least yellow, flags, but that information never reached the Board.

In *Marchand*, the Supreme Court agreed with the plaintiff that management's knowledge about growing safety issues in the company and failure to report those issues to the board was "further evidence that the board had no food safety reporting system in place."[300] Where management received **[*85]** reports that contained what could be considered red, or at least yellow, flags, and the board minutes of the relevant period revealed no evidence that these were disclosed to the board, it is reasonable to infer the absence of a reporting system.[301] Here, as in *Marchand*, Boeing management knew that the 737 MAX had numerous safety defects, but did not report those facts to the Board.

In the critical period leading up to the Lion Air Crash, Boeing management received formal complaints from employees who questioned the safety of the 737 MAX. Further, Boeing's Internal Safety Analysis found that if a pilot took more than ten seconds to identify and respond to the MCAS activation, the result would be catastrophic. Forkner made MCAS's vulnerability issues known within the Company. But before the Lion Air Crash, there is no evidence that management apprised the Board of the AOA disagree sensor's malfunctions or the probability of catastrophic failure.[302]

After the Lion Air Crash, Boeing started revising MCAS and, like the FAA, performed a risk assessment that concluded an unacceptably high risk of catastrophic failure. Boeing also pushed out the Manual Bulletin, and the FAA issued the Emergency **[*86]** Directive.[303] But management told the Board the 737 MAX was safe, and did not brief the Board on the risks of MCAS.

Thus, safety concerns known to management failed to make their way to the Board, supporting the conclusion that the Board failed to establish a reporting system.

v. In addition to the inferences drawn above, the pleading-stage record supports an explicit finding of scienter.

Plaintiffs have pled facts that allowing a reasonable inference that the directors breached their duties of oversight with scienter: not only did the Director Defendants act inconsistently with their fiduciary duties, but they also knew of their shortcomings.[304] In *Marchand*, the Delaware Supreme Court inferred scienter from the lack of any board committee focused on safety; any regular process or protocols requiring management to report on safety risks; any regular schedule for the board to address safety; any board minutes or documents suggesting that they regularly discussed safety; any evidence that red, or at least yellow, flags, were disclosed to the board; and any evidence that management conveyed both favorable and unfavorable safety information to the board.[305] Those allegations support an inference of **[*87]** scienter here as well.

---

[298] *See* Hr'g Tr. 32 ("MR. RABINOVITZ: I do not think there is anything in the record suggesting that the board was briefed on the MCAS at all before the — before the first 737 MAX accident.").

[299] *See* ***Marchand, 212 A.3d at 822***.

[300] ***Id. at 817***.

[301] ***Id. at 822***.

[302] *See* Hr'g. Tr. 32 ("MR. RABINOVITZ: I do not think there is anything in the record suggesting that the board was briefed on the MCAS at all before the — before the first 737 MAX accident.").

[303] Am. Compl. ¶¶ 189-91.

[304] *See, e.g.*, *Horman, 2017 Del. Ch. LEXIS 13, 2017 WL 242571, at *7* (quoting *Massey*, 2011 Del. Ch. LEXIS 83, 2011 WL 2176479, at *22).

[305] ***Marchand, 212 A.3d at 822***.

But no inference is needed: the difficult scienter element is directly met by the Board's own words. They confirm that directors knew the Board should have had structures in place to receive and consider safety information. Collins's March 15, 2019 email to Calhoun is exemplary. In the absence of Board meetings and discussions about safety before the crashes, Collins pitched that "we should devote the entire board meeting (other than required committee meetings and reports) to a review of quality within Boeing," because "[i]n addition to providing necessary information for the Board, this type of agenda would underscore the board's (and management's) unwavering commitment to quality and safety above all other performance criteria."[306] Collins's follow-up email on the "category of 'lessons learned'" reflected on his and Calhoun's time at Medtronic, where they "began each board meeting, executive committee meeting, and operating review with a review of product quality/safety—before any discussion of financial performance, market share/competitive activities, new product development timetables, and certainly stock price,"[307] so that "everyone in the corporation **[*88]** understood that nothing was more important to the CEO and the board than quality/safety."[308] In response, Muilenburg "added Safety data to the Board lead-off briefing, and . . . monthly Board note too,"[309] and the Board held its first meetings to formally address airplane safety.

That the Board knowingly fell short is also evident in the Board's public crowing about taking specific actions to monitor safety that it did not actually perform. Calhoun hustled to "[p]osition the Boeing Board of Directors as an independent body that has exercised appropriate oversight."[310] He falsely touted that the Board was immediately contacted and met "very, very quickly" after the Lion Air Crash;[311] participated in evaluating the 737 MAX's safety risks; considered grounding the 737 MAX after the Lion Air Crash;[312] met within twenty-four hours of that crash to consider grounding; and recommended grounding.[313] Each of Calhoun's public representations was knowingly false.[314] They evidence that at least Calhoun knew what the Board should have been doing all along.

Plaintiffs have met their "onerous pleading burden" under *Caremark* prong one, and are entitled to discovery to prove out that claim.[315] **[*89]** As espoused in *Marchand*, the Board has a rigorous oversight obligation where safety is mission critical, as the fallout from the Board's utter failure to try to satisfy this "bottom-line requirement"[316] can cause "material suffering," even short of death, "among customers, or to the public at large," and attendant reputational and financial harm to the company.[317] Plaintiffs allege a majority of the Director Defendants face liability under that theory, and have stated a claim.

b. Plaintiffs Have Stated A Post-Lion Air Claim Under *Caremark* Prong Two.

Plaintiffs also contend the Director Defendants face a substantial likelihood of liability under *Caremark* prong two because they ignored the Lion Air Crash and other red flags about the 737 MAX's safety before the Ethiopian Airlines Crash.[318] "To state a prong two *Caremark* claim, Plaintiff must plead particularized facts that the board knew of evidence of corporate misconduct—the proverbial red flag—yet acted in bad faith by consciously disregarding its duty to address that misconduct."[319] Plaintiffs have done so here.

306 Am. Compl. Ex. C.

307 *Id.*

308 *Id.*

309 *Id.*

310 Am. Compl. ¶ 263.

311 *Id.* ¶¶ 268-69.

312 *Id.* ¶ 271.

313 *Id.* ¶¶ 274-75.

314 *See, e.g.*, *id.* ¶¶ 271-76; Defs.' Ex. 69. As stated, Count I of the Amended Complaint categorizes the Board's public deception as a breach of fiduciary duty. Although the parties did not focus on that allegation in briefing or at argument, to the extent Plaintiffs pursue the Board's misrepresentations as an independent breach, the Motion is DENIED.

315 ***Marchand, 212 A.3d at 824***

316 ***Id. at 821***.

317 *Chou, 2020 Del. Ch. LEXIS 274, 2020 WL 5028065, at *1*.

318 By the time of the October 2018 Lion Air Crash, Stephenson and McNerney were no longer on the Board.

319 *2020 Del. Ch. LEXIS 274, [WL] at *17* (alterations and internal quotation marks omitted) (quoting *Reiter*, 2016 Del. Ch. LEXIS 158, 2016 WL 6081823, at *8).

A classic prong two claim acknowledges the board had a reporting system, but alleges that system brought information to the board that the board then ignored.[320] In this case, Plaintiffs' prong two claim overlaps and coexists with their prong one claim; Plaintiffs assert the Board ignored red flags at the same time they utterly failed to establish a reporting system.[321]

I can appreciate the breadth of Plaintiffs' **[*90]** theory in view of the Board's pervasive failures under prong one and the scale of the tragedy that followed. Boeing's safety issues manifested in the Lion Air Crash—an accident the Board could not help but learn about, despite the lack of a Board-level monitoring system. Unlike many harms in the *Caremark* context, which include financial misconduct that the board can likely discover only through an internal system, the Board did not require an internal system to learn about the Lion Air Crash and the attendant MCAS failures.[322] The Lion Air Crash and its causes were widely reported in the media; those reports reached the Board; and the Board ignored them.[323]

But I need not decide today whether Plaintiffs' prong two theory is cognizable in view of my conclusion that the Board utterly failed under prong one. Defendants press that "the Board had extensive reporting systems and controls," including its Audit Committee, ERV, ethics and compliance reporting portals, internal audits group, and regular management and legal updates.[324] Assuming Defendants are correct, the Board nonetheless ignored the Lion Air Crash and the consequent revelations about the unsafe 737 MAX.

The Lion Air **[*91]** Crash was a red flag about MCAS that the Board should have heeded but instead ignored. The Board did not request any information about it from management, and did not receive any until November 5, 2018, over one week after it happened. In that communication, Muilenburg advanced management's position that the 737 MAX was safe, and the Board passively accepted that position. The November 12 *WSJ* Article circulated the theory that MCAS had serious engineering defects that were concealed from regulators and pilots, which required immediate investigation and remediation. The Board was aware of that article, but did not question management's contrary position. The Section 220 record does not reveal evidence of any director seeking or receiving additional written information about MCAS or the AOA sensor, Boeing's dealings with the FAA, how it had obtained FAA certification, the required amount of pilot training for the 737 MAX, or about airplane safety generally.[325]

When the Board finally convened to address the Lion Air Crash, the call was optional. The full Board did not anchor the tragedy as an agenda item until it met for its regularly scheduled Board meeting in December 2018, and its focus at that **[*92]** meeting was on the continued production of the 737 MAX, rather than MCAS, potential remedial steps, or safety generally.[326] And when the Board eventually considered whether it should investigate the causes of the Lion Air Crash, at the February 2019 Board meeting, the Board formally resolved to "delay any investigation until the conclusion of the regulatory investigations or until such time as the

---

[320] *See, e.g.*, Pettry on behalf of FedEx Corp. v. Smith, 2021 Del. Ch. LEXIS 134, 2021 WL 2644475, at *7-12 (Del. Ch. June 28, 2021) (reciting the *Caremark* prong two standard, and finding that the board did not ignore red flags that were elevated through the company's reporting system); *Clovis*, 2019 Del. Ch. LEXIS 1293, 2019 WL 4850188, at *13 (quoting ***Marchand, 212 A.2d at 821***) ("*Caremark*'s second prong is implicated when it is alleged the company implemented an oversight system but the board failed to 'monitor it.'"); *cf.* Chou, 2020 Del. Ch. LEXIS 274, 2020 WL 5028065, at *17-26 (concluding that the board consciously ignored red flags that were raised to the board where "Plaintiffs allege[d] that the Director Defendants face a substantial likelihood of liability under *both* prongs of *Caremark*").

[321] *See, e.g.*, Chou, 2020 Del. Ch. LEXIS 274, 2020 WL 5028065, at *26 ("Because the Complaint survives under a 'prong two' theory, I need not decide whether the Director Defendants face a substantial likelihood of liability under 'prong one' of *Caremark*. I note, however, that the Davis Polk Report indicates that several years after acquiring Specialty, ABC had a woefully inadequate compliance system. While the implication of a 'prong one' claim is unnecessary to survive the Defendants' Motion, it nonetheless speaks to a lax approach (at best) to compliance at ABC.").

[322] *See, e.g.*, Am. Compl. ¶¶ 195-98, 208-09; *id.* Ex. D; Defs.' Ex. 55; Hr'g Tr. 32.

[323] *See* Am. Compl. ¶¶ 195-98, 208-09; *id.* Ex. D; Defs.' Ex. 55.

[324] D.I. 146 at 38.

[325] *See* In re Tyson Foods, Inc., 919 A.2d 563, 578 (Del. Ch. 2007) ("[I]t is more reasonable to infer that exculpatory documents would be provided than to believe the opposite: that such documents existed and yet were inexplicably withheld.").

[326] Am. Compl. ¶ 231-32; Defs.' Ex. 84 at - 618203.

Board determines that an internal investigation would be appropriate."[327]

Electing to follow management's steady misrepresentations that the 737 MAX fleet was safe and airworthy, the Board treated the crash as an "anomaly," a public relations problem, and a litigation risk,[328] rather than investigating the safety of the aircraft and the adequacy of the certification process. The Board's declination to test the modicum of information it received and seek the truth of the 737 MAX's safety, despite reported information calling it into question, do not indicate a mere "failed attempt" to address a red flag.[329] As alleged and supported by the *Section 220* record, the Board was aware or should have been aware that its response to the Lion Air Crash fell short.[330]

2. Plaintiffs Have Not Pled Particularized Facts [*93] Demonstrating The Director Defendants Face A Substantial Likelihood Of Liability With Respect To Muilenburg's Retirement And Compensation.

Plaintiffs also allege that the Director Defendants consciously breached their fiduciary duties by allowing Muilenburg to receive unvested equity-based compensation in a quiet retirement, despite knowing that he misled the FAA and the Board, and failed in his response to the Lion Air and Ethiopian Airlines Crashes. Plaintiffs couch this claim as one for waste or, in the alternative, bad faith.[331] But Plaintiffs have not alleged particularized facts sufficient to demonstrate that the Director Defendants face a substantial likelihood of liability under these rigorous standards.[332]

Plaintiffs do not meaningfully challenge the independence and disinterestedness of the Board as to the terms of Muilenburg's departure. Plaintiffs theorize the Board bought Muilenburg's silence because he knew the depth of the Board's ignorance about the 737 MAX. Plaintiffs contend that the Board acted out of self-interest by allowing Muilenburg to retire and claim his unvested equity because "Muilenburg could have accused the **[*94]** Board members of unfairly scapegoating him for doing what the Board wanted."[333] They argue "[t]he Board's pronounced lack of safety oversight incentivized the Board members not to make an enemy of Muilenburg at a time of public clamor over whether the Board bore any culpability for the mass fatalities and resulting financial catastrophe at Boeing."[334] But Plaintiffs do not plead particularized facts supporting their theory that "[p]aying Muilenburg encouraged his silence about his interactions with the Board."[335] Nothing in the *Section 220* production gives rise to the reasonable inference that Muilenburg intended to retaliate against the Board by placing the blame at its feet. This theory is conclusory.

Further, Plaintiffs have not pled particularized facts giving rise to the inference that the Board would face a substantial likelihood of liability under waste or bad faith theories. "[T]he standard for waste is a very high one that is difficult to meet,"[336] and "to prevail on a waste claim the plaintiff must overcome the general presumption of good faith by showing that the board's decision was so egregious or irrational that it could not have been based on a valid assessment of the

---

[327] Am. Compl. ¶ 238; Pls.' Ex. 4.

[328] Am. Compl. ¶ 271.

[329] *Cf.* *Richardson v. Clark, 2020 Del. Ch. LEXIS 378, 2020 WL 7861335, at *11 (Del. Ch. Dec. 31, 2020)*; *In re Qualcomm FCPA Stockholder Deriv. Litig., 2017 Del. Ch. LEXIS 106, 2017 WL 2608723, at *4 (Del. Ch. June 16, 2017)*.

[330] *See* Am. Compl. Ex. C (addressing "lessons learned' and the Board's need to begin addressing safety in a formal setting); *Rich ex rel. Fuqi Int'l, Inc. v. Yu Kwai Chong, 66 A.3d 963, 983-84 (Del. Ch. 2013)* (finding scienter where company's directors "knew that there were material weaknesses in [the company's] internal controls"); *cf.* *In re GoPro, Inc. Stockholder Derivative Litig., 2020 Del. Ch. LEXIS 165, 2020 WL 2036602, at *13 (Del. Ch. Apr. 28, 2020)* (declining to find that Plaintiffs offered "well-pled facts supporting an inference that a majority of the Demand Board personally *knew* about Karma's defect, could meaningfully address the issue at the Board level and yet elected to do nothing").

[331] *See* D.I. 155 at 56-61.

[332] This is true whether the Board's decision to terminate Muilenburg is considered under *Aronson* or *Rales*. *See* *Zuckerberg, 250 A.3d at 877-90*; *see also* D.I. 146 at 58 ("Whether the Board's decision to terminate Muilenburg is considered under *Aronson* or *Rales*, . . .Plaintiffs fail to establish demand futility."); *id.* at 60 (assessing Plaintiffs' claims under *Rales*); D.I. 155 at 38 (citing and applying *Rales*).

[333] D.I. 155 at 59.

[334] *Id.* at 60.

[335] *Id.*

[336] *In re Walt Disney Co. Deriv. Litig., 907 A.2d 693, 759 (Del. Ch. 2005)*.

corporation's best **[*95]** interests."[337] "[T]o excuse demand on grounds of waste the Complaint must allege particularized facts that lead to a reasonable inference that the director defendants authorized 'an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.'"[338] The burden to establish a claim for bad faith is similarly stringent. A finding of bad faith in the fiduciary context is rare.[339] "Absent direct evidence of an improper intent, a plaintiff must point to a decision that lacked any rationally conceivable basis . . . to survive a motion to dismiss."[340]

The Amended Complaint and the *Section 220* record do not support such claims here, as it is reasonable to infer that the Board was validly exercising its business judgment when it decided to allow Muilenburg to retire with compensation. At that time, Boeing was facing substantial backlash and had spent millions of dollars addressing the 737 MAX corporate trauma. Even accepting as true that the Board allowed Muilenburg to go quietly and with full pockets to avoid further public criticism, it is reasonable to infer that doing so was in furtherance **[*96]** of the legitimate business objective of avoiding further reputational and financial harm to the Company.[341] Accordingly, Plaintiffs have failed to allege particularized facts that the decision to forego Muilenburg's termination for cause "was otherwise the product of a valid exercise of business judgment."[342] The Motion is therefore granted as to Plaintiffs' Muilenburg compensation claims.

B. The Motion Is Granted As To Count II's Claim Against The Officer Defendants.

Defendants have also moved to dismiss all claims against the Officer Defendants under *Rules 23.1* and *12(b)(6)*. Defendants argue that Plaintiffs do not plead with particularity facts establishing that demand is excused for Count II of their Complaint, alleging breach of fiduciary duty by Boeing's officers.[343] Defendants further argue that Delaware does not recognize *Caremark* claims against officers, and that Plaintiffs have failed to allege that the Officer Defendants breached their duty of care.[344]

In briefing, Plaintiffs did not address Defendants' demand futility arguments as to Count II.[345] Instead, Plaintiffs' theory under *Rule 23.1* presumably turns on the assumption that the Officer Defendants can face *Caremark* liability, and that therefore demand **[*97]** was futile as to all Defendants facing the same claim. But Plaintiffs have not pled this with the requisite particularity, nor have they argued that any of the Director Defendants are beholden to or dominated by the Boeing officers such that they would be unable to assess Count II regardless of the theory of liability.[346]

---

337 ***Citigroup, 964 A.2d at 136*** (alterations and internal quotation marks omitted).

338 *Id.*

339 *See* *In re Saba Software, Inc. Stockholder Litig., 2017 Del. Ch. LEXIS 52, 2017 WL 1201108, at *20 (Del. Ch. Mar. 31, 2017)* (citing *In re Chelsea Therapeutics Int'l Ltd. Stockholders Litig., 2016 Del. Ch. LEXIS 79, 2016 WL 3044721, at *1 (Del. Ch. May 20, 2016)*). That said, I acknowledge the bulk of this opinion concludes the Director Defendants face liability for bad faith dereliction of their oversight duties.

340 *In re Essendant, Inc. Stockholder Litig., 2019 Del. Ch. LEXIS 1404, 2019 WL 7290944, at *14 (Del. Ch. Dec. 30, 2019)* (alteration and internal quotation marks omitted) (quoting *Chen v. Howard-Anderson, 87 A.3d 648, 684 (Del. Ch. 2014)*); *see also Chelsea Therapeutics*, 2016 Del. Ch. LEXIS 79, 2016 WL 3044721, at *1 (stating that in cases where "there is no indication of conflicted interests or lack of independence on the part of the directors," a finding of bad faith should be reserved for situations where "the nature of [the directors'] action can in no way be understood as in the corporate interest: *res ipsa loquitur*").

341 *See* *Shabbouei v. Potdevin, 2020 Del. Ch. LEXIS 121, 2020 WL 1609177, at *12 (Del. Ch. Apr. 2, 2020)* ("[T]he Board was operating well-within the bounds of proper business judgment when it decided to settle with [the former CEO] rather than fire him 'for cause,' a decision that could have embroiled the Company in an embarrassing legal battle with its former CEO."); *Seinfeld v. Slager, 2012 Del. Ch. LEXIS 139, 2012 WL 2501105, at *6 (Del. Ch. June 29, 2012)* ("Other factors may also properly influence the board, including ensuring a smooth and harmonious transfer of power, securing a good relationship with the retiring employee, preventing future embarrassing disclosure and lawsuits, and so on.").

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

343 D.I. 146 at 60.

344 *See id.* at 61-62.

345 *See generally* D.I. 155; D.I. 159 at 33.

346 *E.g.*, *In re MetLife, Inc. Deriv. Litig., 2020 Del. Ch. LEXIS 265, 2020 WL 4746635, at *13 n.186 (Del. Ch. Aug. 17, 2020)*

Indeed, the Amended Complaint's demand futility allegations do not address the Officer Defendants, asserting only that "a majority of the members of the Board have faced a substantial likelihood of liability for failing to make any good faith effort to implement and oversee a board-level system to monitor and report on safety."[347] Accordingly, Count II is dismissed pursuant to *Rule 23.1*, and therefore I need not address Defendants' arguments under *Rule 12(b)(6)*.

III. CONCLUSION

The Motion is **GRANTED** in part and **DENIED** in part. The parties shall submit an implementing order with twenty days of this decision.

(pointing out that plaintiffs did not argue that any board members were beholden to management so as to disable them from evaluating the claims); *Rales, 634 A.2d at 936*.

[347] Am. Compl. ¶ 299.

In re Caremark Int'l

Court of Chancery of Delaware, New Castle

August 16, 1996, DATE SUBMITTED ; September 25, 1996, DATE DECIDED

CONSOLIDATED CIVIL ACTION NO. 13670

Reporter

698 A.2d 959 *; 1996 Del. Ch. LEXIS 125 **

IN RE CAREMARK INTERNATIONAL INC. DERIVATIVE LITIGATION

Subsequent History: **[**1]** Released for Publication by the Court October 4, 1996.

Disposition: Fee of $ 816,000 plus $ 53,000 of expenses advanced by counsel awarded.

Counsel: Joseph A. Rosenthal, Esquire, of ROSENTHAL, MONHAIT, GROSS & GODDESS, P.A., Wilmington, Delaware; OF COUNSEL: LOWEY DANNENBERG BEMPORAD & SELINGER, P.C., White Plains, New York; GOODKIND LABATON RUDOFF & SUCHAROW, L.L.P., New York, New York; Attorneys for Plaintiffs.

Kevin G. Abrams, Esquire, Thomas A. Beck, Esquire and Richard I.G. Jones, Jr., Esquire, of RICHARDS, LAYTON & FINGER, Wilmington, Delaware; OF COUNSEL: Howard M. Pearl, Esquire, Timothy J. Rivelli, Esquire and Julie A. Bauer, Esquire, of WINSTON & STRAWN, Chicago, Illinois; Attorneys for Caremark International, Inc.

Kenneth J. Nachbar, Esquire, of MORRIS, NICHOLS, ARSHT & TUNNELL, Wilmington, Delaware; OF COUNSEL: William J. Linklater, Esquire, of BAKER & McKENZIE, Chicago, Illinois; Attorneys for Individual Defendants.

Judges: ALLEN, CHANCELLOR

Opinion by: ALLEN

Opinion

[*960] MEMORANDUM OPINION

ALLEN, CHANCELLOR

Pending is a motion pursuant to Chancery Rule 23.1 to approve as fair and reasonable a proposed settlement of a consolidated derivative action on behalf of Caremark International, **[**2]** Inc. ("Caremark"). The suit involves claims that the members of Caremark's board of directors (the "Board") breached their fiduciary duty of care to Caremark in connection with alleged violations by Caremark employees of federal and state laws and regulations applicable to health care providers. As a result of the alleged violations, Caremark was subject to an extensive four year investigation by the United States Department of Health and Human Services and the Department of Justice. In 1994 Caremark was charged in an indictment with multiple felonies. It thereafter entered into a number of agreements with the Department of Justice and others. Those agreements included a plea agreement in which Caremark pleaded guilty to a single felony of mail fraud and agreed to pay civil and criminal fines. Subsequently, Caremark agreed to make reimbursements to various private and public parties. In all, the payments that **[*961]** Caremark has been required to make total approximately $ 250 million.

This suit was filed in 1994, purporting to seek on behalf of the company recovery of these losses from the individual defendants who constitute the board of directors of Caremark. [1] The parties now propose **[**3]** that it be settled and, after notice to Caremark shareholders, a hearing on the fairness of the proposal was held on August 16, 1996.

A motion of this type requires the court to assess the strengths and weaknesses of the claims asserted in light of the discovery record and to evaluate the fairness and adequacy of the consideration offered to the

---

[1] Thirteen of the Directors have been members of the Board since November 30, 1992. Nancy Brinker joined the Board in October 1993.

corporation in exchange for the release of all claims made or arising from the facts alleged. The ultimate issue then is whether the proposed settlement appears to be fair to the corporation and its absent shareholders. In this effort the court does not determine contested facts, but evaluates the claims and defenses on the discovery record to achieve a sense of the relative strengths of the parties' positions. Polk v. Good, Del.Supr., 507 A.2d 531, 536 (1986). In doing this, in most instances, the court is constrained by the absence **[**4]** of a truly adversarial process, since inevitably both sides support the settlement and legally assisted objectors are rare. Thus, the facts stated hereafter represent the court's effort to understand the context of the motion from the discovery record, but do not deserve the respect that judicial findings after trial are customarily accorded.

Legally, evaluation of the central claim made entails consideration of the legal standard governing a board of directors' obligation to supervise or monitor corporate performance. For the reasons set forth below I conclude, in light of the discovery record, that there is a very low probability that it would be determined that the directors of Caremark breached any duty to appropriately monitor and supervise the enterprise. Indeed the record tends to show an active consideration by Caremark management and its Board of the Caremark structures and programs that ultimately led to the company's indictment and to the large financial losses incurred in the settlement of those claims. It does not tend to show knowing or intentional violation of law. Neither the fact that the Board, although advised by lawyers and accountants, did not accurately predict **[**5]** the severe consequences to the company that would ultimately follow from the deployment by the company of the strategies and practices that ultimately led to this liability, nor the scale of the liability, gives rise to an inference of breach of any duty imposed by corporation law upon the directors of Caremark.

I. BACKGROUND

For these purposes I regard the following facts, suggested by the discovery record, as material. Caremark, a Delaware corporation with its headquarters in Northbrook, Illinois, was created in November 1992 when it was spun-off from Baxter International, Inc. ("Baxter") and became a publicly held company listed on the New York Stock Exchange. The business practices that created the problem pre-dated the spin-off. During the relevant period Caremark was involved in two main health care business segments, providing patient care and managed care services. As part of its patient care business, which accounted for the majority of Caremark's revenues, Caremark provided alternative site health care services, including infusion therapy, growth hormone therapy, HIV/AIDS-related treatments and hemophilia therapy. Caremark's managed care services included prescription **[**6]** drug programs and the operation of multi-specialty group practices.

A. Events Prior to the Government Investigation

A substantial part of the revenues generated by Caremark's businesses is derived from third party payments, insurers, and Medicare and Medicaid reimbursement programs. The latter source of payments are subject to the terms of the Anti-Referral Payments Law ("ARPL") which prohibits health care providers from paying any form of remuneration **[*962]** to induce the referral of Medicare or Medicaid patients. From its inception, Caremark entered into a variety of agreements with hospitals, physicians, and health care providers for advice and services, as well as distribution agreements with drug manufacturers, as had its predecessor prior to 1992. Specifically, Caremark did have a practice of entering into contracts for services *(e.g.,* consultation agreements and research grants) with physicians at least some of whom prescribed or recommended services or products that Caremark provided to Medicare recipients and other patients. Such contracts were not prohibited by the ARPL but they obviously raised a possibility of unlawful "kickbacks."

As early as 1989, Caremark's predecessor **[**7]** issued an internal "Guide to Contractual Relationships" ("Guide") to govern its employees in entering into contracts with physicians and hospitals. The Guide tended to be reviewed annually by lawyers and updated. Each version of the Guide stated as Caremark's and its predecessor's policy that no payments would be made in exchange for or to induce patient referrals. But what one might deem a prohibited *quid pro quo* was not always clear. Due to a scarcity of court decisions interpreting the ARPL, however, Caremark repeatedly publicly stated that there was uncertainty concerning Caremark's interpretation of the law.

To clarify the scope of the ARPL, the United States Department of Health and Human Services ("HHS") issued "safe harbor" regulations in July 1991 stating conditions under which financial relationships between health care service providers and patient referral sources, such as physicians, would not violate the ARPL. Caremark contends that the narrowly drawn regulations gave limited guidance as to the legality of many of the agreements used by Caremark that did not fall within the safe-harbor. Caremark's predecessor, however, amended many of its standard forms of agreement **[**8]** with health care providers and revised the Guide in an apparent attempt to comply with the new regulations.

B. *Government Investigation and Related Litigation*

In August 1991, the HHS Office of the Inspector General ("OIG") initiated an investigation of Caremark's predecessor. Caremark's predecessor was served with a subpoena requiring the production of documents, including contracts between Caremark's predecessor and physicians (Quality Service Agreements ("QSAs")). Under the QSAs, Caremark's predecessor appears to have paid physicians fees for monitoring patients under Caremark's predecessor's care, including Medicare and Medicaid recipients. Sometimes apparently those monitoring patients were referring physicians, which raised ARPL concerns.

In March 1992, the Department of Justice ("DOJ") joined the OIG investigation and separate investigations were commenced by several additional federal and state agencies. [2]

[9]** C. *Caremark's Response to the Investigation*

During the relevant period, Caremark had approximately 7,000 employees and ninety branch operations. It had a decentralized management structure. By May 1991, however, Caremark asserts that it had begun making attempts to centralize its management structure in order to increase supervision over its branch operations.

The first action taken by management, as a result of the initiation of the OIG investigation, was an announcement that as of October 1, 1991, Caremark's predecessor would no longer pay management fees to physicians for services to Medicare and Medicaid patients. Despite this decision, Caremark asserts that its management, pursuant to advice, did not believe that such payments were illegal under the existing laws and regulations.

[*963] During this period, Caremark's Board took several additional steps consistent with an effort to assure compliance with company policies concerning the ARPL and the contractual forms in the Guide. In April 1992, Caremark published a fourth revised version of its Guide apparently designed to assure that its agreements either complied with the ARPL and regulations or excluded Medicare and Medicaid **[**10]** patients altogether. In addition, in September 1992, Caremark instituted a policy requiring its regional officers, Zone Presidents, to approve each contractual relationship entered into by Caremark with a physician.

Although there is evidence that inside and outside counsel had advised Caremark's directors that their contracts were in accord with the law, Caremark recognized that some uncertainty respecting the correct interpretation of the law existed. In its 1992 annual report, Caremark disclosed the ongoing government investigations, acknowledged that if penalties were imposed on the company they could have a material adverse effect on Caremark's business, and stated that no assurance could be given that its interpretation of the ARPL would prevail if challenged.

Throughout the period of the government investigations, Caremark had an internal audit plan designed to assure compliance with business and ethics policies. In addition, Caremark employed Price Waterhouse as its outside auditor. On February 8, 1993, the Ethics Committee of Caremark's Board received and reviewed an outside auditors report by Price Waterhouse which concluded that there were no material weaknesses in Caremark's **[**11]** control structure. [3] Despite the positive findings of Price Waterhouse, however, on April 20, 1993, the Audit & Ethics Committee adopted a new internal audit charter requiring a comprehensive review of compliance policies and the compilation of an employee ethics handbook concerning such policies. [4]

---

[2] In addition to investigating whether Caremark's financial relationships with health care providers were intended to induce patient referrals, inquiries were made concerning Caremark's billing practices, activities which might lead to excessive and medically unnecessary treatments for patients, potentially improper waivers of patient co-payment obligations, and the adequacy of records kept at Caremark pharmacies.

[3] At that time, Price Waterhouse viewed the outcome of the OIG Investigation as uncertain. After further audits, however, on February 7, 1995, Price Waterhouse informed the Audit & Ethics Committee that it had not become aware of any irregularities or illegal acts in relation to the OIG investigation.

[4] Price Waterhouse worked in conjunction with the Internal Audit Department.

The Board appears to have been informed about this project and other efforts to assure compliance with the law. For example, Caremark's management reported to the Board that Caremark's sales force was receiving an ongoing education regarding the ARPL and the proper use of Caremark's form contracts which had been approved by in-house **[**12]** counsel. On July 27, 1993, the new ethics manual, expressly prohibiting payments in exchange for referrals and requiring employees to report all illegal conduct to a toll free confidential ethics hotline, was approved and allegedly disseminated. [5] The record suggests that Caremark continued these policies in subsequent years, causing employees to be given revised versions of the ethics manual and requiring them to participate in training sessions concerning compliance with the law.

During 1993, Caremark took several additional steps which appear to have been aimed at increasing management supervision. These steps included **[**13]** new policies requiring local branch managers to secure home office approval for all disbursements under agreements with health care providers and to certify compliance with the ethics program. In addition, the chief financial officer was appointed to serve as Caremark's compliance officer. In 1994, a fifth revised Guide was published.

D. Federal Indictments Against Caremark and Officers

On August 4, 1994, a federal grand jury in Minnesota issued a 47 page indictment charging Caremark, two of its officers (not the firm's chief officer), an individual who had been a sales employee of Genentech, **[*964]** Inc., and David R. Brown, a physician practicing in Minneapolis, with violating the ARPL over a lengthy period. According to the indictment, over $ 1.1 million had been paid to Brown to induce him to distribute Protropin, a human growth hormone drug marketed by Caremark. [6] The substantial payments involved started, according to the allegations of the indictment, in 1986 and continued through 1993. Some payments were "in the guise of research grants", Ind. P20, and others were "consulting agreements", Ind. P19. The indictment charged, for example, that Dr. Brown performed virtually none **[**14]** of the consulting functions described in his 1991 agreement with Caremark, but was nevertheless neither required to return the money he had received nor precluded from receiving future funding from Caremark. In addition the indictment charged that Brown received from Caremark payments of staff and office expenses, including telephone answering services and fax rental expenses.

In reaction to the Minnesota Indictment and the subsequent filing of this and other derivative actions in 1994, the Board met and was informed by management that the investigation had resulted in an indictment; Caremark denied **[**15]** any wrongdoing relating to the indictment and believed that the OIG investigation would have a favorable outcome. Management reiterated the grounds for its view that the contracts were in compliance with law.

Subsequently, five stockholder derivative actions were filed in this court and consolidated into this action. The original complaint, dated August 5, 1994, alleged, in relevant part, that Caremark's directors breached their duty of care by failing adequately to supervise the conduct of Caremark employees, or institute corrective measures, thereby exposing Caremark to fines and liability. [7]

[16]** On September 21, 1994, a federal grand jury in Columbus, Ohio issued another indictment alleging that an Ohio physician had defrauded the Medicare program by requesting and receiving $ 134,600 in exchange for referrals of patients whose medical costs were in part reimbursed by Medicare in violation of the ARPL. Although unidentified at that time, Caremark was the

[5] Prior to the distribution of the new ethics manual, on March 12, 1993, Caremark's president had sent a letter to all senior, district, and branch managers restating Caremark's policies that no physician be paid for referrals, that the standard contract forms in the Guide were not to be modified, and that deviation from such policies would result in the immediate termination of employment.

[6] In addition to prescribing Protropin, Dr. Brown had been receiving research grants from Caremark as well as payments for services under a consulting agreement for several years before and after the investigation. According to an undated document from an unknown source, Dr. Brown and six other researchers had been providing patient referrals to Caremark valued at $ 6.55 for each $ 1 of research money they received.

[7] Caremark moved to dismiss this complaint on September 14, 1994. Prior to that motion, another stockholder derivative action had been filed in the United States District Court for the Northern District of Illinois, complaining of similar misconduct on the part of Caremark, its Directors, and three employees, as well as several other claims including RICO violations. *Brumberg v. Mieszala,* No. 94 C 4798 (N.D. Ill.). The federal court entered a stay of all proceedings pending resolution of this case.

health care provider who allegedly made such payments. The indictment also charged that the physician, Elliot Neufeld, D.O., was provided with the services of a registered nurse to work in his office at the expense of the infusion company, in addition to free office equipment.

An October 28, 1994 amended complaint in this action added allegations concerning the Ohio indictment as well as new allegations of over billing and inappropriate referral payments in connection with an action brought in Atlanta, *Booth v. Rankin*. Following a newspaper article report that federal investigators were expanding their inquiry to look at Caremark's referral practices in Michigan as well as allegations of fraudulent billing of insurers, a second amended complaint was filed in this action. The third, and final, amended complaint was filed **[**17]** on April 11, 1995, adding allegations that the federal indictments had caused Caremark to incur significant legal fees and forced it to sell its home infusion business at a loss. [8]

After each complaint was filed, defendants filed a motion to dismiss. According to defendants, **[*965]** if a settlement had not been reached in this action, the case would have been dismissed on two grounds. First, they contend that the complaints fail to allege particularized facts sufficient to excuse the demand requirement under Delaware Chancery Court Rule 23.1. Second, defendants assert that plaintiffs had failed to state a cause of action due to the fact that Caremark's charter eliminates directors' personal liability for money damages, to the extent permitted by law.

Settlement Negotiations

[18]** In September, following the announcement of the Ohio indictment, Caremark publicly announced that as of January 1, 1995, it would terminate all remaining financial relationships with physicians in its home infusion, hemophilia, and growth hormone lines of business. [9] In addition, Caremark asserts that it extended its restrictive policies to all of its contractual relationships with physicians, rather than just those involving Medicare and Medicaid patients, and terminated its research grant program which had always involved some recipients who referred patients to Caremark.

Caremark began settlement negotiations with federal and state government entities in May 1995. In return for a guilty plea to a single count of mail fraud by the corporation, the payment of a criminal fine, the payment of substantial civil damages, and cooperation with further federal investigations on matters relating to the OIG **[**19]** investigation, the government entities agreed to negotiate a settlement that would permit Caremark to continue participating in Medicare and Medicaid programs. On June 15, 1995, the Board approved a settlement ("Government Settlement Agreement") with the DOJ, OIG, U.S. Veterans Administration, U.S. Federal Employee Health Benefits Program, federal Civilian Health and Medical Program of the Uniformed Services, and related state agencies in all fifty states and the District of Columbia. [10] **[**20]** No senior officers or directors were charged with wrongdoing in the Government Settlement Agreement or in any of the prior indictments. In fact, as part of the sentencing in the Ohio action on June 19, 1995, the United States stipulated that *no senior executive of Caremark participated in, condoned, or was willfully ignorant of wrongdoing in connection with the home infusion business practices.* [11]

The federal settlement included certain provisions in a "Corporate Integrity Agreement" designed to enhance future compliance with law. The parties have not discussed this agreement, except to say that the negotiated provisions of the settlement of this claim are not redundant of those in that agreement.

---

[8] On January 29, 1995, Caremark entered into a definitive agreement to sell its home infusion business to Coram Health Care Company for approximately $ 310 million. Baxter purchased the home infusion business in 1987 for $ 586 million.

[9] On June 1, 1993, Caremark had stopped entering into new contractual agreements in those business segments.

[10] The agreement, covering allegations since 1986, required a Caremark subsidiary to enter a guilty plea to two counts of mail fraud, and required Caremark to pay $ 29 million in criminal fines, $ 129.9 million relating to civil claims concerning payment practices, $ 3.5 million for alleged violations of the Controlled Substances Act, and $ 2 million, in the form of a donation, to a grant program set up by the Ryan White Comprehensive AIDS Resources Emergency Act. Caremark also agreed to enter into a compliance agreement with the HHS.

[11] On July 25, 1995, another shareholder derivative complaint was filed against Caremark and seven of its Directors, asserting allegations related to the Minnesota indictment and the terms of the Government Settlement Agreement. *Lenzen v. Piccolo,* No. 95 CH 7118 (Circuit Court of Cook County, Illinois).

Settlement negotiations between the parties in this action commenced in May 1995 as well, based upon a letter proposal of the plaintiffs, dated May 16, 1995. [12] These negotiations resulted in a memorandum of understanding ("MOU"), dated June 7, 1995, and the execution of the Stipulation and Agreement of Compromise and Settlement on June 28, 1995, which is the subject of this action. [13] The MOU, approved by the Board on June **[*966]** 15, 1995, required the Board to adopt several resolutions, discussed **[**21]** below, and to create a new compliance committee. The Compliance and Ethics Committee has been reporting to the Board in accord with its newly specified duties.

After negotiating these settlements, Caremark learned in December 1995 that several private insurance company payors ("Private Payors") believed that Caremark was liable for damages to them for allegedly improper business practices related to those at issue in the OIG investigation. As a result of intensive negotiations with the Private Payors and the Board's extensive consideration of the alternatives for dealing with such claims, the Board approved a $ 98.5 million settlement **[**22]** agreement with the Private Payors on March 18, 1996. In its public disclosure statement, Caremark asserted that the settlement did not involve current business practices and contained an express denial of any wrongdoing by Caremark. After further discovery in this action, the plaintiffs decided to continue seeking approval of the proposed settlement agreement.

F. The Proposed Settlement of this Litigation

In relevant part the terms upon which these claims asserted are proposed to be settled are as follows:

1. That Caremark, undertakes that it and its employees, and agents not pay any form of compensation to a third party in exchange for the referral of a patient to a Caremark facility or service or the prescription of drugs marketed or distributed by Caremark for which reimbursement may be sought from Medicare, Medicaid, or a similar state reimbursement program;

2. That Caremark, undertakes for itself and its employees, and agents not to pay to or split fees with physicians, joint ventures, any business combination in which Caremark maintains a direct financial interest, or other health care providers with whom Caremark has a financial relationship or interest, in exchange **[**23]** for the referral of a patient to a Caremark facility or service or the prescription of drugs marketed or distributed by Caremark for which reimbursement may be sought from Medicare, Medicaid, or a similar state reimbursement program;

3. That the full Board shall discuss all relevant material changes in government health care regulations and their effect on relationships with health care providers on a semi-annual basis;

4. That Caremark's officers will remove all personnel from health care facilities or hospitals who have been placed in such facility for the purpose of providing remuneration in exchange for a patient referral for which reimbursement may be sought from Medicare, Medicaid, or a similar state reimbursement program;

5. That every patient will receive written disclosure of any financial relationship between Caremark and the health care professional or provider who made the referral;

6. That the Board will establish a Compliance and Ethics Committee of four directors, two of which will be non-management directors, to meet at least four times a year to effectuate these policies and monitor business segment compliance with the ARPL, and to report to the Board semi-annually **[**24]** concerning compliance by each business segment; and

7. That corporate officers responsible for business segments shall serve as compliance officers who must report semi-annually to the Compliance and Ethics Committee and, with the assistance of outside counsel, review existing contracts and get advanced approval of any new contract forms.

II. LEGAL PRINCIPLES

A. Principles Governing Settlements of Derivative Claims

As noted at the outset of this opinion, this Court is now

[12] No government entities were involved in these separate, but concurrent negotiations.

[13] Plaintiff's initial proposal had both a monetary component, requiring Caremark's director-officers to relinquish stock options, and a remedial component, requiring management to adopt and implement several compliance related measures. The monetary component was subsequently eliminated.

required to exercise an informed judgment whether the proposed settlement is fair and reasonable in the light of all relevant factors. *Polk v. Good, Del.Supr., 507 A.2d 531 (1986)*. On an application of this kind, this Court attempts to protect the best interests of the corporation and its absent shareholders all of whom will **[*967]** be barred from future litigation on these claims if the settlement is approved. The parties proposing the settlement bear the burden of persuading the court that it is in fact fair and reasonable. *Fins v. Pearlman, Del.Supr., 424 A.2d 305 (1980)*.

B. Directors' Duties To Monitor Corporate Operations

The complaint charges the director defendants with breach of their **[**25]** duty of attention or care in connection with the on-going operation of the corporation's business. The claim is that the directors 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. The complaint thus does not charge either director self-dealing or the more difficult loyalty-type problems arising from cases of suspect director motivation, such as entrenchment or sale of control contexts. [14] The theory here advanced is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment. The good policy reasons why it is so difficult to charge directors with responsibility for corporate losses for an alleged breach of care, where there is no conflict of interest or no facts suggesting suspect motivation involved, were recently described in *Gagliardi v. TriFoods Int'l Inc., Del.Ch., 683 A.2d 1049 (1996) (1996 Del.Ch. LEXIS 87 at p.20)*.

[26]** 1. Potential liability for directoral decisions: Director liability for a breach of the duty to exercise appropriate attention may, in theory, arise in two distinct contexts. First, such liability may be said to follow *from a board decision* that results in a loss because that decision was ill advised or "negligent". Second, liability to the corporation for a loss may be said to arise from an *unconsidered failure of the board to act* in circumstances in which due attention would, arguably, have prevented the loss. *See generally Veasey & Seitz, The Business Judgment Rule in the Revised Model Act…63 TEXAS L. REV. 1483 (1985)*. The first class of cases will typically be subject to review under the director-protective business judgment rule, assuming the decision made was the product of a *process* that *was either* deliberately considered in good faith or was otherwise rational. See *Aronson v. Lewis, Del.Supr., 473 A.2d 805 (1984)*; *Gagliardi v. TriFoods Int'l Inc., Del.Ch. 683 A.2d 1049 (1996)*. What should be understood, but may not widely be understood by courts or commentators who are not often required to face such questions, [15] **[**28]** is **[**27]** that compliance 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. That is, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through "stupid" to "egregious" or "irrational", provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a *good faith* effort to advance corporate interests. To employ a different rule -- one that permitted an "objective" evaluation of the decision -- would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests. [16] Thus, the

---

[14] *See* *Weinberger v. UOP, Inc., Del.Supr., 457 A.2d 701, 711 (1983)* (entire fairness test when financial conflict of interest involved); *Unitrin, Inc. v. American General Corp., Del.Supr., 651 A.2d 1361, 1372 (1995)* (intermediate standard of review when "defensive" acts taken); *QVC Network, Inc. v. Paramount Communications, Inc., Del.Supr., 637 A.2d 34, 45 (1994)* (intermediate test when corporate control transferred).

[15] *See* American Law Institute, Principles of Corporate Governance § 4.01(c) (to qualify for business judgment treatment a director must "rationally" believe that the decision is in the best interests of the corporation).

[16] The vocabulary of negligence while often employed, *e.g.,* *Aronson v. Lewis, Del. Supr., 473 A.2d 805 (1984)* is not well-suited to judicial review of board attentiveness, *see, e.g.,* *Joy v. North, 692 F.2d 880, 885-6 (2d. Cir. 1982)*, especially if one attempts to look to the substance of the decision as any evidence of possible "negligence." Where review of board functioning is involved, courts leave behind as a relevant point of reference the decisions of the hypothetical "reasonable person", who typically supplies the test for negligence liability. It is doubtful that we want business men and women to be encouraged to make decisions as hypothetical persons of *ordinary* judgment and prudence might. The corporate form gets its utility in large part from its ability to allow diversified investors to accept greater investment risk. If those in charge of the corporation are to be adjudged personally liable for losses on the basis of a substantive judgment based upon

business **[*968]** judgment rule is process oriented and informed by a deep respect for all *good faith* board decisions.

[29]** 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. If the shareholders thought themselves entitled to some other quality of judgment than such a director produces in the good faith exercise of the powers of office, then the shareholders should have elected other directors. Judge Learned Hand made the point rather better than can I. In speaking of the passive director defendant Mr. Andrews in *Barnes v. Andrews,* Judge Hand said:

> True, he was not very suited by experience for the job he had undertaken, but I cannot hold him on that account. After all it is the same corporation that chose him that now seeks to charge him….Directors are not specialists like lawyers or doctors….They are the general advisors of the business and if they faithfully give such ability as they have to their charge, it would not be lawful to hold them liable. Must a director guarantee that his judgment is good? Can a shareholder **[**30]** call him to account for deficiencies that their votes assured him did not disqualify him for his office? While he may not have been the Cromwell for that Civil War, Andrews did not engage to play any such role. [17]

In this formulation Learned Hand correctly identifies, in my opinion, the core element of any corporate law duty of care inquiry: whether there was good faith effort to be informed and exercise judgment.

2. Liability for failure to monitor: The second class of cases in which director liability for inattention is theoretically possible entail circumstances in which a loss eventuates not from a decision but, from unconsidered inaction. Most of the decisions that a corporation, acting through its human agents, makes are, of course, not the subject of director attention. Legally, the board itself will be required only to authorize the most significant corporate acts or transactions: mergers, changes in capital structure, fundamental changes in business, **[**31]** appointment and compensation of the CEO, etc. As the facts of this case graphically demonstrate, ordinary business decisions that are made by officers and employees deeper in the interior of the organization can, however, vitally affect the welfare of the corporation and its ability to achieve its various strategic and financial goals. If this case did not prove the point itself, recent business history would. Recall for example the displacement of senior management and much of the board of Salomon, Inc.; [18] **[**32]** the replacement of senior management of Kidder, Peabody following the discovery of large trading losses resulting from phantom trades by a highly compensated trader; [19] or the extensive financial loss and reputational injury suffered by Prudential Insurance as a result its junior officers misrepresentations in connection with the distribution of limited partnership interests. [20] Financial and organizational disasters such as these raise the question, what is **[*969]** the board's responsibility with respect to the organization and monitoring of the enterprise to assure that the corporation functions within the law to achieve its purposes?

Modernly this question has been given special importance by an increasing tendency, especially under federal law, to employ the criminal law to assure corporate compliance with external legal requirements, including environmental, financial, employee and product safety as well as assorted other health and safety regulations. In 1991, pursuant to the Sentencing Reform Act of 1984, [21] the United States Sentencing Commission adopted Organizational Sentencing Guidelines which impact importantly on the prospective effect these criminal sanctions might have on business corporations. The Guidelines set forth a uniform

what an persons of ordinary or average judgment and average risk assessment talent regard as "prudent" "sensible" or even "rational", such persons will have a strong incentive at the margin to authorize less risky investment projects.

[17] ***208 App. Div. 856 (S.D.N.Y. 1924)***.

[18] *See, e.g., Rotten at the Core,* the Economist, August 17, 1991, at 69-70, *The Judgment of Salomon: An Anticlimax,* Bus. Week, June 1, 1992, at 106.

[19] *See* Terence P. Pare, *Jack Welch's Nightmare on Wall Street,* Fortune, Sept. 5, 1994, at 40-48.

[20] Michael Schroeder and Leah Nathans Spiro, *Is George Ball's Luck Running Out?,* Bus. Week, November 8, 1993, at 74-76; Joseph B. Treaster, *Prudential To Pay Policyholders $ 410 Million,* New York Times, Sept 25, 1996, (at D-1).

[21] See Sentencing Reform Act of 1984, Pub.L. 98-473, Title II, § 212 (a)(2) (1984); 18 USCA §§ 3331-4120.

sentencing structure for organizations to be sentenced for violation of federal criminal statutes and provide for penalties that equal or often **[**33]** massively exceed those previously imposed on corporations. [22] The Guidelines offer powerful incentives for corporations today to have in place compliance programs to detect violations of law, promptly to report violations to appropriate public officials when discovered, and to take prompt, voluntary remedial efforts.

In 1963, the Delaware Supreme Court in *Graham v. Allis-Chalmers Mfg. Co*., [23] addressed the question of potential liability of board members for losses experienced by the corporation as a result of the corporation having violated the anti-trust laws of the United States. There was no claim in that case that the directors knew about the behavior of subordinate employees of the corporation that had resulted in the liability. Rather, as in this case, the claim **[**34]** asserted was that the directors *ought to have known* of it and if they had known they would have been under a duty to bring the corporation into compliance with the law and thus save the corporation from the loss. The Delaware Supreme Court concluded that, under the facts as they appeared, there was no basis to find that the directors had breached a duty to be informed of the ongoing operations of the firm. In notably colorful terms, the court stated 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." [24] The Court found that there were no grounds for suspicion in that case and, thus, concluded that the directors were blamelessly unaware of the conduct leading to the corporate liability. [25]

[35]** How does one generalize this holding today? 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 systems 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. I doubt that such a broad generalization of the *Graham* holding would have been accepted by the Supreme Court in 1963. The case can be more narrowly interpreted 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. *See* *188 A.2d at 130-31*.

A broader interpretation of *Graham v. Allis Chalmers* -- that it means that a corporate board has no responsibility to assure that appropriate information and reporting systems **[*970]** are established by management -- would not, in any event, **[**36]** be accepted by the Delaware Supreme Court in 1996, in my opinion. In stating the basis for this view, I start with the recognition that in recent years the Delaware Supreme Court has made it clear -- especially in its jurisprudence concerning takeovers, from *Smith v. Van Gorkom* through *QVC v. Paramount Communications* [26] -- the seriousness with which the corporation law views the role of the corporate board. Secondly, I note the elementary fact that relevant and timely *information* is an essential predicate for satisfaction of the board's supervisory and monitoring role under Section 141 of the Delaware General Corporation Law. Thirdly, I note the potential impact of the federal organizational sentencing guidelines on any business organization. Any rational person attempting in good faith to meet an organizational governance responsibility would be bound to take into account this development and the enhanced penalties and the opportunities for reduced sanctions that it offers.

[37]** In light of these developments, it would, in my opinion, be a mistake to conclude that our Supreme Court's statement in *Graham* concerning "espionage" means 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

[22] *See* United States Sentencing Commission, Guidelines Manual, Chapter 8 (U.S. Government Printing Office November 1994).

[23] *41 Del. Ch. 78, 188 A.2d 125 (1963)*.

[24] *Id. 188 A.2d at 130*.

[25] Recently, *the Graham* standard was applied by the Delaware Chancery in a case involving Baxter. *In Re Baxter International, Inc. Shareholders Litig., Del.Ch., 654 A.2d 1268, 1270 (1995)*.

[26] *E.g., Smith v. Van Gorkom, Del.Supr., 488 A.2d 858 (1985)*; *Paramount Communications v. QVC Network, Del. Supr., 637 A.2d 34 (1993)*.

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.

Obviously the level of detail that is appropriate for such an information system is a question of business judgment. And obviously too, no rationally designed information and reporting system will remove the possibility that the corporation will violate laws or regulations, or that senior officers or directors may nevertheless sometimes be misled or otherwise fail reasonably to detect acts material to the corporation's compliance with the law. But it is important that the board exercise a good faith judgment that the corporation's information **[**38]** 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.

Thus, I am of the view that 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, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards [27]. I now turn to an analysis of the claims asserted with this concept of the directors duty of care, as a duty satisfied in part by assurance of adequate information flows to the board, in mind.

[39]** III ANALYSIS OF THIRD AMENDED COMPLAINT AND SETTLEMENT

A. The Claims

On balance, after reviewing an extensive record in this case, including numerous documents and three depositions, I conclude that this settlement is fair and reasonable. In light of the fact that the Caremark Board already has a functioning committee charged with overseeing corporate compliance, the changes in corporate practice that are presented as consideration for the settlement do not impress one as very significant. Nonetheless, that consideration **[*971]** appears fully adequate to support dismissal of the derivative claims of director fault asserted, because those claims find no substantial evidentiary support in the record and quite likely were susceptible to a motion to dismiss in all events. [28]

[40]** In order to Show that the Caremark directors breached their duty of care by failing adequately to control Caremark's employees, plaintiffs would have to show either (1) that the directors knew or (2) should have known that violations of law were occurring and, in either event, (3) that the directors took no steps in a good faith effort to prevent or remedy that situation, and (4) that such failure proximately resulted in the losses complained of, although under *Cede & Co. v. Technicolor, Inc., Del.Supr., 636 A.2d 956 (1994)* this last element may be thought to constitute an affirmative defense.

1. Knowing violation for statute: Concerning the possibility that the Caremark directors knew of violations of law, none of the documents submitted for review, nor any of the deposition transcripts appear to provide evidence of it. Certainly the Board understood that the company had entered into a variety of contracts with physicians, researchers, and health care providers and it was understood that some of these contracts were with persons who had prescribed treatments that Caremark participated in providing. The board was informed that the company's reimbursement for patient **[**41]** care was frequently from government funded sources and that such services were subject to the ARPL. But the Board appears to have been

[27] Any action seeking recover for losses would logically entail a judicial determination of proximate cause, since, for reasons that I take to be obvious, it could never be assumed that an adequate information system would be a system that would prevent all losses. I need not touch upon the burden allocation with resect to a proximate cause issue in such a suit. *See* *Cede & Co. v. Technicolor, Inc., Del.Supr., 636 A.2d 956 (1994)*; *Cinerama, Inc. v. Technicolor, Inc., Del.Ch., 663 A.2d 1134 (1994)*, *aff'd.*, *Del.Supr., 663 A.2d 1156 (1995)*. Moreover, questions of waiver of liability under certificate provisions authorized by *8 Del.C. § 102(b)(7)* may also be faced.

[28] *See In* *Re Baxter International, Inc. Shareholders Litig., Del.Ch., 654 A.2d 1268, 1270 (1995)*. A claim in some respects similar to that here made was dismissed. The court relied, in part, on the fact that the Baxter certificate of incorporation contained a provision as authorized by *Section 102(b)(7)* of the Delaware General Corporation Law, waiving director liability for due care violations. *Id. at 1270*. That fact was thought to require pre-suit demand on the board in that case.

informed by experts that the company's practices while contestable, were lawful. There is no evidence that reliance on such reports was not reasonable. Thus, this case presents no occasion to apply a principle to the effect that knowingly causing the corporation to violate a criminal statute constitutes a breach of a director's fiduciary duty. *See* Roth v. Robertson, N.Y.Sup.Ct., 64 Misc. 343, 118 N.Y.S. 351 (1909); Miller v. American Tel. & Tel Co., 507 F.2d 759 (3rd Cir. 1974). It is not clear that the Board knew the detail found, for example, in the indictments arising from the Company's payments. But, of course, 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. Such a requirement would simple be inconsistent with the scale and scope of efficient organization size in this technological age.

2. Failure to monitor: Since it does appears that the Board was to some extent unaware of the activities that led to liability, **[**42]** I turn to a consideration of the other potential avenue to director liability that the pleadings take: director inattention or "negligence". 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, in my opinion 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 exits -- will establish the lack of good faith that is a necessary condition to liability. 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.

Here the record supplies essentially no evidence that the director defendants were guilty of a sustained failure to exercise **[**43]** their oversight function. To the contrary, insofar as I am able to tell on this record, the corporation's information systems appear to have represented a good faith attempt to be informed of relevant facts. If the directors did not know the specifics of the activities **[*972]** that lead to the indictments, they cannot be faulted.

The liability that eventuated in this instance was huge. But the fact that it resulted from a violation of criminal law alone does not create a breach of fiduciary duty by directors. The record at this stage does not support the conclusion that the defendants either lacked good faith in the exercise of their monitoring responsibilities or conscientiously permitted a known violation of law by the corporation to occur. The claims asserted against them must be viewed at this stage as extremely weak.

B. The Consideration For Release of Claim

The proposed settlement provides very modest benefits. Under the settlement agreement, plaintiffs have been given express assurances that Caremark will have a more centralized, active supervisory system in the future. Specifically, the settlement mandates duties to be performed by the newly named Compliance and Ethics Committee **[**44]** on an ongoing basis and increases the responsibility for monitoring compliance with the law at the lower levels of management. In adopting the resolutions required under the settlement, Care mark has further clarified its policies concerning the prohibition of providing remuneration for referrals. These appear to be positive consequences of the settlement of the claims brought by the plaintiffs, even if they are not highly significant. Nonetheless, given the weakness of the plaintiffs' claims the proposed settlement appears to be an adequate, reasonable, and beneficial outcome for all of the parties. Thus, the proposed settlement will be approved.

IV, ATTORNEYS' FEES

The various firms of lawyers involved for plaintiffs seek an award of $ 1,025,000 in attorneys' fees and reimbursable expenses. [29] In awarding attorneys' fees, this Court considers an array of relevant factors. *E.g., In* Re Beatrice Companies, Inc. Litigation, 1986 Del. Ch. LEXIS 414, C.A. No. 8248, Allen, C. (Apr. 16, 1986). Such factors include, most importantly, the financial value of the benefit *that the lawyers work produced;* the strength of the claims (because substantial settlement value may sometimes be produced **[**45]** even though the litigation added little value -- i.e., perhaps any lawyer could have settled this claim for this substantial value or more); the amount of complexity of the legal services; the fee customarily charged for such services; and the contingent nature of the undertaking.

---

[29] Of the total requested amount, approximately $ 710,000 is designated as reimbursement for the number of hours spent by the attorneys on the case, calculated at their normal billing rate, and $ 53,000 for out-of-pocket expenses.

In this case no factor points to a substantial fee, other than the amount and sophistication of the lawyer services required. There is only a modest substantive benefit produced; in the particular circumstances of the government activity there was realistically a very slight contingency faced by the attorneys at the time they expended time. The services rendered required a high degree of sophistication and expertise. I am told that at normal hourly billing rates approximately $ 710,000 of time was expended **[**46]** by the attorneys.

In these circumstances, I conclude that an award of a fee determined by reference to the time expended at normal hourly rates plus a premium of 15% of that amount to reflect the limited degree of real contingency in the undertaking, is fair. Thus I will award a fee of $ 816,000 plus $ 53,000 of expenses advanced by counsel.

I am today entering an order consistent with the foregoing. [30]

[47]**

---

[30] The court has been informed by letter of counsel that after the fairness of the proposed settlement had been submitted to the court, Caremark was involved in a merger in which its stock was canceled and the holders of its stock became entitled to shares of stock of the acquiring corporation. No party to this suit, or the surviving corporation, has sought to dismiss this case thereafter on the basis that plaintiffs' have loss standing to sue. As plaintiffs continue to have an equity interest in the entity that owns the claims and more especially because no party has moved for any modification of the procedural setting of the matter submitted, I conclude that any merger that may have occurred is without effect on the decision of the motion or the judgment to be entered.

In re Clovis Oncology, Inc. Derivative Litig.

Court of Chancery of Delaware

July 1, 2019, Submitted; October 1, 2019, Decided

CONSOLIDATED C.A. No. 2017-0222-JRS

Reporter

2019 Del. Ch. LEXIS 1293 *; 2019 WL 4850188

IN RE CLOVIS ONCOLOGY, INC. DERIVATIVE LITIGATION

Notice: THIS OPINION HAS NOT BEEN RELEASED FOR PUBLICATION. UNTIL RELEASED, IT IS SUBJECT TO REVISION OR WITHDRAWAL.

Subsequent History: Related proceeding at *Wenduo Guo v. Mahaffy, 2020 U.S. Dist. LEXIS 178990 (D. Colo., Sept. 29, 2020)*

Prior History: *Medina v. Clovis Oncology, Inc., 2016 U.S. Dist. LEXIS 19784 (D. Colo., Feb. 18, 2016)* *McKenry v. Atwood, 2017 Del. Ch. LEXIS 567 (Del. Ch., May 2, 2017)*

Counsel: [*1] Seth D. Rigrodsky, Esquire, Brian D. Long, Esquire and Gina M. Serra, Esquire of Rigrodsky & Long, P.A., Wilmington, Delaware; Nicholas I. Porritt, Esquire, Adam M. Apton, Esquire and Adam C. McCall, Esquire of Levi & Korsinsky, LLP, Washington, D.C.; Kip B. Shuman, Esquire of The Shuman Law Firm, San Francisco, California; and Rusty E. Glenn, Esquire of The Shuman Law Firm, Denver, Colorado, Attorneys for Plaintiffs Carl McKenry and Juzet Macalinao on behalf of Clovis Oncology, Inc.

Gregory P. Williams, Esquire, Blake Rohrbacher, Esquire and Robert L. Burns, Esquire of Richards Layton & Finger, P.A., Wilmington, Delaware, Attorneys for Defendants Brian G. Atwood, M. James Barrett, James C. Blair, Keith T. Flaherty, Ginger L. Graham, Paul H. Klingenstein, Edward J. McKinley and Thorlef Spickschen.

William M. Lafferty, Esquire and Ryan Stottmann, Esquire of Morris, Nichols, Arsht & Tunnell LLP, Wilmington, Delaware and Tariq Mundiya, Esquire, Todd G. Cosenza, Esquire and Charles Dean Cording, Esquire of Willkie Farr & Gallagher LLP, New York, New York, Attorneys for Defendants Patrick J. Mahaffy, Erle T. Mast and Nominal Defendant Clovis Oncology, Inc.

Judges: SLIGHTS, Vice Chancellor.

Opinion by: SLIGHTS

Opinion

MEMORANDUM [*2] OPINION

SLIGHTS, Vice Chancellor

Like many upstart biopharmaceutical companies, nominal defendant, Clovis Oncology, Inc. (or the "Company"), had one drug among its drugs under development, Rociletinib (or "Roci"), that was especially promising. Roci, a therapy for the treatment of lung cancer, performed well during the early stages of its clinical trial. But data from later stages of the trial revealed the drug likely would not be approved for market by the Food and Drug Administration ("FDA"). Plaintiffs, Clovis stockholders, allege members of the Clovis board of directors (the "Board") breached their fiduciary duties by failing to oversee the Roci clinical trial and then allowing the Company to mislead the market regarding the drug's efficacy.[1] These breaches, it is alleged, caused Roci to sustain corporate trauma in the form of a sudden and significant depression in market capitalization. Plaintiffs also allege that certain members of the Board and a member of senior management engaged in unlawful stock trades before the market was apprised of Roci's failure.[2]

Defendants have moved to dismiss each of Plaintiffs'

---

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

[2] *See* *Brophy v. Cities Serv. Co., 31 Del. Ch. 241, 70 A.2d 5 (Del. Ch. 1949)*.

derivative claims under *Court of Chancery Rules 23.1* and *12(b)(6)* for failure to plead demand futility **[*3]** with particularity and failure to state viable claims. As explained below, Plaintiffs have well-pled that Defendants face a substantial likelihood of liability under *Caremark* and our Supreme Court's recent explication of *Caremark* in *Marchand v. Barnhill*.[3] Clovis conducted its clinical trial of Roci subject to strict protocols and associated FDA regulations. Yet, assuming the pled facts are true, the Board ignored red flags that Clovis was not adhering to the clinical trial protocols, thereby placing FDA approval of the drug in jeopardy. With the trial's skewed results in hand, the Board then allowed the Company to deceive regulators and the market regarding the drug's efficacy.

As explained in *Marchand*, "to satisfy their duty of loyalty, directors must make a good faith effort to implement an oversight system and then *monitor it*."[4] This is especially so when a monoline company operates in a highly regulated industry.[5] Here, Plaintiffs have well-pled Roci was "intrinsically critical to the [C]ompany's business operation," yet the Board ignored multiple warning signs that management was inaccurately reporting Roci's efficacy before seeking confirmatory scans to corroborate Roci's cancer-fighting **[*4]** potency—violating both internal clinical trial protocols and associated FDA regulations.[6] In other words, Plaintiffs have well-pled a *Caremark* claim.

The same cannot be said for Plaintiffs' attempt to plead *Brophy* and unjust enrichment claims.[7] Specifically, with respect to *Brophy*, Plaintiffs have failed to plead facts that allow a reasonable inference of scienter. The allegedly unlawful trades were so small in relation to each fiduciary's Clovis stock holdings as to defy any inference of the bad intent required to state a claim. And Plaintiffs' unjust enrichment claim, when reduced to its essence, rests on their deficient *Brophy* claim.

I. FACTUAL BACKGROUND

I draw the facts from the allegations in the Supplemental Consolidated Verified Shareholder Derivative Complaint (the "Complaint"), documents incorporated by reference or integral to that pleading and judicially noticeable facts.[8] For purposes of this motion to dismiss, I accept as true the Complaint's well-pled factual allegations and draw all reasonable inferences in Plaintiffs' favor.[9]

A. Parties and Relevant Non-Parties

Plaintiffs, Carl McKenry and Juzet Macalinao, are Clovis stockholders.[10] They **[*5]** have held Clovis common stock since March 26, 2014 and January 1, 2014, respectively.[11]

Nominal Defendant, Clovis, is a biopharmaceutical firm focused on acquiring, developing and commercializing cancer treatments.[12] During the Relevant Period,[13] Clovis had no drugs on the market but did have three drugs in development. Of these, Roci was the most promising.[14]

---

[3] ***Marchand v. Barnhill, 212 A.3d 805 (Del. 2019)***.

[4] ***Id. at 821*** (emphasis supplied).

[5] ***Id. at 809***.

[6] ***Id. at 822***.

[7] *Brophy, 31 Del. Ch. 241, 70 A.2d 5*.

[8] *See Wal-Mart Stores, Inc. v. AIG Life Ins. Co., 860 A.2d 312, 320 (Del. 2004)* (quoting *In re Santa Fe Pac. Corp. S'holder Litig., 669 A.2d 59, 69 (Del. 1995))* (noting that on a motion to dismiss, the Court may consider documents that are "incorporated by reference" or "integral" to the complaint); *D.R.E. 201-02* (codifying Delaware's judicial notice doctrine). *See also Amalgamated Bank v. Yahoo! Inc., 132 A.3d 752, 797 (Del. Ch. 2016)*, *abrogated on other grounds*, ***214 A.3d 933, 2019 Del. LEXIS 385, 2019 WL 3683525 (Del. Aug. 7, 2019)*** (noting that where, as here, the nominal defendant has produced documents in response to a demand for books and records under *8 Del. C. § 220* on the condition that such documents be deemed incorporated by reference in any complaint that might be filed, the court may consider the documents in their entirety rather than rely only the portions "cherry-picked" by the plaintiff).

[9] ***Marchand, 212 A.3d at 813*** ("At this stage of the case, we are bound to draw all fair inferences in the plaintiff's favor from the well-pled facts.").

[10] Suppl. Consol. Verified S'holder Deriv. Compl. ("Compl.") (D.I. 37) ¶¶ 27-28.

[11] Compl. ¶¶ 27-28, 247.

[12] Compl. ¶ 29.

[13] The Complaint defines the "Relevant Period" as the start of the phase II Roci trial on February 26, 2014, through the initiation of this litigation. Compl. ¶ 7.

[14] Compl. ¶¶ 63, 68.

Plaintiffs bring this derivative action against all nine members of the Board (collectively, the "Board Defendants"), each of whom was a member of the Board during the Relevant Period.[15] Defendant, Erle Mast, is Clovis' former Executive Vice President and Chief Financial Officer ("CFO").[16] Defendants collectively owned upwards of 17.4% of the Company's stock.[17]

The Board has two relevant sub-committees. The Nominating and Corporate Governance Committee is charged with developing and overseeing the effectiveness of Clovis' legal, ethics and regulatory compliance matters.[18] The Audit Committee oversees typical audit functions and, importantly, reviews earnings reports with management before release to the market.[19]

Defendant, Brian G. Atwood, has served on the Board since Clovis' inception in 2009.[20] He served as a member of the Audit Committee and the **[*6]** Nominating and Corporate Governance Committee for fiscal years 2013-2015.[21] Atwood had previous experience as co-founder of a biotechnology company and as a managing director for a healthcare-focused venture capital firm.[22]

Defendant, M. James Barrett, Ph.D., has served on the Board since Clovis' inception.[23] He serves as Chairman of the Board and as Chairman of the Nominating and Corporate Governance Committee.[24] Additionally, Barrett has held positions as a general partner in a healthcare venture capital firm and as the chairman, CEO and founder of a medical technology company.[25]

Defendant, James Blair, Ph.D., has served on the Board since Clovis' inception.[26] He is a member of the Nominating and Corporate Governance Committee and serves as Chairman of the Compensation Committee.[27] Blair has over thirty years of experience as a general partner in a life sciences venture capital management company.[28] Some of his other experience includes serving on the boards of over 40 life science companies as well as the advisory board of the Department of Molecular Biology at Princeton University.[29]

Defendant, Keith Flaherty, M.D., has served on the Board since 2013.[30] He is a member of the Nominating **[*7]** and Corporate Governance Committee.[31] Additionally, Flaherty is an Associate Professor of Medicine at Harvard Medical School and has been a principal investigator for numerous first-in-human clinical trials with novel, targeted therapies.[32]

Defendant, Ginger Graham, has served on the Board since 2013.[33] She is a member of the Compensation Committee.[34] Graham has previous experience as the president and CEO of a biopharmaceutical company and has served on the boards of multiple healthcare firms.[35]

Defendant, Paul Klingenstein, has served on the Board

[15] Compl. ¶¶ 1, 257.

[16] Compl. ¶ 38.

[17] Compl. ¶¶ 30, 41.

[18] Compl. ¶¶ 56-57. The Nominating and Corporate Governance Committee is also charged with providing "general compliance oversight," receiving "updates about the compliance program," and reviewing "the status and effectiveness of [Clovis'] compliance programs with respect to non-financial regulatory requirements, including . . . Federal health care program requirements and [FDA] requirements (and similar non-U.S. requirements, as applicable)." Compl. ¶ 279.

[19] Compl. ¶ 58.

[20] Compl. ¶ 30.

[21] *Id.*

[22] *Id.*

[23] Compl. ¶ 31.

[24] *Id.*

[25] *Id.*

[26] Compl. ¶ 32.

[27] *Id.*

[28] *Id.*

[29] *Id.*

[30] Compl. ¶ 33.

[31] *Id.*

[32] *Id.*

[33] Compl. ¶ 34.

[34] *Id.*

[35] *Id.*

since Clovis' inception.[36] He is a member of the Audit Committee.[37] Klingenstein has additional experience as a managing partner of a healthcare venture capital firm, which he formed in 1999.[38] And he has served on the boards of multiple pharmaceutical companies.[39]

Defendant, Patrick J. Mahaffy, is one of Clovis' co-founders and has been Clovis' CEO, President and a member of the Board since Clovis' inception.[40] Mahaffy previously served as the president and CEO of two biopharmaceutical companies—one of which he also founded.[41]

Defendant, Edward J. McKinley, has served on the Board since Clovis' inception.[42] He is a member of the Audit Committee. **[*8]** [43]

Defendant, Thorlef Spickschen, has served on the Board since Clovis' inception.[44] He is a member of the Compensation Committee.[45] Before joining Clovis, he served as the chairman of a publicly-traded biotechnology company, as well as Eli Lilly & Co.'s managing director for Germany and Central Europe.[46]

Defendant, Erle T. Mast, is a Clovis co-founder and served as Executive Vice President and CFO from the Company's inception in 2009 until his resignation in March 2016.[47] Mast was not a member of the Board during the Relevant Period.[48]

Non-party, Dr. Andrew Allen, served as Clovis' Chief Medical Officer ("CMO") during the Relevant Period.[49] Non-party, AstraZeneca PLC, is a pharmaceutical company based in the United Kingdom. AstraZeneca manufactures Tagrisso (described below), which would have directly competed with Roci had Roci made it to market.[50]

B. Clovis Initiates Roci's Clinical Trial

At the beginning of the Relevant Period, Clovis had no products on the market and generated no sales revenue.[51] Accordingly, Clovis "reli[ed] solely on investor capital for all [] operations."[52] The Company's prospects rested largely on one of its three developmental drugs, Roci, a cancer drug designed to treat **[*9]** a previously-untreatable type of lung cancer.[53] Because of the estimated $3 billion annual market for drugs of its type, Clovis expected Roci to generate large profits if Clovis could secure FDA approval for the drug and shepherd it to market.[54]

As the Roci clinical trial began, the Board knew time was of the essence. AstraZeneca's competing drug, Tagrisso, was also in the race for FDA approval.[55] Appreciating Roci's importance to Clovis' success, the Board was hyper-focused on the drug's development and clinical trial.[56] Indeed, it is alleged the Board Defendants "spent hours at Board meetings discussing [Roci]" and were "regularly apprised" of the drug's

---

36 Compl. ¶ 35.

37 *Id.*

38 *Id.*

39 *Id.*

40 Compl. ¶ 36.

41 *Id.*

42 Compl. ¶ 37.

43 *Id.*

44 Compl. ¶ 38.

45 *Id.*

46 *Id.*

47 Compl. ¶ 40.

48 *Id.*

49 Compl. ¶ 13.

50 Compl. ¶ 76.

51 Compl. ¶¶ 63, 68.

52 Compl. ¶ 68.

53 Compl. ¶ 71 ("[P]rior to the Relevant Period (and the approval of competitor drug Tagrisso), no targeted therapies were approved for the treatment of tumors with the T790M resistance mutation.").

54 Compl. ¶¶ 71-72.

55 Compl. ¶¶ 72, 76, 79, 101.

56 Compl. ¶¶ 8, 20, 101. *See, e.g.*, Compl. ¶ 20 ("Clovis' internal documents confirm that the Board was regularly apprised of the ongoing [Roci clinical trial] and spent hours at Board meetings discussing [Roci's] trial status and competitor drugs, particularly Tagrisso.") (citing Compl. Ex. A at 00120-00126; 00180-00181; 00371-00372; 00494-00495; 00732-00733; 00870; 00873; 001069; 01073).

progress.[57]

To obtain FDA approval, new drugs like Roci and Tagrisso must prove their efficacy and safety in clinical trials.[58] Before commencing a clinical trial, the FDA requires a drug's sponsor to agree to certain standards that define how the trial will be conducted, how the trial data will be analyzed and, most relevant here, how success in the trial will be measured.[59] These agreed-upon standards become the "clinical trial protocol."[60] If the drug's sponsor fails to adhere to the clinical trial protocol, the FDA will not approve a **[*10]** new drug for market.[61]

Clovis named its Roci clinical trial "TIGER-X."[62] TIGER-X incorporated a standardized and well-known clinical trial protocol called "RECIST."[63] Clovis chose RECIST instead of a lesser-known or bespoke clinical trial protocol because RECIST "has become the most widely used system for assessing response in cancer clinical trials, and is the preferred and accepted system for use in new drug applications to regulatory agencies."[64] By selecting RECIST, Clovis was able to "give investors confidence in the Company's reported results" by facilitating "comparisons between [Roci] and competing therapies."[65]

One of RECIST's important functions is to establish the "criteria defining success" for the clinical trial.[66] This success-defining metric is called the objective response rate (or "ORR").[67] ORR measures the percentage of patients who experience meaningful tumor shrinkage when treated with the drug.[68] This metric is important both to the FDA in its approval process and to physicians in deciding whether to prescribe the drug.[69] Not surprisingly, then, the "[Board] was laser-focused on [Roci's] ORR." **[*11]** [70]

As Roci's clinical trial progressed, the Board knew investors would not view an ORR incorporating unconfirmed responses as "meaningful," nor would the FDA accept such results as "approvable."[71] Indeed, each of the Board Defendants appreciated the FDA "could only make its decision . . . to approve Roci based [] on confirmed responses."[72]

C. TIGER-X Trial's Undisclosed Failure to Follow

[57] Compl. ¶ 20.

[58] Compl. ¶ 77.

[59] Compl. ¶¶ 81-82.

[60] Compl. ¶ 81 (citing Friedman, et al., *Fundamentals of Clinical Trials* 3-8 (4th ed. 2010) (describing clinical trial protocols as "a written agreement between the investigator [the drug company], the participant, and the scientific community.")).

[61] Compl. ¶¶ 81, 99.

[62] Compl. ¶¶ 65-67.

[63] Compl. ¶¶ 82, 84, 88, 89. "RECIST" stands for "Response Evaluation Criteria in Solid Tumors." Compl. ¶ 83.

[64] Compl. ¶ 83 (quoting Manola et al., *Assessment of Treatment Outcome, in* UICC MANUAL OF CLINICAL ONCOLOGY 40, 44 (Brian O'Sullivan et al. eds., 9th ed. 2015)).

[65] Compl. ¶ 85.

[66] Compl. ¶ 82.

[67] Compl. ¶¶ 8, 82.

[68] Compl. ¶ 8. Importantly, RECIST "unequivocally requires each instance of tumor shrinkage (a response) to be 'confirmed.' This means that any initial observation . . . [of tumor shrinkage] must have been observed in a subsequent scan before it can be included in the calculation of ORR." Compl. ¶¶ 82, 83, 86, 97-98. Indeed, "[m]embers of the medical and scientific communities view response confirmation as the key metric to guaranteeing the reliability, soundness, and reproducibility of claimed efficacy results." Compl. ¶ 97 (citing Eisenhaur, et al., *New response evaluation criteria in solid tumors: Revised RECIST guideline (version 1.1)*, 45 EUROPEAN J. CANCER, 228, 236 (2009)). Defendants assert that, during the time Clovis was submitting data to the FDA, it was not clear the FDA required confirmed responses because the FDA had granted Roci "[a]ccelerated [a]pproval" for which confirmation was not required for "interim results." *See* Defs.' Br. in Supp. of Their Mot. to Dismiss Pls.' Consol. Verified S'holder Compl. ("DOB") (D.I. 16) at 11-12, 14, 28. Plaintiffs respond by pointing to RECIST guidelines stating, "confirmation [of responses] is required." *See* Pls.' Answering Br. in Opp'n to Defs.' Mot. to Dismiss ("PAB") (D.I. 23) at 9. Of course, at this stage, I cannot resolve this or any other factual dispute; I am obliged to "accord the plaintiff the benefit of all reasonable inferences." ***Marchand, 212 A.3d at 820***.

[69] Compl. ¶¶ 8, 120, Ex. A at 00371.

[70] Compl. ¶ 8. *See also* Compl. ¶ 78 ("The single most critical metric that the [Board] Defendants, regulators, medical professionals, and investors focused on during the phase II trials was [Roci's] [ORR]. Oncologists and researchers view ORR as the critical measure of a cancer drug's efficacy.").

[71] Compl. ¶ 97.

[72] Compl. ¶¶ 99-100 (citing FDA guidance documents).

RECIST Standards

Ostensibly intending to follow RECIST, the TIGER-X protocol specifically required and set out a schedule for confirmation scans.[73] And throughout the Relevant Period, Clovis' press releases, investor calls, Securities and Exchange Commission ("SEC") filings and statements to medical journals reinforced the belief that Clovis was reporting a confirmed ORR of about 60% "per RECIST."[74] Mindful of the race to market, Clovis' management consistently represented that Roci's ORR was at least as encouraging as Tagrisso's.[75]

Despite these public signals, as early as June 12, 2014, the Board received reports indicating Clovis **[*12]** was improperly calculating Roci's ORR.[76] Specifically, these reports suggested that, while the clinical trial protocol required Clovis to calculate ORR based only on confirmed responses, Clovis was actually calculating ORR, in part, based on unconfirmed responses.[77] For example, on June 12, 2014, the Board reviewed management's presentations from a May 31, 2014 medical conference (the "ASCO conference").[78] That data indicated Roci's ORR was "58 percent" (the "ASCO ORR").[79] At the same meeting, management told the Board the ASCO ORR would improve "as patients get to their second and third scans."[80] By definition, then, the ASCO ORR was partially based on unconfirmed results (i.e., it was not RECIST compliant).[81] Notwithstanding this revelation, the Board did nothing.

Mahaffy continued publicly to report Roci's ORR at 58% in investor calls,[82] and on August 7, 2014, Clovis issued a press release restating this inflated number.[83] Soon after, the Board viewed another report signaling that Clovis' management was calculating Roci's ORR with unconfirmed responses and that only "80% of unconfirmed [responses] convert to confirmed."[84]

On September 9, 2014, Clovis closed a critical $287 million private placement **[*13]** of convertible senior notes in order to finance ongoing operations.[85] The Board relied heavily upon the market's positive reaction to Roci's publicly reported ORR to make its case for further investment in the Company.[86]

As the Company was touting Roci's prospects, management gave a presentation to the Board explicitly comparing Roci's 63% mixed ORR to Tagrisso's confirmed 70%.[87] Another Board presentation from the same time period showed that management was reporting Roci's ORR using partially unconfirmed responses by noting that Roci's ORR was "**Unconfirmed*."[88]

As TIGER-X progressed, Clovis' public statements regarding Roci remained upbeat. Roci was Clovis'

[73] Compl. ¶¶ 87-91, 99-100.

[74] *See, e.g.*, Compl. ¶¶ 80, 90, 91-99, 102-103, 106, 112, Ex. A at 00296 (symposium presentation slide showing responses "per RECIST"), 00302 (same), 01004 (board slide deck showing response "per RECIST"). *See also* Compl. ¶ 95 (describing a medical paper that republished data originally disclosed by Clovis' Chief Medical Officer) (citing Sequist, et al., *Rociletinib in EGFR-Mutated Non-Small-Cell Lung Cancer*, 372 NEW ENG. J. MED. 1700, 1704 (2015)).

[75] Compl. ¶¶ 102-03, 112.

[76] Compl. ¶¶ 103-104, 224. *See, e.g.*, Compl. ¶ 224 ("[T]he [Board] Defendants were well aware that the ORR data was 'immature' and based on both unconfirmed and confirmed responses.") (citing Compl. Ex. A at 00162, 00246, 00371, 00495, 01021).

[77] Compl. ¶¶ 103-104, 106-08, 201.

[78] Compl. ¶ 104.

[79] Compl. ¶¶ 12, 16, 103-104, Ex. A at A0060, A0074, A0108; *see also* the SEC's settlement agreement and subsequent settlement consent decree confirming that the 60% ORR presented at the ASCO conference included unconfirmed responses while the actual ORR, including only confirmed responses, was only 40%. Compl. ¶ 128.

[80] Compl. ¶ 104, Ex. A at 00120.

[81] *See* Compl. ¶ 10 ("RECIST unequivocally requires each instance of tumor shrinkage (a response) to be 'confirmed.'"). Plaintiffs allege that an ORR including unconfirmed scans is, by definition, *not* an "ORR" because ORR can only be calculated with confirmed scans. Compl. ¶ 105.

[82] Compl. ¶ 107.

[83] Compl. ¶¶ 107-08, 201; Clovis, Current Report (Form 8-K) (Aug. 7, 2014).

[84] Compl. ¶¶ 107-08, Ex. A at 00162.

[85] Compl. ¶ 110.

[86] Compl. ¶¶ 110-11.

[87] Compl. ¶¶ 12-13, 101, 112, Ex. A at 00231; *see also* Letter to Vice Chancellor Slights from Brian D. Long, Esq., on behalf of Pls.' Resp. to Questions Posed by the Ct. at the June 19, 2019 Hr'g in this Matter ("Pls.' Letter") (D.I. 61) at 2-3.

[88] Compl. ¶¶ 13, 224, 259, Ex. A at 00246; Pls.' Letter at 2-3.

champion and it was prepared to do battle with Tagrisso. On September 9, 2014, Mahaffy told a securities analyst that Roci and Tagrisso had "similar response rate[s]," and on November 18, 2014, Clovis issued a press release stating that Roci's ORR was 67%.[89]

The Board, however, continued to receive signals that management was not vigilantly following RECIST. On December 3, 2014, the Board reviewed a report stating, "in mid-March, we will have a response rate of less than 60% (could be less than 50%)."[90] The same report revealed the Company **[*14]** was waiting on "data maturity" and that at least some patients had not received a second scan at that time, indicating continued non-compliance with RECIST.[91]

With hands on their ears to muffle the alarms, on February 27, 2015, Defendants Mahaffy, Mast, Atwood, Barrett, Blair, Flaherty, Graham, Klingenstein, McKinley and Spickschen signed Clovis' 2014 Annual Report.[92] The report reaffirmed previous, inflated ORR reports and omitted that Clovis was relying on partially unconfirmed responses.[93]

On April 29, 2015, management updated the Board by presenting a series of slides depicting that the highest ORR for any subgroup of Roci patients was 53.3% and revealing the numbers were as low as 37.1% for other groups.[94] The next day, Clovis management and CMO Allen published data from the TIGER-X trial in the *New England Journal of Medicine* ("NEJM").[95] The NEJM article showed Roci's ORR at 59% as "assessed according to . . . [RECIST]."[96] At about this time, in the spring of 2015, Clovis statisticians had already informed "senior clinical personnel" that there was "a 'divergence between the confirmed and unconfirmed ORR'" for Roci.[97]

Approximately one month later, on June 9, 2015, Clovis officials met with the **[*15]** FDA regarding Roci's critical New Drug Application ("NDA").[98] The NDA filing necessarily included the Company's disclosure of TIGER-X data for final FDA approval.[99] At the meeting, management reported an ORR of 50% without informing the FDA that this ORR included unconfirmed responses.[100] Notwithstanding its report to the FDA, management continued to report a 60% ORR in public statements.[101]

On June 19, 2015, Mahaffy, Mast and other members of senior management received "close to final" data from the TIGER-X trial.[102] The data showed an ORR of 45.1% for the 500mg dose (significantly lower than the 60% ORR the Company had been disclosing to the market).[103] Mahaffy wrote to another Clovis executive that the data "[s]eems worrying."[104] Three days later, on June 22, CMO Allen resigned without warning.[105] On July 7, Clovis' management received the "final" TIGER-X data showing that Roci's ORR was only 42%.[106]

On July 14, 2015, Clovis conducted a secondary offering of 4.1 million shares and raised more than $316 million.[107] The prospectus for the offering was signed by the entire Board and disclosed a "'60 percent ORR' at the 'recommended dose of 500mg.'"[108] It did not disclose that the ORR included unconfirmed **[*16]** responses.[109]

---

[89] Compl. ¶¶ 112-13.

[90] Compl. ¶ 120, Ex. A at 00371.

[91] *Id.* ("We really want to get to at least 2 scans on every patient and to more than 2 on as many as we can.").

[92] Compl. ¶¶ 206-07.

[93] *Id.*

[94] Compl. ¶ 16, Ex. A at 00633, 00640, 00717, 00724, 00726. *See also* Pls.' Letter at 3-4.

[95] Compl. ¶ 123.

[96] Compl. ¶¶ 124, 208.

[97] Compl. ¶ 126.

[98] Compl. ¶ 129.

[99] *Id.*

[100] *Id.*

[101] Compl. ¶¶ 128-29.

[102] Compl. ¶ 130.

[103] *Id.*

[104] *Id.*

[105] Compl. ¶ 131.

[106] Compl. ¶ 137.

[107] Compl. ¶ 133.

[108] Compl. ¶¶ 134, 136.

[109] Compl. ¶ 136.

The FDA requested additional data in support of the NDA in October 2015.[110] In response, Clovis disclosed that Roci's current *confirmed* ORR was between 28% and 34%.[111] At the same time, management presented a slide to the Board to illustrate how Roci was stacking up against Tagrisso.[112] The slide clearly showed an ORR of 46% that was "(Unconf + Conf)" while Tagrisso's ORR was "Confirmed."[113] Management advised the Board in connection with the NDA that "[w]e will cite the unconfirmed investigator assessed response rate of ~46%."[114] The public continued to hear a different story, however. For instance, a November 5, 2015 press release and earnings call announced third quarter results and cited presentations from medical conferences claiming Roci's ORR was 60%.[115]

D. The Fallout

The conflicting reports regarding Roci's ORR eventually prompted the FDA to ask questions and to call for a meeting with Clovis executives on November 9, 2015.[116] During the meeting, the FDA emphasized it would credit only confirmed responses on the NDA[117] and insisted Clovis comply with TIGER-X's stated protocol (which had explicitly incorporated RECIST).[118] Mahaffy updated the Board on this most recent FDA meeting the following **[*17]** week.[119]

The public was finally informed of Roci's true ORR when, on November 16, 2015, Clovis issued a press release stating the correct *confirmed* ORR was as low as 28-34%.[120] Clovis' stock price immediately dropped 70%, wiping out more than $1 billion in market capitalization.[121]

On April 8, 2016, the FDA voted to delay action on Clovis' NDA until the Company could provide concrete evidence of a risk/benefit profile meriting approval.[122] On this news, Clovis' stock price fell another 17%.[123] On May 5, 2016, Clovis withdrew its NDA for Roci and terminated enrollment in all ongoing Roci studies.[124]

E. Undisclosed Side Effects and Other TIGER-X Protocol Violations

In addition to the Company's refusal properly to report ORR, the Board was advised that Roci had serious, undisclosed side effects and that the TIGER-X trial had been compromised by other clinical trial protocol violations during the Relevant Period.[125] FDA regulations and internal Clovis policies required Clovis to abide by certain informed consent, patient eligibility, data reliability, recordkeeping and adverse event reporting practices.[126] The Company routinely missed these marks throughout the TIGER-X trial.[127]

For example, on August 17, 2015, a **[*18]** research associate notified senior Clovis management of protocol violations involving patient informed consent, patient enrollment, adverse event reporting, data alteration and missing data.[128] Management received a similar report ten days later.[129] The following month, on September 17, 2015, Clovis management identified 238 protocol deviations.[130] On October 14, 2015, in a notice letter (Form 483) to the Company, the FDA identified a failure to report two serious adverse events, approximately twelve patient eligibility violations and various failures to

[110] Compl. ¶ 140.

[111] Compl. ¶¶ 140-41.

[112] Compl. ¶ 143, Ex. A at 01021; Pls.' Letter at 45.

[113] *Id.*

[114] Pls.' Letter at 4-5; Compl. Ex. A at 01069.

[115] Compl. ¶¶ 144-45, 215.

[116] Compl. ¶¶ 17, 146.

[117] *Id.*

[118] Compl. ¶¶ 80, 82.

[119] Compl. Ex. A at 01073 (containing minutes from a special Board meeting on November 15, 2015).

[120] Compl. ¶¶ 222-23.

[121] Compl. ¶¶ 18, 223.

[122] Compl. ¶ 228.

[123] Compl. ¶ 227.

[124] Compl. ¶ 229.

[125] Compl. ¶¶ 1, 19, 22, 149-96.

[126] Compl. ¶¶ 149-68.

[127] Compl. ¶ 171.

[128] *Id.*

[129] *Id.*

[130] *Id.*

maintain case history and informed consent records.[131] It was also discovered that the clinical trial administrators had failed to monitor other medications enrollees were taking while participating in the trial.[132] The Board was notified of several of these clinical trial protocol violations on December 10, 2015, and likely received additional information about the problems "at regularly scheduled board meetings" where "hours of discussion occurred . . . regarding [Roci]."[133]

Protocol violations were not the only problems with the Roci clinical trial. The Board also learned that one of the drug's side effects, QT prolongation, was more common **[*19]** than management publicly reported.[134] Specifically, the Board received a report on April 29, 2014, that a grade 3 out of 4 (indicating a severe response) QT prolongation occurred in 6.2% of patients.[135] Nevertheless, the Board sat idle as the Company reported a "manageable side effect profile" throughout May 2014.[136] On October 7, 2014, Board materials indicated that a grade 3 QT prolongation occurred in 2.5% of patients.[137] The same results were reported in forecasts the Board received from management in December of 2014.[138]

The Company's misleading reports regarding Roci's side effects continued into 2015. In February and July of 2015, Clovis disclosed that Roci's only grade 3 adverse event "of note" was hyperglycemia.[139] The prospectus for the July 2015 secondary offering made a similar disclosure.[140] Although an August 6, 2015 press release mentioned the QT prolongation side effect, it emphasized that the only grade 3 adverse event identified in more than 5% of patients was hyperglycemia.[141] Mahaffy and Mast made public statements in September and November of 2015 that Roci did not have "typical side effects" and that the "only grade 3 or 4 adverse event that has been identified in more than ten percent **[*20]** of patients is hyperglycemia."[142] By this time, however, Clovis had already reported data to the FDA indicating that Roci had a 12% incidence of grade 3 or higher QT prolongation.[143] And, by April 2016, management had informed the Board that the FDA was going to require a "Boxed Warning" (the strongest of the FDA warnings) because it had concluded Roci significantly increased the risk of QT prolongation.[144]

F. Defendants' Stock Sales and Related Litigation

As the TIGER-X tribulations unfolded, three members of the Board, Defendants Barrett, Blair and Spickschen, along with CFO Mast, sold small percentages of their Clovis stock holdings.[145] These trades, and their timing relative to the November 16, 2015 fall in Clovis' stock price, are depicted in the chart below.[146]

Go to table1

At first glance, the trades appear to be **[*21]** significant. But it is undisputed that each of the Director Defendants retained between 96% and 99.9% of their total holdings throughout the Relevant Period.[147]

After news of the failed TIGER-X trial broke, and the value of Clovis' stock fell precipitously, Clovis, Mahaffy and Mast were each named as defendants in a series of securities fraud class actions.[148] One of these cases

---

131 *Id.*

132 Compl. ¶¶ 173, 175-176.

133 Compl. ¶¶ 174, 259.

134 Compl. ¶ 189.

135 Compl. ¶ 179.

136 Compl. ¶ 103.

137 Compl. ¶ 180.

138 Compl. ¶ 181.

139 Compl. ¶¶ 122, 136.

140 Compl. ¶ 136 ("[T]he only common grade 3 [side effect] was hyperclycemia.") (alteration in original).

141 Compl. ¶ 211.

142 Compl. ¶¶ 139, 148, 216.

143 Compl. ¶¶ 148, 216.

144 Compl. ¶¶ 184, 226.

145 Compl. ¶ 31 (Barrett's sales), ¶ 38 (Spickschen's sales), ¶ 40 (Mast's sales), ¶ 354 (Blair's sales).

146 Compl. ¶ 354.

147 Tr. of Oral Arg. on Defs.' Mot. to Dismiss (D.I. 63) at 35:3-5; Transmittal Aff. of Robert L. Burns, Esq. in Supp. of Defs.' Mot. to Dismiss Pls.' Consol. Verified S'holder Deriv. Compl., ("Burns Aff.") (D.I. 19) Ex. O at 45 (showing the Board Defendants' stock holdings as of April 13, 2015); Clovis, Proxy Statement (Schedule 14A) (Apr. 30, 2015) (showing the Board Defendants' stock holdings as of April 13, 2015).

148 Compl. ¶¶ 26, 231. *See, e.g., Medina v. Clovis Oncology, Inc., et al., Civil Action No. 1:15-cv-2546, 2016 U.S. Dist.*

was settled for $142 million in cash and Clovis stock.[149] The SEC's September 18, 2018 complaint against Clovis, Mahaffy and Mast led to the entry of an onerous consent decree requiring the three defendants to pay $20 million, $250 thousand and $100 thousand in civil penalties, respectively.[150] Additionally, Mast was required to disgorge $454,154 (representing his unjust profits from selling Clovis stock).[151] The FDA also launched its own investigation of Clovis relating to the TIGER-X trial.[152]

G. Procedural Posture

On May 31, 2016 and December 15, 2016, Plaintiffs served the Company with demands to inspect books and records under *8 Del. C. § 220* in response to which they received approximately 3,000 pages of documents.[153] Plaintiffs filed their first complaint on March 23, 2017.[154] They amended the **[*22]** complaint on May 18, 2017.[155] Defendants moved to dismiss the first amended complaint under *Court of Chancery Rules 23.1* and *12(b)(6)* on August 1, 2017.[156]

As noted, on September 18, 2018, the SEC filed a complaint against Clovis, Mahaffy and Mast that resulted in consent decrees and civil penalties.[157] After the SEC settlements, Plaintiffs moved to amend their complaint again on November 19, 2018, to add allegations regarding the SEC enforcement actions.[158] After this Court granted leave to amend, the parties supplemented their briefing on Defendants' motions to dismiss.[159] Following oral argument and post-argument filings, the motion to dismiss was submitted for decision on July 1, 2019.

II. ANALYSIS

The Complaint comprises three counts.[160] Count I is a derivative claim for breach of fiduciary duty against the Board Defendants.[161] Specifically, Plaintiffs allege the Board Defendants breached their fiduciary duties under *Caremark* by their "actions and inactions . . . in connection with the TIGER-X trial."[162] In this regard, Count I alleges either that (i) the Board Defendants failed to institute an oversight system for the TIGER-X trial or (ii) the Board Defendants consciously disregarded a series of red flags related to the TIGER-X trial. **[*23]** [163]

Count II asserts a derivative claim against the Board Defendants for unjust enrichment, and Count III asserts a derivative claim for breach of fiduciary duty against Barrett, Blair, Mast and Spickschen under *Brophy*, which permits a corporation to recover from its fiduciaries for harm caused by improper stock trades.[164]

As for Count I, Plaintiffs have pled particularized facts that "create a reasonable doubt that, as of the time the complaint [was] filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."[165] Specifically, Plaintiffs have well-pled that the Board ignored red flags that the Company was violating—perhaps consciously violating—the RECIST protocol

LEXIS 19784 (reported in Westlaw as 2016 WL 660133).

149 Compl. ¶ 239.

150 Compl. ¶¶ 240-41, 245.

151 Compl. ¶ 245.

152 Compl. ¶ 232.

153 Compl. ¶¶ 43-44.

154 *See* Verified S'holder Deriv. Compl. (D.I. 1); Compl. ¶¶ 43, 250.

155 D.I. 8.

156 D.I. 15-16.

157 Compl. ¶¶ 240-43, 245.

158 D.I. 34, 36-37.

159 D.I. 46, 50, 54.

160 Compl. ¶¶ 341-360. Count I has received the most attention. *See, e.g.*, PAB (D.I. 23) at 58, 62-63 (devoting approximately three total pages to the *Brophy* and unjust enrichment claims).

161 Compl. ¶¶ 342-44.

162 Compl. ¶¶ 344-45; *Caremark, 698 A.2d 959*.

163 *See* PAB (D.I. 23) at 31 ("Defendants Face a Substantial Likelihood of Personal Liability for Failing to Prevent or Correct Clovis from Providing Shareholders and the FDA with Misleading Study Data Results."), 44 ("The [Board] Defendants Also Face a Substantial Likelihood of Personal Liability for Failing to Implement Any System of Internal Controls to Ensure Compliance with Study Protocol or Receive Notice of Study Protocol Violations.").

164 *Brophy, 31 Del. Ch. 241, 70 A.2d 5*; Compl. ¶¶ 349-60.

165 *Rales v. Blasband, 634 A.2d 927, 934 (Del. 1993)*.

and then misleading the market and regulators regarding Roci's progress through the TIGER-X trial. Because Plaintiffs have pled particularized facts to support a reasonable inference the Board Defendants face a substantial likelihood of liability on Count I, Defendants' motion to dismiss Count I under Rule 23.1 must be denied. Having so concluded, *a fortiori*, I deny the Motion to Dismiss under Rule 12(b)(6) as well.[166]

Regarding Counts II and **[*24]** III, Plaintiffs have failed to plead particularized facts showing that the Defendants face a substantial likelihood of personal liability as to either count. Defendants' motion to dismiss Counts II and III, therefore, must be granted.

A. The Applicable Rule 23.1 Standard

There is no dispute that each of the Complaint's three counts purports to state a derivative claim.[167] As Justice Moore emphasized in his seminal *Aronson* decision, 8 Del. C. § 141(a) codifies a bedrock of Delaware corporate law—the board of directors, not stockholders, manages the business and affairs of the corporation, including the decision to cause the corporation to sue.[168] With this in mind, our law has established procedural imperatives to ensure that shareholders do not "imping[e] on the managerial freedom of directors."[169] To wrest control over the litigation asset away from the board of directors, the stockholder must demonstrate that demand on the board to pursue the claim would be futile such that the demand requirement should be excused.[170]

Plaintiffs acknowledge they did not make a pre-suit demand on the Board.[171] It is settled, therefore, that their Complaint must "comply with stringent requirements of factual **[*25]** particularity that differ substantially from the permissive notice pleadings" of Chancery Rule 8 in order to demonstrate that demand upon the Board would have been futile.[172] Where, as here, a plaintiff challenges board inaction—as opposed to a business decision of the Board—the court analyzes demand futility under the well-known and "well-balanced" *Rales* standard.[173] This standard requires plaintiffs to plead facts regarding demand futility with particularity but balances that requirement with a mandate that the court draw all reasonable inferences in the plaintiffs' favor.[174]

Demand futility turns on "whether the board that would be addressing the demand can impartially consider [the demand's] merits without being influenced by improper considerations."[175] Such improper influence arises if a majority of the board's members (i) are "compromised" because they face "a 'substantial likelihood' of personal liability" with respect to at least one of the alleged claims or (ii) lack independence because they are beholden to an interested person.[176]

B. Plaintiffs Have Well-Pled the Board Faces a

166 *See* McPadden v. Sidhu, 964 A.2d 1262, 1270 (Del. Ch. 2008) ("[A] complaint that survives a motion to dismiss pursuant to Rule 23.1 will also survive a 12(b)(6) motion to dismiss[.]"); 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).").

167 Compl. ¶¶ 347-48, 351-52, 359-60; DOB (D.I. 16) at 1.

168 Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000) (citing 8 Del. C. § 141(a)).

169 Aronson, 473 A.2d at 811.

170 *See* Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1044 (Del. 2004).

171 Compl. ¶ 250.

172 Brehm, 746 A.2d at 254 (noting that conclusory statements or mere notice pleading are insufficient to satisfy Rule 23.1).

173 Rales, 634 A.2d at 932-34; ***Marchand, 212 A.3d at 818*** (citing ***Del. Cty. Empls.' Ret. Fund v. Sanchez, 124 A.3d 1017, 1022 (Del. 2015)*** (explaining that the *Rales* test is "well balanced")).

174 Rales, 634 A.2d at 934 (requiring "particularized factual allegations"); ***Marchand, 212 A.3d at 818*** (requiring "reasonable inferences" to be drawn in plaintiff's favor).

175 Rales, 634 A.2d at 934.

176 Guttman v. Huang, 823 A.2d 492, 501 (Del. Ch. 2003) (quoting Rales, 634 A.2d at 936); In re Goldman Sachs Grp., Inc. S'holder Litig., 2011 Del. Ch. LEXIS 151, 2011 WL 4826104, at *18 (Del. Ch. Oct. 12, 2011). The parties agree the first prong in the *Rales* analysis applies where, as here, a plaintiff challenges board inaction such as when a board is alleged to have consciously disregarded its oversight responsibilities. *See* Wood v. Baum, 953 A.2d 136, 140 (Del. 2008); DOB (D.I. 16) at 18; PAB (D.I. 23) at 28.

Substantial Likelihood of Liability Under *Caremark* (Count I)

The parties agree that Count I implicates *Caremark,* ***[*26]*** *Stone v. Ritter* and their progeny.[177] These cases require well-pled allegations of bad faith to survive dismissal—i.e., allegations "the directors knew that they were not discharging their fiduciary obligations," a standard of wrongdoing "qualitatively different from, and more culpable than . . . gross negligence."[178] Given this high bar, it is now indubitably understood, and oft-repeated, that a *Caremark* claim is among the hardest to plead and prove.[179] At the pleadings stage, this means Plaintiffs must allege particularized facts that either (i) "the directors completely fail[ed] to implement any reporting or information system or controls, or . . . [(ii)] having implemented such a system or controls, consciously fail[ed] to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."[180] Implicit in these standards is the requirement that plaintiffs plead particular facts allowing a reasonable inference the directors acted with scienter, which "requires proof that a director acted inconsistent with his fiduciary duties and, most importantly, that the director *knew* he was so acting."[181]

Caremark rests on the **[*27]** presumption that corporate fiduciaries are afforded "great discretion to design context- and industry-specific approaches tailored to their companies' businesses and resources."[182] Indeed, "[b]usiness decision-makers must operate in the real world, with imperfect information, limited resources, and uncertain future. To impose liability on directors for making a 'wrong' *business decision* would cripple their ability to earn returns for investors by taking *business risks*."[183] But, as fiduciaries, corporate managers must be informed of, and oversee compliance with, the regulatory environments in which their businesses operate. In this regard, as relates to *Caremark* liability, it is appropriate to distinguish the board's oversight of the company's *management of business risk* that is inherent in its business plan from the board's oversight of the company's *compliance with positive law*—including regulatory mandates. As this Court recently noted, "[t]he legal academy has observed that Delaware courts are more inclined to find *Caremark* oversight liability at the board level when the company operates in the midst of obligations imposed upon it by positive law yet fails to implement compliance systems, **[*28]** or fails to monitor existing compliance systems, such that a violation of law, and resulting liability, occurs."[184]

Our Supreme Court's recent decision in *Marchand v. Barnhill* underscores the importance of the board's oversight function when the company is operating in the midst of "mission critical" regulatory compliance risk.[185] The regulatory compliance risk at issue in *Marchand* was food safety and the failure to manage it at the board level allegedly allowed Blue Bell Creameries to distribute mass quantities of ice cream tainted by *listeria*.[186] The Court held that Blue Bell's board had not

---

[177] *See* ***Marchand, 212 A.3d at 820-21*** (discussing the *Caremark* progeny); *Caremark, 698 A.2d at 970*; *Stone v. Ritter, 911 A.2d 362 (Del. 2006)*.

[178] *Stone, 911 A.2d at 369-70* (citing *In re Walt Disney Co. Deriv. Litig., 906 A.2d 27 (Del. 2006))*.

[179] *See* *Stone, 911 A.2d at 372* ("[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.") (internal quotation marks omitted); *Guttman, 823 A.2d at 506* ("A *Caremark* claim is a difficult one to prove."); *Caremark, 698 A.2d at 967* ("The theory here advanced is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.").

[180] ***Marchand, 212 A.3d at 821*** (quoting *Stone, 911 A.2d at 370-72*).

[181] *In re Massey Energy Co. Derivative & Class Action Litig., 2011 Del. Ch. LEXIS 83, 2011 WL 2176479, at *22 (Del. Ch. May 31, 2011)* (citing *Stone, 911 A.2d at 370*) (emphasis in original).

[182] ***Marchand, 212 A.3d at 821***.

[183] ***In re Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 126 (Del. Ch. 2009)*** (emphasis supplied).

[184] *In re Facebook, Inc. Sec. 220 Litig., 2019 Del. Ch. LEXIS 197, 2019 WL 2320842, at *14 (Del. Ch. May 31, 2019)*. The court explained: "In other words, it is more difficult to plead and prove *Caremark* liability based on a failure to monitor and prevent harm flowing from risks that confront the business in the ordinary course of its operations. Failure to monitor compliance with positive law, including regulatory mandates, is more likely to give rise to oversight liability." *Id.* (collecting authorities).

[185] ***Marchand, 212 A.3d at 824*** (applying *Caremark, 698 A.2d 959*).

[186] ***Id. at 809***.

made a "good faith effort to put in place a reasonable system of monitoring and reporting" when it left compliance with food safety mandates to management's discretion rather than implementing and then overseeing a more structured compliance system.[187]

As *Marchand* makes clear, when a company operates in an environment where externally imposed regulations govern its "mission critical" operations, the board's oversight function must be more rigorously exercised.[188] Key to the Supreme Court's analysis was the fact that food safety was the "most central safety and legal compliance **[*29]** issue facing the company."[189] To be sure, even in this context, *Caremark* does not demand omniscience. But it does demand a "good faith effort to implement an oversight system and then monitor it."[190] This entails a sensitivity to "compliance issue[s] intrinsically critical to the company[]."[191]

1. *Caremark*'s First Prong

The so-called first prong of *Caremark* requires Plaintiffs to well-plead that the Board "completely fail[ed] to implement any reporting or information system or controls[.]"[192] But Plaintiffs acknowledge the Board's Nominating and Corporate Governance Committee was "specifically charged" with "provid[ing] general compliance oversight . . . with respect to . . . Federal health care program requirements and FDA requirements."[193] And they further acknowledge "[t]he Board . . . reviewed detailed information regarding [Roci's] TIGER-X trial at each Board meeting."[194] Given these acknowledged facts, it is difficult to conceive how Plaintiffs would prove the Board had no "reporting or information system or controls[.]"[195]

2. *Caremark*'s Second Prong

Caremark's second prong is implicated when it is alleged the company implemented an oversight system but the board failed to "monitor it." **[*30]** [196] To state a claim under this prong, Plaintiffs must well-plead that a "red flag" of non-compliance waived before the Board Defendants but they chose to ignore it.[197] In this regard, the court must remain mindful that "red flags are only useful when they are either waived in one's face or displayed so that they are visible to the careful observer."[198] But, as *Marchand* makes clear, the careful observer is one whose gaze is fixed on the company's mission critical regulatory issues.[199] For Clovis, this was Roci's TIGER-X trial and the clinical trial protocols and related FDA regulations governing that study.

Plaintiffs have alleged particularized facts supporting reasonable inferences that: (i) the Board knew the TIGER-X protocol incorporated RECIST;[200] (ii) RECIST requires reporting only confirmed responses;[201] (iii)

---

[187] ***Id. at 823-24***.

[188] ***Id. at 824*** ("food safety was essential and mission critical" and the "most central consumer safety and legal compliance issue facing the company"). *See also* ***id. at 822*** (observing that food safety "has to be one of the most central issues at the company" and "a compliance issue intrinsically critical to the company's [monoline] business operation").

[189] *Id.*

[190] ***Id. at 821***.

[191] ***Id. at 822***.

[192] ***Id. at 821***.

[193] Compl. ¶ 279.

[194] Compl. ¶ 16. Plaintiffs also allege Clovis maintained extensive policies addressing the alleged deviations from the clinical study protocol. *See* Compl. ¶¶ 150 (protocol on recordkeeping), 146 (informed consent protocol), 154, 158 (regarding FDA regulations), 67 (regarding reporting adverse events).

[195] ***Marchand, 212 A.3d at 821***.

[196] *Id.*

[197] *See* *South v. Baker, 62 A.3d 1, 16-17 (Del. Ch. 2012)*.

[198] *Wood, 953 A.2d at 143* (internal citations omitted); *In re Citigroup, Inc. S'holders Litig., 2003 Del. Ch. LEXIS 61, 2003 WL 21384599, at *2 (Del. Ch. June 5, 2003)* (internal quotes omitted).

[199] ***Marchand, 212 A.3d 805***.

[200] Compl. ¶¶ 82, 84, 88, 89. Indeed, the Company elected to adopt RECIST even though it could have incorporated other clinical trial protocols. Compl. ¶¶ 80, 83.

[201] Compl. ¶ 86. As noted, Defendants vigorously dispute whether RECIST requires only confirmed responses to be included in ORR. *See, e.g.*, DOB (D.I. 16) at 14, 28. While Defendants may ultimately prove that their interpretation of RECIST is correct, they cannot rewrite Plaintiffs' Complaint on a motion to dismiss. *See* Compl. ¶ 86, Ex. B (D.I. 37) at 1

industry practice and FDA guidance require that the study managers report only confirmed responses;[202] (iv) management was publicly reporting unconfirmed responses to keep up with Tagrisso's response rate;[203] and (v) the Board knew management was incorrectly reporting responses but did nothing to address this fundamental departure from the RECIST protocol.[204] When Clovis' serial non-compliance **[*31]** with RECIST was finally revealed to the regulators, Roci was doomed.[205] And when the drug's failure was revealed to the market, Clovis' stock price tumbled.[206]

ORR was the crucible in which Roci's safety and efficacy were to be tested.[207] Roci was Clovis' mission critical product.[208] And the Board knew, upon completion of the TIGER-X trial, the FDA would consider only confirmed responses when determining whether to approve Roci's NDA per the agency's own regulations.[209] As pled, these regulations, and the reporting requirements of the RECIST protocol, were not nuanced.[210] The Board was comprised of experts and the RECIST criteria are well-known in the pharmaceutical industry.[211] Moreover, given the degree to which Clovis relied upon ORR when raising capital, it is reasonable to infer the Board would have understood the concept and would have appreciated the distinction between confirmed and unconfirmed responses.[212] The inference of Board knowledge is further enhanced by the fact the Board knew that even after FDA approval, physicians (i.e., future prescribers) would evaluate Roci based on its ORR.[213]

Defendants argue the FDA blessed Clovis' plan to report unconfirmed responses for "interim" results because Roci was on an accelerated approval track.[214]

(RECIST guidelines stating that "[*c*]*onfirmation of response* is required for trials . . .") (emphasis in original). *See also* [*Vanderbilt Income & Growth Assocs., L.L.C. v. Arvida/JMB Managers, Inc., 691 A.2d 609, 613 (Del. 1996)*] (emphasizing the trial court cannot ignore well-pled allegations in a complaint on a motion to dismiss).

202 Compl. ¶ 99-100 (citing FDA guidance documents).

203 *See, e.g.*, Compl. ¶¶ 16, 104, 120, 134, 136, 143, 206-07, 259.

204 Compl. ¶¶ 104, 107-08, 120, 259; Compl. Ex. A at 00120, 00162, 00246, 00371.

205 Compl. ¶¶ 223, 228.

206 Compl. ¶¶ 18, 222-23.

207 Compl. ¶ 8 ("ORR was the "primary endpoint"—the key measure of success—in the TIGER-X trial.").

208 Compl. ¶¶ 8, 20, 101; *see also* Compl. ¶ 63 (Clovis had no drugs on the market).

209 Compl. ¶ 99.

210 *See* Compl. ¶ 10 ("RECIST unequivocally requires each instance of tumor shrinkage (a response) to be 'confirmed.'"). Defendants attack Plaintiffs' assertions that (i) the Board understood RECIST and (ii) ORR was more than a mere "nuts and bolts" requirement. *See* Defs.' Reply Br. in Supp. of Their Mot. to Dismiss Pls.' Consol. Verified S'holder Deriv. Compl. (D.I. 27) at 16 (there are "no well-pled allegations even suggesting the [Board] Defendants understood (or should have understood) that ORR results were reported (allegedly) incorrectly based on the highly technical detail on which Plaintiffs focus."). Plaintiffs have alleged sufficient facts to support an inference that the Board Defendants *did* understand (or should have understood) that Clovis was reporting ORR results incorrectly. For example, Board slides explicitly warn that ORR numbers are "[u]nconfirmed." Compl. Ex. A at 00162, 00246. Tagrisso was compared with Roci by highlighting their respective ORRs with the caveat that Roci's ORR was "(Unconf + Conf)" while Tagrisso's was "Confirmed." Compl. Ex. A at 01021. Additionally, Plaintiffs point to scholarly publications indicating that "confirmation [of responses] is the 'industry standard.'" Compl. ¶ 97. Since Roci was such an important product for the Company, it is reasonable to infer that the Board presentations regarding ORR, at the least, should have prompted questions—if not objections—from the Board. Furthermore, the Complaint alleges circumstances where any reliance on Clovis' management regarding ORR reporting would be unreasonable in light of the Board presentations and the competitive pressure Roci faced from Tagrisso—rendering a reliance defense under [*8 Del. C. § 141(e)*] inappropriate, at least at this stage.

211 Compl. ¶¶ 30-38; *see also* Compl. ¶ 83 (quoting Manola et al., *Assessment of Treatment Outcome,* ***[*32]*** *in* UICC MANUAL OF CLINICAL ONCOLOGY 40, 44 (Brian O'Sullivan et al. eds., 9th ed. 2015).

212 Compl. ¶¶ 110-11.

213 Compl. ¶¶ 8, 120, Ex. A at 00371.

214 *See, e.g.*, DOB (D.I. 16) at 14. Defendants cite to Compl. Ex. A (D.I. 37) at 00001069. This document is an October 7, 2015 Board report stating "a few highlights" "in terms of the FDA review so far." One of those highlights was that "[w]e will cite the unconfirmed investigator assessed response rate of [] 46%." *Id.* Defendants claim this means that the FDA did not have an "issue" with reporting unconfirmed results. DOB (D.I. 16) at 30. This report might be interpreted as suggesting either that (i) the FDA implicitly condoned reporting unconfirmed responses or (ii) the FDA did not notice or was not specifically

Additionally, Defendants claim FDA guidance was not as clear as the Complaint depicts.[215] But, again, that is not what the Complaint alleges.[216] Whether Plaintiffs' allegations hold up during discovery, at summary judgment or at trial remains to be seen.

Drawing all reasonable inferences in Plaintiffs' favor, I am satisfied they have well-pled that the Board consciously ignored red flags that revealed a mission critical failure to comply with the RECIST protocol and associated FDA regulations. Additionally, at this stage, Plaintiffs' allegation that this failure of oversight caused monetary and reputational harm to the Company is sufficient to provide a causal nexus between the breach of fiduciary duty and the corporate trauma.[217] Therefore, Defendants' motion to dismiss Count I (Plaintiffs' *Caremark* claim) under Rules 23.1 and 12(b)(6) must be denied.

C. Plaintiffs Fail to State a *Brophy* Claim (Count III)

Generally, "corporate officers and directors may purchase and sell the corporation's **[*33]** stock at will, without any liability to the corporation."[218] Indeed, Delaware law recognizes that it is good when fiduciaries align their interests with the company through stock ownership, a dynamic facilitated by the fact that many

told that Clovis reneged on a promise to use only confirmed responses. Which interpretation will carry the day remains to be seen. At this point, I cannot ignore that the Complaint contradicts the assertion that the FDA knew about and blessed reliance on unconfirmed results. Compl. ¶ 129 ("Documents publicly released by the FDA on April 8, 2016 demonstrate that at that June 9, 2015 meeting, the [Board] Defendants privately reported an ORR of 50% (without informing the FDA that the ORR was unconfirmed)[.]"). On this point, my conclusion at this stage is similar to Judge Moore's in the related federal securities litigation, Medina v. Clovis Oncology, Inc., 215 F.Supp. 3d 1094, 1112 (D. Colo. 2017) (stating, after an extensive review of RECIST requirements, that he "agrees with plaintiffs' interpretation of RECIST" "at this stage" that RECIST "requires that responses be confirmed."). Like Judge Moore, I note that my conclusion is a reflection of the applicable standard of review, fully acknowledging that "Defendants [might] present evidence at summary judgment indicating that their interpretation of RECIST was reasonable and that the FDA would accept [] unconfirmed responses." Id. at 1117.

[215] DOB (D.I. 16) at 14.

[216] Compl. ¶ 86 ("RECIST unequivocally requires each instance of tumor shrinkage (a response) to be 'confirmed.'"). *See also* ***Sanchez, 124 A.3d at 1020*** ("all reasonable inferences from the pled facts must . . . be drawn in favor of the plaintiff in determining whether the plaintiff has met its burden under *Aronson*."). I acknowledge the parties' agreement that the Company's Section 220 documents would be deemed incorporated in the Complaint whether cited there or not. This is a now-standard form of agreement and it serves the laudable purpose of eliminating the need for parties and the court to address whether referring to Section 220 documents has converted a motion to dismiss into a motion for summary judgment. *See* Yahoo!, 132 A.3d at 797 (confirming parties can agree that Section 220 documents are deemed incorporated by reference in the complaint without altering the Rule 12(b)(6) standard of review). But incorporating documents that might not square with a complaint's otherwise well-pled allegations is a far cry from providing the court with an undisputed factual predicate upon which judgment as a matter of law may rest. In other words, Section 220 documents, hand selected by the company, cannot be offered to rewrite an otherwise well-pled complaint. This view of the so-called *Yahoo*! agreement is entirely consistent with the "incorporation by reference doctrine," whereby the court may "review the actual document to ensure that the plaintiff has not misrepresented its contents and that any inference the plaintiff seeks to have drawn is a reasonable one." *Id.* The doctrine "limits the ability of the plaintiff to take language out of context because the defendants can point the court to the entire document." *Id.* "In the end, the only effect of the Incorporation Condition (within the parties' agreement) will be to ensure that the plaintiff cannot seize on a document, take it out of context, and insist on an unreasonable inference that the court could not draw if it considered related documents." Id. at 798. Mindful of this purpose, our courts must regulate how far down the road of incorporation by reference a defendant may go when plaintiff has well-pled something as fact (*e.g.*, that the Board understood ORR), even if another document might suggest the facts are otherwise. Section 220 documents may or may not comprise the entirety of the evidence on a particular point. Until that is tested, Defendants cannot ask the court to accept their Section 220 documents as definitive fact and thereby turn pleading stage inferences on their head. That is not, and should not be, the state of our law.

[217] Compl. ¶ 21. With this said, Plaintiffs' causation case will be challenging. It appears Roci was not what Clovis hoped it would be. If that proves true, then Plaintiffs may have difficulty connecting the oversight failure(s) to the corporate trauma. It might well be that Roci simply did not work and nothing the Board did or did not do would change that. For now, questions of causation are fact intensive and, as such, cannot be addressed at the pleading stage. In re Massey Energy Co. Deriv. & Class Action Litig., 160 A.3d 484, 506 (Del. Ch. 2017).

[218] Tuckman v. Aerosonic Corp., 1982 Del. Ch. LEXIS 452, 1982 WL 17810, at *11 (Del. Ch. May 20, 1982).

directors and officers are compensated in stock.[219] With the desirability of aligned incentives in mind, our law sets the bar for stating a claim for breach of fiduciary duty based on insider trading very high.[220]

"[A]n insider's trade may be deemed a breach of the fiduciary duty of loyalty, when: (1) 'the corporate fiduciary possessed material, nonpublic information'; and (2) 'the corporate fiduciary used that information improperly by making trades because she was motivated, in whole or in part, by the substance of that information.'"[221] In other words, Plaintiffs must plead facts that support an inference that Barrett, Blair, Mast and Spickschen acted with scienter.[222]

At the pleading stage, by necessity, a *Brophy* claim usually rests on circumstantial facts and a successful claim typically includes allegations of unusually large, suspiciously timed trades that allow a reasonable inference of scienter.[223] While the fact a fiduciary sells stock near the time **[*34]** he learns of material, nonpublic information might be evidence of the seller's motive, temporal proximity alone generally is insufficient to support an inference of scienter that will survive a motion to dismiss.[224] The other important piece of circumstantial evidence that, along with timing, might support an inference of scienter is the size of the trade relative to the defendant's overall stock holdings.[225] If a defendant sells only a small portion of her holdings and retains a "huge stake in the company[,]" then it is difficult reasonably to infer she was "fleeing disaster or seeking to make an unfair buck[.]"[226]

Plaintiffs allege three of the Director Defendants each traded one time, six months or more before Clovis disclosed the lower ORR results, with each trade representing a very small fraction of the trader's overall stake in the Company.[227] Specifically, each of the directors named in Count III retained between 96% and 99.9% of their total holdings as of April 13, 2015 (i.e., after the alleged improper trades).[228] In other words, in large measure, notwithstanding their alleged knowledge of the corporate trauma soon to come, each of these Defendants rode over **[*35]** the falls with the rest of Clovis' stockholders when the corporate storm hit the Company.

---

[219] *See* *In re Oracle Corp., 867 A.2d 904, 930 (Del. Ch. 2004)*, *aff'd*, ***872 A.2d 960 (Del. 2005)*** ("[T]he use of equity as a compensation tool is a legitimate choice under our law and Delaware statutory law permits and its common law creates incentives for stockholders to serve as directors and officers.").

[220] *See* *Guttman, 823 A.2d at 502* ("[I]t is unwise to formulate a common law rule that makes a director 'interested' [for demand futility purposes] whenever a derivative plaintiff cursorily alleges that he made sales of company stock in the market at a time when he possessed material, non-public information.").

[221] *Tilden v. Cunningham, 2018 Del. Ch. LEXIS 510, 2018 WL 5307706, at *19 (Del. Ch. Oct. 26, 2018)* (quoting *In re Oracle, 867 A.2d at 934*).

[222] *Guttman, 823 A.2d at 505*; *Brophy, 31 Del. Ch. 241, 70 A.2d 5*.

[223] *See, e.g.*, *In re Fitbit, Inc. S'holder Deriv. Litig., 2018 Del. Ch. LEXIS 571, 2018 WL 6587159, at *1 (Del. Ch. Dec. 14, 2018)* (finding that plaintiffs adequately alleged that insiders sold substantial amounts of their holdings in an initial public offering and a secondary offering after voting to waive lock-up agreements intended to prevent insiders from selling more shares after the initial public offering).

[224] *See* *Guttman, 823 A.2d at 502*; *Rattner v. Bidzos, 2003 Del. Ch. LEXIS 103, 2003 WL 22284323, at *10, *12 (Del. Ch. Sept. 30, 2003)* (noting that a complaint seeking an inference based on the "timing and size of [] sales" should plead facts to "assist in determining whether the pattern of executed trades was the product of an orchestrated scheme to defraud the market . . . or good faith adherence to Company policy or consistent with prior individual practices.").

[225] *See, e.g.*, *In re Oracle, 867 A.2d at 954* (analyzing the size of stock sales relative to defendants' overall holdings, and concluding that, even though the dollar values generated from sales were large (nearly $1 billion), the fact that the sales were between 7% and 2% of defendants' overall holdings was inconsistent with a "rational inference of scienter.").

[226] *Id.*

[227] Compl. ¶¶ 222-23 (stock price decline was on 11/16/15), 354 (stock trades were on 5/15/15 (Barrett), 3/5/15 (Blair), 5/15/15 (Spickschen)); Burns Aff. (D.I. 19) Ex. O at 45 (showing shares owned as of April 13, 2015).

[228] Compl. ¶ 354; Clovis, Proxy Statement (Schedule 14A) (Apr. 30, 2015) (showing that, as of April 13, 2015, Barrett owned more than 2,300,000 shares, Blair owned more than 2,200,000 shares and Spickschen owned more than 116,000 shares. These Defendants sold approximately 2,424; 8,528; and 4,309 shares, respectively yielding a percent of total holdings sold of approximately .1%; .5%; and 4% respectively). Compl. ¶ 354.

Regarding Mast, Plaintiffs allege he traded nine times in a consistent pattern (selling about 3,000 shares on the first of every month), which is inconsistent with an inference that he sold because insider knowledge allowed him to anticipate a decline.[229] While Mast sold a larger percentage of his overall holdings when compared with the other Defendants named in Count III, he still retained approximately 90% of his holdings throughout the Relevant Period.[230]

Noticeably absent from the Complaint are any well-pled facts that the trades at issue represented a deviation from the sellers' past trading practices.[231] To the contrary, the alleged selling patterns are inconsistent with a rational inference that these Defendants were motivated to sell based on their knowledge of Roci's true ORR.

After carefully reviewing the Complaint, I am satisfied it is not reasonably conceivable that these four defendants—who sold only a sliver of their holdings and suffered approximately the same decrease in net worth as other Clovis stockholders—made their trades with the requisite scienter required to sustain a **[*36]** *Brophy* claim. Therefore, Defendants' motion to dismiss under *Rule 12(b)(6)*, and by extension *Rule 23.1*, is granted.

D. Plaintiffs Fail to State an Unjust Enrichment Claim (Count II)

In Count II, Plaintiffs attempt to state a derivative claim for unjust enrichment in addition to their *Caremark* and *Brophy* claims.[232] As "representatives of Clovis," they seek "restitution from the Board Defendants" and an order requiring Defendants to disgorge "all profits, benefits and other compensation obtained . . . from their wrongful conduct and fiduciary breaches."[233]

Unjust enrichment is the "unjust retention of a benefit to the loss of another, or the retention of money or other property of another against the fundamental principles of justice or equity and good conscience."[234] "The elements of unjust enrichment are: (1) an enrichment, (2) an impoverishment, (3) a relation between the enrichment and impoverishment, (4) the absence of justification, and (5) the absence of a remedy provided by law."[235]

Even with *Section 220* documents in hand, Plaintiffs have not attempted to connect the Board Defendants' enrichment to alleged wrongdoing beyond their *Brophy* claim.[236] In search of an enrichment, Plaintiffs can point only to the Board Defendants' **[*37]** regular compensation and the profits obtained by some of the Board Defendants who sold stock. Because I have determined Plaintiffs have failed to state a viable *Brophy* claim, the only potential "enrichment" that remains is the Board Defendants' regular compensation.

Not surprisingly, Plaintiffs fail to connect the Board Defendants' "benefits and other compensation" with the

---

[229] Compl. ¶¶ 222-23 (stock decline was on 11/16/15), 354 (between 3/9/15 and 11/2/15, Mast's trades occurred early in the month and, with one exception, were for 1,000 shares each.). The nature of the stock trades in this case make it distinguishable from other cases involving numerous insiders unloading significant portions of their stock. *See, e.g.*, *Silverberg ex rel. Dendreon Corp. v. Gold, 2013 Del. Ch. LEXIS 312, 2013 WL 6859282, at *15 (Del. Ch. Dec. 31, 2013)* (denying a motion to dismiss where directors sold between 77% and 58% of their holdings within a day of FDA approval milestone and these sales were the first time that the directors had sold any of their shares despite owning them for more than a decade).

[230] Burns Aff. (D.I. 19) Ex. O at 45; Clovis, Proxy Statement (Schedule 14A) (Apr. 30, 2015) (showing that, as of April 13, 2015, Mast owned more than 330,000 shares). Mast sold 33,000 shares from March until November of 2015—yielding a percentage of total holdings sold of approximately 10%). Compl. ¶ 354.

[231] *See* *Rattner, 2003 Del. Ch. LEXIS 103, 2003 WL 22284323, at *12*; *Guttman, 823 A.2d at 503-04* (declining to draw an inference of scienter from the unusual timing of trades where the complaint did not plead facts related to sellers' past trading practices).

[232] Compl. ¶¶ 349-52.

[233] Compl. ¶ 351.

[234] *Nemec v. Shrader, 991 A.2d 1120, 1130 (Del. 2010)* (citing *Fleer Corp. v. Topps Chewing Gum, Inc., 539 A.2d 1060, 1062 (Del. 1988))*.

[235] *Id.*

[236] Of course, *Brophy* is a species of unjust enrichment that does not require a showing of actual harm to the corporation, but instead focuses "on the public policy of preventing unjust enrichment based on the misuse of confidential corporate information." *Kahn v. Kolberg Kravis Roberts & Co., L.P., 23 A.3d 831, 840 (Del. 2011)* (citing *Brophy, 31 Del. Ch. 241, 70 A.2d 5*). Therefore, I have analyzed Plaintiffs' allegations of enrichment associated with the alleged improper stock trades under *Brophy*'s rubric with respect to Count III.

alleged wrongdoing (i.e., oversight failures).[237] In apparent recognition of this pleading gap, Plaintiffs cite *Caspian Select Credit Master Fund Ltd. v. Gohl* for the general proposition that an unjust enrichment claim that is duplicative of a breach of fiduciary duty claim can survive a motion to dismiss if the fiduciary duty claim survives.[238] But that general proposition is not helpful here. In *Caspian*, a controlling shareholder allegedly engaged in self-dealing by being on both sides of a stock issuance.[239] There was a clear enrichment tied to an alleged breach of the fiduciary duty of loyalty.[240] Where, as here, the underlying breach arises from a *Caremark* violation, it is difficult to discern how that breach would give rise to an enrichment, and Plaintiffs have not well-pled that connection here.

Defendants' **[*38]** motion to dismiss Count II is granted under *Rule 12(b)(6)* for failure to state a viable claim and, by extension, under *Rule 23.1* for failure to plead particular facts that would allow an inference that a majority of the Board faces a substantial likelihood of liability for unjust enrichment.

III. CONCLUSION

Based on the foregoing, Defendants' motion to dismiss Plaintiffs' Complaint is DENIED as to Count I but GRANTED as to Counts II and III.

IT IS SO ORDERED.

---

[237] Compl. ¶ 351.

[238] PAB (D.I. 23) at 62 (citing *Caspian Select Credit Master Fund Ltd. v. Gohl, 2015 Del. Ch. LEXIS 246, 2015 WL 5718592, at *16 (Del. Ch. Sept. 28, 2015))*.

[239] *Id.*

[240] *Id.*

Table1 (*Return to related document text*)

Name	Date	Shares	Price	Proceeds
Barrett	5/15/11	2,424	$92.2.2	**$223,536**
Blair	3/5/15	8,528	$77.70	**$662,625**
Spickschen	5/15/15	4,30P	$85.00	**$366,269**
Mast	3/9/15	9,000	$79.55	**$716,202**
	4/1/15	3,000	$72.2.6	**$216,786**
	5/1/15	3,000	$82.2.5	**$246,744**
	6/1/15	3,000	$86.69	**$266,064**
	7/1/15	3,000	$86.59	**$259,761**
	8/03/15	3,000	$86.12	**$258,369**
	9/1/15	3,000	$79.09	**$237,258**
	10/1/15	3,000	$90.77	**$272,304**
	11/2/15	3,000	$104.18	**$312,543**
		33,000		**$2,786,031**
	Total:	**48,261**		**$4,038,461**

Table1 (*Return to related document text*)

In re Oracle Corp. Derivative Litig.

Court of Chancery of Delaware, New Castle

May 28, 2003, Submitted ; June 13, 2003, Decided

CONSOLIDATED C.A. No. 18751

Reporter

824 A.2d 917 *; 2003 Del. Ch. LEXIS 55 **

IN RE ORACLE CORP. DERIVATIVE LITIGATION

Subsequent History: **[**1]** As Revised June 17, 2003.

Appeal denied by *Oracle Corp. v. Barone, 829 A.2d 141, 2003 Del. LEXIS 392 (Del., July 28, 2003)*

Summary judgment granted by *In re Oracle Corp. Derivative Litig., 867 A.2d 904, 2004 Del. Ch. LEXIS 177 (Del. Ch., Nov. 24, 2004)*

Prior History: *In re Oracle Corp. Derivative Litig., 808 A.2d 1206, 2002 Del. Ch. LEXIS 92 (Del. Ch., July 10, 2002)*

In re Oracle Corp. Secs. Litig., 2003 U.S. Dist. LEXIS 9980 (N.D. Cal., Mar. 24, 2003)

Disposition: Motion to terminate action denied.

Counsel: Robert D. Goldberg, Esquire, BIGGS & BATTAGLIA, Wilmington, Delaware; Lee D. Rudy, Esquire and Robert B. Weiser, Esquire, SCHIFFRIN & BARROWAY, LLP, Bala Cynwyd, Pennsylvania; Samuel Rudman, Esquire and Douglas Wilens, Esquire, CAULEY, GELLER, BOWMAN & RUDMAN, LLP, Boca Raton, Florida, Attorneys for Plaintiffs.

Kenneth J. Nachbar, Esquire, MORRIS, NICHOLS, ARSHT & TUNNELL, Wilmington, Delaware, Attorney for the Individual Defendants.

David C. McBride, Esquire, Adam W. Poff, Esquire, and Christian Douglas Wright, Esquire, YOUNG CONAWAY STARGATT & TAYLOR, LLP, Wilmington, Delaware; George M. Newcombe, Esquire and James G. Kreissman, Esquire, SIMPSON THACHER & BARTLETT, LLP, Palo Alto, California, Attorneys for Nominal Defendant Oracle Corporation.

Judges: STRINE, Vice Chancellor.

Opinion by: STRINE

Opinion

[*920] STRINE, Vice Chancellor

In this opinion, I address the motion of the special litigation committee ("SLC") of Oracle Corporation to terminate this action, "the Delaware Derivative Action," and other such actions pending in the name of Oracle against certain Oracle directors and officers. These actions allege that these Oracle directors engaged in insider trading while in possession **[**2]** of material, non-public information showing that Oracle would not meet the earnings guidance it gave to the market for the third quarter of Oracle's fiscal year 2001. The SLC bears the burden of persuasion on this motion and must convince me that there is no material issue of fact calling into doubt its independence. This requirement is set forth in *Zapata Corp. v. Maldonado* [1] and its progeny. [2]

The question of independence "turns on whether a director is, *for any substantial reason,* incapable of making a decision with only the best interests of the corporation in mind." [3] **[**3]** That is, the independence test ultimately "focus[es] on impartiality and objectivity." [4] In this case, the SLC has failed to demonstrate that no material factual question exists regarding its independence.

---

[1] *430 A.2d 779 (Del. 1981)*.

[2] *E.g., Lewis v. Fuqua, 502 A.2d 962 (Del. Ch. 1985)*.

[3] *Parfi Holding AB v. Mirror Image Internet, Inc., 794 A.2d 1211, 1232 (Del. Ch. 2001)* (emphasis in original), *rev'd in part on other grounds, 817 A.2d 149 (Del. 2002)*, *cert. denied,* ***123 S. Ct. 2076 (2003)***.

[4] *Id.*

During discovery, it emerged that the two SLC members - both of whom are professors at Stanford University - are being asked to investigate fellow Oracle directors who have important ties to Stanford, too. Among the directors who are accused by the derivative plaintiffs of insider trading are: (1) another Stanford professor, who taught one of the SLC members when the SLC member was a Ph.D. candidate and who serves as a senior fellow and a steering committee member alongside that SLC member at the Stanford Institute for Economic Policy Research or "SIEPR"; (2) a Stanford alumnus who has directed millions of dollars of contributions to Stanford during recent years, serves as Chair of SIEPR's Advisory Board and has a conference center named for him at SIEPR's facility, and has contributed nearly $ 600,000 to SIEPR and the Stanford Law School, both parts of Stanford with which one of the SLC members is closely affiliated; and (3) Oracle's CEO, who has made millions of dollars in donations to Stanford through a personal **[*921]** foundation and large donations indirectly through Oracle, and **[**4]** who was considering making donations of his $ 100 million house and $ 170 million for a scholarship program as late as August 2001, at around the same time period the SLC members were added to the Oracle board. Taken together, these and other facts cause me to harbor a reasonable doubt about the impartiality of the SLC.

It is no easy task to decide whether to accuse a fellow director of insider trading. For Oracle to compound that difficulty by requiring SLC members to consider accusing a fellow professor and two large benefactors of their university of conduct that is rightly considered a violation of criminal law was unnecessary and inconsistent with the concept of independence recognized by our law. The possibility that these extraneous considerations biased the inquiry of the SLC is too substantial for this court to ignore. I therefore deny the SLC's motion to terminate.

I. Factual Background

A. Summary of the Plaintiffs' Allegations

The Delaware Derivative Complaint centers on alleged insider trading by four members of Oracle's board of directors - Lawrence Ellison, Jeffrey Henley, Donald Lucas, and Michael Boskin (collectively, the "Trading Defendants"). Each of **[**5]** the Trading Defendants had a very different role at Oracle.

Ellison is Oracle's Chairman, Chief Executive Officer, and its largest stockholder, owning nearly twenty-five percent of Oracle's voting shares. By virtue of his ownership position, Ellison is one of the wealthiest men in America. By virtue of his managerial position, Ellison has regular access to a great deal of information about how Oracle is performing on a week-to-week basis.

Henley is Oracle's Chief Financial Officer, Executive Vice President, and a director of the corporation. Like Ellison, Henley has his finger on the pulse of Oracle's performance constantly.

Lucas is a director who chairs Oracle's Executive Committee and its Finance and Audit Committee. Although the plaintiffs allege that Lucas's positions gave him access to material, non-public information about the company, they do so cursorily. On the present record, it appears that Lucas did not receive copies of week-to-week projections or reports of actual results for the quarter to date. Rather, his committees primarily received historical financial data.

Boskin is a director, Chairman of the Compensation Committee, and a member of the Finance and Audit **[**6]** Committee. As with Lucas, Boskin's access to information was limited mostly to historical financials and did not include the week-to-week internal projections and revenue results that Ellison and Henley received.

According to the plaintiffs, each of these Trading Defendants possessed material, non-public information demonstrating that Oracle would fail to meet the earnings and revenue guidance it had provided to the market in December 2000. In that guidance, Henley projected - subject to many disclaimers, including the possibility that a softening economy would hamper Oracle's ability to achieve these results -- that Oracle would earn 12 cents per share and generate revenues of over $ 2.9 billion in the third quarter of its fiscal year 2001 ("3Q FY 2001"). Oracle's 3Q FY 2001 ran from December 1, 2000 to February 28, 2001.

The plaintiffs allege that this guidance was materially misleading and became even more so as early results for the quarter came in. To start with, the plaintiffs assert that the guidance rested on an untenably **[*922]** rosy estimate of the performance of an important new Oracle product, its "Suite 11i" systems integration product that was designed to enable a business **[**7]** to run all of its information systems using a complete, integrated package of software with financial, manufacturing, sales, logistics, and other applications features that were "inter-operable." The reality, the plaintiffs contend, was that Suite 11i was riddled with bugs and not ready for prime time. As a result, Suite 11i was not in a position to make a material contribution to earnings growth.

In addition, the plaintiffs contend more generally that the Trading Defendants received material, non-public information that the sales growth for Oracle's other products was slowing in a significant way, which made the attainment of the earnings and revenue guidance extremely difficult. This information grew in depth as the quarter proceeded, as various sources of information that Oracle's top managers relied upon allegedly began to signal weakness in the company's revenues. These signals supposedly included a slowdown in the "pipeline" of large deals that Oracle hoped to close during the quarter and weak revenue growth in the first month of the quarter.

During the time when these disturbing signals were allegedly being sent, the Trading Defendants engaged in the following trades:

> **[**8]** * On January 3, 2001, Lucas sold 150,000 shares of Oracle common stock at $ 30 per share, reaping proceeds of over $ 4.6 million. These sales constituted 17% of Lucas's Oracle holdings.
> * On January 4, 2001, Henley sold one million shares of Oracle stock at approximately $ 32 per share, yielding over $ 32.3 million. These sales represented 7% of Henley's Oracle holdings.
> * On January 17, 2001, Boskin sold 150,000 shares of Oracle stock at over $ 33 per share, generating in excess of $ 5 million. These sales were 16% of Boskin's Oracle holdings.
> * From January 22 to January 31, 2001, Ellison sold over 29 million shares at prices above $ 30 per share, producing over $ 894 million. Despite the huge proceeds generated by these sales, they constituted the sale of only 2% of Ellison's Oracle holdings.

Into early to mid-February, Oracle allegedly continued to assure the market that it would meet its December guidance. Then, on March 1, 2001, the company announced that rather than posting 12 cents per share in quarterly earnings and 25% license revenue growth as projected, the company's earnings for the quarter would be 10 cents per share and license revenue growth only 6%. **[**9]** The stock market reacted swiftly and negatively to this news, with Oracle's share price dropping as low as $ 15.75 before closing at $ 16.88 -- a 21% decline in one day. These prices were well below the above $ 30 per share prices at which the Trading Defendants sold in January 2001.

Oracle, through Ellison and Henley, attributed the adverse results to a general weakening in the economy, which led Oracle's customers to cut back sharply on purchases. Because (the company claimed) most of its sales close in the late days of quarters, the company did not become aware that it would miss its projections until shortly before the quarter closed. The reasons given by Ellison and Henley subjected them to sarcastic rejoinders from analysts, who noted that they had only recently suggested that Oracle was better-positioned than other companies to continue to deliver growth in a weakening economy.

B. <u>The Plaintiffs' Claims in the Delaware Derivative Action</u>

The plaintiffs make two central claims in their amended complaint in the Delaware **[*923]** Derivative Action. First, the plaintiffs allege that the Trading Defendants breached their duty of loyalty by misappropriating inside information and using **[**10]** it as the basis for trading decisions. This claim rests its legal basis on the venerable case of *Brophy v. Cities Service Co.* [5] Its factual foundation is that the Trading Defendants were aware (or at least possessed information that should have made them aware) that the company would miss its December guidance by a wide margin and used that information to their advantage in selling at artificially inflated prices.

Second, as to the other defendants -- who are the members of the Oracle board who did not trade -- the plaintiffs allege a *Caremark* [6] violation, in the sense that the board's indifference to the deviation between the company's December guidance and reality was so extreme as to constitute subjective bad faith.

[11]** C. <u>The Various Litigations</u>

Oracle's failure to meet its earnings and revenue guidance, and the sales by the Trading Defendants, inevitably generated a spate of lawsuits. Several derivative actions were filed in the state and federal courts of California. Those actions are, in substance, identical to the Delaware Derivative Action. Those suits have now all been stayed in deference to the SLC's investigation and the court's ruling on this motion.

---

[5] *31 Del. Ch. 241, 70 A.2d 5 (Del. Ch. 1949)*.

[6] *In re Caremark Int'l Derivative Litig., 698 A.2d 959 (Del. Ch. 1996)*.

Federal class actions were also filed, and the consolidated complaint in those actions formed the basis for much of the amended complaint in the Delaware Derivative Action. By now, the "Federal Class Action" has been dismissed for failure to state a claim upon which relief can be granted for the third time; this time the order addressing the second amended complaint dismissed the Federal Class Action with prejudice. [7]

D. The Formation of the Special Litigation **[**12]** Committee

On February 1, 2002, Oracle formed the SLC in order to investigate the Delaware Derivative Action and to determine whether Oracle should press the claims raised by the plaintiffs, settle the case, or terminate it. Soon after its formation, the SLC's charge was broadened to give it the same mandate as to all the pending derivative actions, wherever they were filed.

The SLC was granted full authority to decide these matters without the need for approval by the other members of the Oracle board.

E. The Members of the Special Litigation Committee

Two Oracle board members were named to the SLC. Both of them joined the Oracle board on October 15, 2001, more than a half a year after Oracle's 3Q FY 2001 closed. The SLC members also share something else: both are tenured professors at Stanford University.

Professor Hector Garcia-Molina is Chairman of the Computer Science Department at Stanford and holds the Leonard Bosack and Sandra Lerner Professorship in the Computer Science and Electrical Engineering Departments at Stanford. A renowned expert in his field, Garcia-Molina was a professor at Princeton before coming to Stanford in 1992. Garcia Molina's appointment at Stanford **[**13]** represented a homecoming of some sort, because he obtained both his undergraduate and graduate degrees from Stanford.

[*924] The other SLC member, Professor Joseph Grundfest, is the W.A. Franke Professor of Law and Business at Stanford University. He directs the University's well-known Directors' College [8] and the Roberts Program in Law, Business, and Corporate Governance at the Stanford Law School. Grundfest is also the principal investigator for the Law School's Securities Litigation Clearinghouse. Immediately before coming to Stanford, Grundfest served for five years as a Commissioner of the Securities and Exchange Commission. Like Garcia-Molina, Grundfest's appointment at Stanford was a homecoming, because he obtained his law degree and performed significant post-graduate work in economics at Stanford.

As will be discussed more specifically later, Grundfest also serves as a steering committee member and a senior fellow **[**14]** of the Stanford Institute for Economic Policy Research, and releases working papers under the "SIEPR" banner.

For their services, the SLC members were paid $ 250 an hour, a rate below that which they could command for other activities, such as consulting or expert witness testimony. Nonetheless, during the course of their work, the SLC members became concerned that (arguably scandal-driven) developments in the evolving area of corporate governance as well as the decision in *Telxon v. Meyerson,* [9] might render the amount of their compensation so high as to be an argument against their independence. Therefore, Garcia-Molina and Grundfest agreed to give up any SLC-related compensation if their compensation was deemed by this court to impair their impartiality.

F. The SLC Members Are Recruited to the Board

The SLC members were recruited to the board primarily by defendant Lucas, with help from defendant Boskin. [10] The wooing of them began in the summer of **[**15]** 2001. Before deciding to join the Oracle board, Grundfest, in particular, did a good deal of due diligence. His review included reading publicly available information, among other things, the then-current complaint in the Federal Class Action.

Grundfest then met with defendants Ellison and Henley, among others, and asked them some questions about the Federal Class Action. The claims in the Federal Class Action are predicated on facts that are substantively identical to those on which the claims in the Delaware Derivative Action are based. Grundfest

[7] *See* In re Oracle Corp. Secs. Litig., 2003 U.S. Dist. LEXIS 9980, No. C 01-0988 MJJ slip op. at 2 (N.D. Cal. Mar. 24, 2003).

[8] In the interests of full disclosure, I spoke at the Directors' College in spring 2002.

[9] 802 A.2d 257 (Del. 2002).

[10] *See* Grundfest Dep. at 466-69; Garcia-Molina Dep. at 15-16.

received answers that were consistent enough with what he called the "exogenous" information about the case to form sufficient confidence to at least join the Oracle board. Grundfest testified that this did not mean that he had concluded that the claims in the Federal Class Action had no merit, only that Eillson's and Henley's explanations of their conduct were plausible. Grundfest did, however, **[**16]** conclude that these were reputable businessmen with whom he felt comfortable serving as a fellow director, and that Henley had given very impressive answers to difficult questions regarding the way Oracle conducted its financial reporting operations. [11]

[17]** **[*925]** G. The SLC's Advisors

The most important advisors retained by the SLC were its counsel from Simpson Thacher & Bartlett LLP. Simpson Thacher had not performed material amounts of legal work for Oracle [12] or any of the individual defendants before its engagement, and the plaintiffs have not challenged its independence.

National Economic Research Advisors ("NERA") was retained by the SLC to perform some analytical work. The plaintiffs have not challenged NERA's independence.

H. **[**18]** The SLC's Investigation and Report

The SLC's investigation was, by any objective measure, extensive. The SLC reviewed an enormous amount of paper and electronic records. SLC counsel interviewed seventy witnesses, some of them twice. SLC members participated in several key interviews, including the interviews of the Trading Defendants.

Importantly, the interviewees included all the senior members of Oracle's management most involved in its projection and monitoring of the company's financial performance, including its sales and revenue growth. These interviews combined with a special focus on the documents at the company bearing on these subjects, including e-mail communications.

The SLC also asked the plaintiffs in the various actions to identify witnesses the Committee should interview. The Federal Class Action plaintiffs identified ten such persons and the Committee interviewed all but one, who refused to cooperate. The Delaware Derivative Action plaintiffs and the other derivative plaintiffs declined to provide the SLC with any witness list or to meet with the SLC.

During the course of the investigation, the SLC met with its counsel thirty-five times for a total of eighty **[**19]** hours. In addition to that, the SLC members, particularly Professor Grundfest, devoted many more hours to the investigation.

In the end, the SLC produced an extremely lengthy Report totaling 1,110 pages (excluding appendices and exhibits) that concluded that Oracle should not pursue the plaintiffs' claims against the Trading Defendants or any of the other Oracle directors serving during the 3Q FY 2001. The bulk of the Report defies easy summarization. I endeavor a rough attempt to capture the essence of the Report in understandable terms, surfacing some implicit premises that I understand to have un dergirded **[*926]** the SLC's conclusions. Here goes.

Having absorbed a huge amount of material regarding Oracle's financial condition during the relevant period, the flow of information to top Oracle executives, Oracle's

---

[11] The plaintiffs claim that Grundfest prejudged the Trading Defendants' culpability in a manner equivalent to that of the Chairman of the HealthSouth special litigation committee, as discussed in the recent Biondi v. Scrushy, 820 A.2d 1148 (Del. Ch. 2003) decision. The two situations are not reasonably comparable. In *Biondi,* the HealthSouth SLC Chairman publicly announced his conclusion that the HealthSouth CEO, who was the target of the SLC's investigation, had not acted with the required *scienter.* He did so in a company press release in advance of the SLC's own investigation. Here, Grundfest simply made a judgment that Ellison and Henley had given a plausible accounting for themselves and were, in general, reputable businessmen with whom he was comfortable serving as a fellow director. I find credible Grundfest's contention that he took their statements for what they were, statements by persons with a self-interest in exculpation. That said, it would have been a better practice for the Report to have identified that Grundfest had inquired about the Federal Class Action in determining whether to join Oracle's board. *Cf.* Report at VII-1 ("The interviews commenced in April 2002 and were completed by early November 2002.").

[12] Some six years before the SLC investigation began, Simpson Thacher had performed a modest amount of legal work for Oracle. Simpson Thacher also represents Cadence Design Systems, a company of which Trading Defendant Donald Lucas is a director, and had billed Cadence less than $ 50,000 for that work. In 1996-1997, Simpson Thacher also billed Cadence for $ 62,355 for certain legal advice. The SLC determined that the Cadence work was not material to Simpson Thacher and the plaintiffs have not challenged that determination.

business and its products, and the general condition of the market at that time, the SLC concluded that even a hypothetical Oracle executive who possessed all information regarding the company's performance in December and January of 3Q FY 2001 would not have possessed material, non-public information that the company would fail to meet the earnings and revenue guidance it provided **[**20]** the market in December. Although there were hints of potential weakness in Oracle's revenue growth, especially starting in mid-January 2001, there was no reliable information indicating that the company would fall short of the mark, and certainly not to the extent that it eventually did.

Notably, none of the many e-mails from various Oracle top executives in January 2001 regarding the quarter anticipated that the company would perform as it actually did. Although some of these e-mails noted weakening, all are generally consistent with the proposition that Oracle executives expected to achieve the guidance. At strongest, they (in the SLC's view) can be read as indicating some doubts and the possibility that the company would fall short of the mark by a small margin, rather than the large one that ultimately resulted. Furthermore, the SLC found that the plaintiffs' allegations regarding the problems with Suite 11i were overstated and that the market had been adequately apprised of the state of that product's performance. And, as of that quarter, most of Oracle's competitors were still meeting analysts' expectations, suggesting that Oracle's assumption that general economic weakening **[**21]** would not stymie its ability to increase revenues in 3Q FY 2001 was not an unreasonable one.

Important to this conclusion is the SLC's finding that Oracle's quarterly earnings are subject to a so-called "hockey stick effect," whereby a large portion of each quarter's earnings comes in right at the end of the quarter. In 3Q FY 2001, the late influx of revenues that had often characterized Oracle's performance during its emergence as one of the companies with the largest market capitalization in the nation did not materialize; indeed, a large amount of product was waiting in Oracle warehouses for shipment for deals that Oracle had anticipated closing but did not close during the quarter.

Thus, taking into account all the relevant information sources, the SLC concluded that even Ellison and Henley -- who were obviously the two Trading Defendants with the most access to inside information -- did not possess material, non-public information. As to Lucas and Boskin, the SLC noted that they did not receive the weekly updates (of various kinds) that allegedly showed a weakening in Oracle's performance during 3Q FY 2001. As a result, there was even less of a basis to infer wrongdoing on their **[**22]** part. [13]

In this same regard, the Report also noted that Oracle insiders felt especially confident about meeting 3Q FY 2001 guidance because the company closed a large transaction involving Covisint in December -- a transaction that produced revenue giving the company a boost in meeting its guidance. Although the plaintiffs in this case argue that the Covisint transaction **[*927]** was a unique deal that had its origins in earlier quarters when the economy was stronger and that masked a weakening in Oracle's then-current performance, the reality is that that the transaction was a real one of economic substance and that the revenue was properly accounted for in 3Q FY 2001. Combined **[**23]** with other indications that Oracle was on track to meet its guidance, the SLC concluded that the Covisint transaction supported their conclusion that the Trading Defendants did not possess material, non-public information contradicting the company's previous guidance. [14]

Moreover, as the SLC Report points out, the idea that the Trading Defendants acted with *scienter* in trading in January 2001 was problematic in light of several factors. Implicitly the first and foremost is the reality that Oracle is a functioning business with real products of value. Although it is plausible to imagine a scenario where someone of Ellison's wealth would cash out, fearing the imminent collapse of a house of cards he had sold to **[**24]** an unsuspecting market, this is not the situation that Ellison faced in January 2001.

As of that time, Oracle faced no collapse, even if it, like other companies, had to deal with a slowing economy. And, as the SLC points out, Ellison sold only two percent of his holdings. A good deal of these sales were related to options that he had held for over nine years

[13] As part of its analysis, the SLC assumed that Lucas and Boskin possessed the same information base as Ellison and Henley -- that of a hypothetical fully informed executive. Nonetheless, the Report also made specific findings as to Lucas and Boskin that emphasized that they were differently situated in terms of informational access.

[14] The SLC also noted that the Trading Defendants had sold their shares during a permissible trading window under Oracle's internal policies. These policies generally discouraged trading in the last month of a quarter and channeled trading into periods after the market had absorbed SEC filings.

and that had to be exercised by August 2001. [15] In view of Oracle's basic health, Ellison's huge wealth, and his retention of ninety-eight percent of his shares, the SLC concluded that any inference that Ellison acted with *scienter* and attempted to reap improper trading profits was untenable.

[25]** The same reasoning also motivated the SLC's conclusions as to Henley, who sold only seven percent of his stake in Oracle. Both Ellison and Henley stood to expose a great deal of their personal wealth to substantial risk by undertaking a scheme to cash out a small portion of their holdings and risking a greater injury to Oracle, a company in which they retained a far greater stake than they had sold. As important, these executives stood to risk their own personal reputations despite the absence of any personal cash crunch that impelled them to engage in risky, unethical, and illegal behavior. [16]

Although Lucas and Boskin sold somewhat larger proportions of their Oracle holdings -- sixteen percent and seventeen percent respectively -- these proportions, the SLC concluded, were of the kind that federal courts had found lacking in suspicion. **[**26]** As with Ellison and Henley, the SLC identified no urgent need on either's part to generate cash by trading (illegally) on non-public, material information.

Of course, the amount of the proceeds each of the Trading Defendants generated was extremely large. By selling only two percent of his holdings, Ellison generated nearly a billion dollars, enough to flee to a **[*928]** small island nation with no extradition laws and to live like a Saudi prince. But given Oracle's fundamental health as a company and his retention of ninety-eight percent of his shares, Ellison (the SLC found) had no need to take desperate -- or, for that matter, even slightly risky -- measures. The same goes for the other Trading Defendants; there was simply nothing special or urgent about their financial circumstances in January 2001 that would have motivated (or did motivate, in the SLC's view) the Trading Defendants to cash out because they believed that Oracle would miss its earnings guidance. And, of course, the SLC found that none of them possessed information that indicated that Oracle would, in fact, miss its mark for 3Q FY 2001.

For these and other reasons, the SLC concluded that the plaintiffs' allegations that **[**27]** the Trading Defendants had breached their fiduciary duty of loyalty by using inside information about Oracle to reap illicit trading gains were without merit. The SLC also determined that, consistent with this determination, there was no reason to sue the other members of the Oracle board who were in office as of 3Q FY 2001. Therefore, the SLC determined to seek dismissal of the Delaware Derivative Action and the other derivative actions.

II. <u>The SLC Moves to Terminate</u>

Consistent with its Report, the SLC moved to terminate this litigation. The plaintiffs were granted discovery focusing on three primary topics: the independence of the SLC, the good faith of its investigative efforts, and the reasonableness of the bases for its conclusion that the lawsuit should be terminated. Additionally, the plaintiffs received a large volume of documents comprising the materials that the SLC relied upon in preparing its Report.

III. <u>The Applicable Procedural Standard</u>

In order to prevail on its motion to terminate the Delaware Derivative Action, the SLC must persuade me that: (1) its members were independent; (2) that they acted in good faith; and (3) that they had reasonable bases for **[**28]** their recommendations. [17] If the SLC meets that burden, I am free to grant its motion or may, in my discretion, undertake my own examination of whether Oracle should terminate and permit the suit to proceed if I, in my oxymoronic judicial "business judgment," conclude that procession is in the best interests of the company. [18] This two-step analysis comes, of course, from *Zapata.*

In that case, the Delaware Supreme Court also

---

[15] There was also evidence in the Report that Ellison's financial advisor had been hounding him for some time to sell some shares and to diversify. The taxes due on the expiring options were also large and provided a rationale for selling, as did Ellison's and his financial advisor's desire for Ellison to reduce some debt. Although these were motives for Ellison to obtain cash, the SLC concluded that Ellison had no compelling need for funds that supported an inference of *scienter.*

[16] As with Ellison, both Boskin and Lucas had cash needs, in their cases related to residences, but nothing in the record created by the SLC indicates any exigency.

[17] *Zapata v. Maldonado, 430 A.2d 779, 788-89 (Del. 1981)*; *Katell v. Morgan Stanley Group, 1995 Del. Ch. LEXIS 76, 1995 WL 376952 at *5 (Del. Ch. June 15, 1995)*.

[18] *Zapata, 430 A.2d at 789*.

instructed this court to apply a procedural standard akin to a summary judgment inquiry when ruling on a special litigation committee's motion to terminate. In other words, the Oracle SLC here "should be prepared to meet the normal burden under Rule 56 that there is no genuine issue as to any material fact and that [it] is entitled to dismiss as a matter of **[**29]** law." [19] Candidly, this articulation of a special litigation committee's burden is an odd one, insofar as it applies a procedural standard designed for a particular purpose -- the substantive dismissal of a case -- with a standard centered on the determination of when a corporate committee's business decision about claims belonging to the corporation should be accepted by the court.

As I understand it, this standard requires me to determine whether, on the **[*929]** basis of the undisputed factual record, I am convinced that the SLC was independent, acted in good faith, and had a reasonable basis for its recommendation. If there is a material factual question about these issues causing doubt about any of these grounds, I read *Zapata* and its progeny as requiring a denial of the SLC's motion to terminate. [20]

[30]** In this case, the plaintiffs principally challenge the SLC's independence and the reasonableness of its recommendation. For reasons I next explain, I need examine only the more difficult question, which relates to the SLC's independence.

IV. Is the SLC Independent?

A. The Facts Disclosed in the Report

In its Report, the SLC took the position that its members were independent. In support of that position, the Report noted several factors including:

* the fact that neither Grundfest nor Garcia-Molina received compensation from Oracle other than as directors;
* the fact that neither Grundfest nor Garcia-Molina were on the Oracle board at the time of the alleged wrongdoing;
* the fact that both Grundfest and Garcia-Molina were willing to return their compensation as SLC members if necessary to preserve their status as independent;
* the absence of any other material ties between Oracle, the Trading Defendants, and any of the other defendants, on the one hand, and Grundfest and Garcia-Molina, on the other; and

* the absence of any material ties between Oracle, the Trading Defendants, and any of the other defendants, on the one hand, and the SLC's **[**31]** advisors, on the other.

Noticeably absent from the SLC Report was any disclosure of several significant ties between Oracle or the Trading Defendants and Stanford University, the university that employs both members of the SLC. In the Report, it was only disclosed that:

* defendant Boskin was a Stanford professor;
* the SLC members were aware that Lucas had made certain donations to Stanford; and
* among the contributions was a donation of $ 50,000 worth of stock that Lucas donated to Stanford Law School after Grundfest delivered a speech to a venture capital fund meeting in response to Lucas's request. It happens that Lucas's son is a partner in the fund and that approximately half the donation was allocated for use by Grundfest in his personal research.

B. The "Stanford" Facts that Emerged During Discovery

In view of the modesty of these disclosed ties, it was with some shock that a series of other ties among Stanford, Oracle, and the Trading Defendants emerged during discovery. Although the plaintiffs have embellished these ties considerably **[*930]** beyond what is reasonable, the plain facts are a striking departure from the picture presented in the Report.

[32]** Before discussing these facts, I begin with certain features of the record -- as I read it -- that are favorable to the SLC. Initially, I am satisfied that neither of the SLC members is compromised by a fear that support for the procession of this suit would endanger his ability to make a nice living. Both of the SLC

---

[19] *See* id. at 788.

[20] *See* Lewis v. Fuqua, 502 A.2d 962, 966 (Del. Ch. 1985); Kaplan v. Wyatt, 484 A.2d 501, 506-08 (Del. Ch. 1984), *aff'd*, 499 A.2d 1184 (Del. 1985). Importantly, the granting of the SLC's motion using the Rule 56 standard does not mean that the court has made a determination that the claims the SLC wants dismissed would be subject to termination on a summary judgment motion, only that the court is satisfied that there is no material factual dispute that the SLC had a reasonable basis for its decision to seek termination. *See* Kaplan v. Wyatt, 484 A.2d 501, 519 (Del. Ch. 1984) ("It is the Special Litigation Committee which is under examination at this first-step stage of the proceedings, and not the merits of the plaintiff's cause of action."), *aff'd*, 499 A.2d 1184 (Del. 1985).

members are distinguished in their fields and highly respected. Both have tenure, which could not have been stripped from them for making a determination that this lawsuit should proceed.

Nor have the plaintiffs developed evidence that either Grundfest or Garcia-Molina have fundraising responsibilities at Stanford. Although Garcia-Molina is a department chairman, the record is devoid of any indication that he is required to generate contributions. And even though Grundfest heads up Stanford's Directors' College, the plaintiffs have not argued that he has a fundraising role in that regard. For this reason, it is important to acknowledge up front that the SLC members occupy positions within the Stanford community different from that of the University's President, deans, and development professionals, all of whom, it can be reasonably assumed, are required to engage heavily **[**33]** in the pursuit of contributions to the University.

This is an important point of departure for discussing the multitude of ties that have emerged among the Trading Defendants, Oracle, and Stanford during discovery in this case. In evaluating these ties, the court is not faced with the relatively easier call of considering whether these ties would call into question the impartiality of an SLC member who was a key fundraiser at Stanford [21] or who was an untenured faculty member subject to removal without cause. Instead, one must acknowledge that the question is whether the ties I am about to identify would be of a material concern to two distinguished, tenured faculty members whose current jobs would not be threatened by whatever good faith decision they made as SLC members.

[34]** With this question in mind, I begin to discuss the specific ties that allegedly compromise the SLC's independence, beginning with those involving Professor Boskin.

1. Boskin

Defendant Michael J. Boskin is the T.M. Friedman Professor of Economics at Stanford University. During the Administration of President George H.W. Bush, Boskin occupied the coveted and important position of Chairman of the President's Council of Economic Advisors. He returned to Stanford after this government **[*931]** service, continuing a teaching career there that had begun many years earlier.

During the 1970s, Boskin taught Grundfest when Grundfest was a Ph.D. candidate. Although Boskin was not Grundfest's advisor and although they do not socialize, the two have remained in contact over the years, speaking occasionally about matters of public policy.

Furthermore, both Boskin and Grundfest are senior fellows and steering conmiittee members at the Stanford Institute for Economic Policy Research, which was previously defined as "SIEPR." According to the SLC, the title of senior fellow is largely an honorary one. According to SIEPR's own web site, however, "senior fellows actively participate in SIEPR research **[**35]** and participate in its governance." [22]

Likewise, the SLC contends that Grundfest went MIA as a steering committee member, having failed to attend a meeting since 1997. The SIEPR web site, however, identifies its steering committee as having the role of "advising the director [of SIEPR] and guiding [SIEPR] on matters pertaining to research and academics." [23] Because Grundfest allegedly did not attend to these duties, his service alongside Boskin in that capacity is, the SLC contends, not relevant to his independence.

[36]** That said, the SLC does not deny that both

[21] ***Compare*** *In re The Limited, Inc. S'holders Litig., 2002 Del. Ch. LEXIS 28, 2002 WL 537692 at *6-7 (Del. Ch. Mar. 27, 2002)* (concluding that a university president who had solicited a $ 25 million contribution from a corporation's President, Chairman, and CEO was not independent of that corporate official in light of the sense of "owingness" that the university president might harbor with respect to the corporate official), *and* *Lewis v. Fuqua, 502 A.2d 962, 966-67 (Del. Ch. 1985)* (finding that a special litigation committee member was not independent where the committee member was also the president of a university that received a $ 10 million charitable pledge from the corporation's CEO and the CEO was a trustee of the university), *with* *In re Walt Disney Co. Derivative Litig., 731 A.2d 342, 359 (Del. Ch. 1998)* (deciding that the plaintiffs had not created reasonable doubt as to a director's independence where a corporation's Chairman and CEO had given over $ 1 million in donations to the university at which the director was the university president and from which one of the CEO's sons had graduated), *aff'd in part, rev'd in part sub nom.* *Brehm v. Eisner, 746 A.2d 244 (Del. 2000)*.

[22] Stanford Institute for Economic Policy Research, *SIEPR Staff and Researchers: Senior Fellows* (last visited June 4, 2003), *at* *http://siepr.stanford.edu/people/srfellows.html*.

[23] Stanford Institute for Economic Policy Research, *Insider SIEPR: Steering Committee* (last visited June 4, 2003), *at* *http://siepr.stanford.edu/about/steering.html*.

Boskin and Grundfest publish working papers under the SIEPR rubric and that SIEPR helps to publicize their respective works. Indeed, as I will note later in this opinion, Grundfest, in the same month the SLC was formed, addressed a meeting of some of SIEPR's largest benefactors -- the so-called "SIEPR Associates." The SLC just claims that the SIEPR affiliation is one in which SIEPR basks in the glow of Boskin and Grundfest, not the other way around, and that the mutual service of the two as senior fellows and steering committee members is not a collegial tie of any significance.

With these facts in mind, I now set forth the ties that defendant Lucas has to Stanford.

2. Lucas

As noted in the SLC Report, the SLC members admitted knowing that Lucas was a contributor to Stanford. They also acknowledged that he had donated $ 50,000 to Stanford Law School in appreciation for Grundfest having given a speech at his request. About half of the proceeds were allocated for use by Grundfest in his research.

But Lucas's ties with Stanford are far, far richer than the SLC Report lets on. To begin, Lucas is a Stanford alumnus, having obtained both **[**37]** his undergraduate and graduate degrees there. By any measure, he has been a very loyal alumnus.

In showing that this is so, I start with a matter of some jousting between the SLC and the plaintiffs. Lucas's brother, Richard, died of cancer and by way of his will established a foundation. Lucas became Chairman of the Foundation and serves as a director along with his son, a couple of other family members, and some non-family members. A principal object of the Foundation's beneficence has been Stanford. The Richard M. Lucas Foundation has given $ 11.7 million to Stanford since its 1981 founding. Among its notable contributions, the Foundation funded the establishment of the Richard M. Lucas Center **[*932]** for Magnetic Resonance Spectroscopy and Imaging at Stanford's Medical School. Donald Lucas was a founding member and lead director of the Center.

The SLC Report did not mention the Richard M. Lucas Foundation or its grants to Stanford. In its briefs on this motion, the SLC has pointed out that Donald Lucas is one of nine directors at the Foundation and does not serve on its Grant Review Committee. Nonetheless, the SLC does not deny that Lucas is Chairman of the board of the Foundation and **[**38]** that the board approves all grants.

Lucas's connections with Stanford as a contributor go beyond the Foundation, however. From his own personal funds, Lucas has contributed $ 4.1 million to Stanford, a substantial percentage of which has been donated within the last half-decade. Notably, Lucas has, among other things, donated $ 424,000 to SIEPR and approximately $ 149,000 to Stanford Law School. Indeed, Lucas is not only a major contributor to SIEPR, he is the Chair of its Advisory Board. At SIEPR's facility at Stanford, the conference center is named the Donald L. Lucas Conference Center.

From these undisputed facts, it is inarguable that Lucas is a very important alumnus of Stanford and a generous contributor to not one, but two, parts of Stanford important to Grundfest: the Law School and SIEPR.

With these facts in mind, it remains to enrich the factual stew further, by considering defendant Ellison's ties to Stanford.

3. Ellison

There can be little doubt that Ellison is a major figure in the community in which Stanford is located. The so-called Silicon Valley has generated many success stories, among the greatest of which is that of Oracle and its leader, Ellison. One **[**39]** of the wealthiest men in America, Ellison is a major figure in the nation's increasingly important information technology industry. Given his wealth, Ellison is also in a position to make -- and, in fact, he has made -- major charitable contributions.

Some of the largest of these contributions have been made through the Ellison Medical Foundation, which makes grants to universities and laboratories to support biomedical research relating to aging and infectious diseases. Ellison is the sole director of the Foundation. Although he does not serve on the Foundation's Scientific Advisory Board that sifts through grant applications, he has reserved the right -- as the Foundation's sole director -- to veto any grants, a power he has not yet used but which he felt it important to retain. The Scientific Advisory Board is comprised of distinguished physicians and scientists from many institutions, but not including Stanford.

Although it is not represented on the Scientific Advisory Board, Stanford has nonetheless been the beneficiary of grants from the Ellison Medical Foundation -- to the tune of nearly $ 10 million in paid or pledged funds. Although the Executive Director of the Foundation **[**40]** asserts by way of an affidavit that the grants are awarded to specific researchers and may be taken to another institution if the researcher leaves, [24] the grants are conveyed under contracts between the Foundation and Stanford itself and purport by their terms to give Stanford the right (subject to Foundation approval) to select a substitute principal investigator if the original one becomes unavailable. [25]

[*933] During the time Ellison has been CEO of Oracle, the company itself has also made over $ 300,000 in donations to Stanford. Not only that, when Oracle established a generously endowed educational foundation -- the Oracle Help Us Help Foundation -- to help further the deployment of educational technology in schools serving disadvantaged **[**41]** populations, it named Stanford as the "appointing authority," which gave Stanford the right to name four of the Foundation's seven directors. [26] Stanford's acceptance reflects the obvious synergistic benefits that might flow to, for example, its School of Education from the University's involvement in such a foundation, as well as the possibility that its help with the Foundation might redound to the University's benefit when it came time for Oracle to consider making further donations to institutions of higher learning.

Taken together, these facts suggest that Ellison (when considered as an individual and as the key executive and major stockholder of Oracle) had, at the very least, been involved in several endeavors of value to Stanford.

Beginning in the year 2000 and continuing well into 2001 -- the same year that Ellison **[**42]** made the trades the plaintiffs contend were suspicious and the same year the SLC members were asked to join the Oracle board -- Ellison and Stanford discussed a much more lucrative donation. The idea Stanford proposed for discussion was the creation of an Ellison Scholars Program modeled on the Rhodes Scholarship at Oxford. The proposed budget for Stanford's answer to Oxford: $ 170 million. The Ellison Scholars were to be drawn from around the world and were to come to Stanford to take a two-year interdisciplinary graduate program in economics, political science, and computer technology. During the summer between the two academic years, participants would work in internships at, among other companies, Oracle.

The omnipresent SIEPR was at the center of this proposal, which was put together by John Shoven, the Director of SIEPR. Ellison had serious discussions and contact with SIEPR around the time Shoven's proposal first surfaced. [27] Indeed, in February 2001, Ellison delivered a speech at SIEPR -- at which he was introduced by defendant Lucas. In a CD-ROM that contains images from the speech, Shoven's voice-over touts SIEPR's connections with "some of the most powerful and prominent **[**43]** business leaders." [28]

As part of his proposal for the Ellison Scholars Program, Shoven suggested that three of the four Trading Defendants -- Ellison, Lucas, and Boskin -- be on the Program board. In the hypothetical curriculum that Shoven presented to Ellison, he included a course entitled "Legal Institutions and the Modern Economy" to be taught by Grundfest. Importantly, the Shoven proposal included a disclaimer indicating that listed faculty members may not have been consulted, and Grundfest denies that he was. The circumstances as a whole make that denial credible, although there is one confounding factor.

[*934] Lucas, who was active in encouraging Ellison to form a program of this kind at Stanford, **[**44]** testified at his deposition that he had spoken to Grundfest about the proposed Ellison Scholars Program "a number of years ago." [29] Lucas seems to recall having asked Grundfest if he would be involved with the yet-to-be created Program, but his memory was, at best, hazy. At his own deposition, Grundfest was confronted more generically with whether he had heard of the Program and had agreed to teach in it if it was created, but not

---

[24] *See* Sprott Aff. PP 7-8.

[25] *See, e.g.,* Pls.' Ex. H, at DID 000035-DID 000036 (stating that if any of the principal researchers are unable to carry out funded project, Stanford may nominate a replacement researcher, subject to the approval of the Foundation).

[26] The other three directors are named by Oracle. *See* Help Us Help Foundation, *About Us* (last visited June 5, 2003), *at* http://www.helpushelp.org/pages/AboutUs.html # board.

[27] Shovan's proposal for the Ellison Scholars Program was dated October 2000. *See* Pls.' Ex. H, at DID 0000181.

[28] CD-ROM: SIEPR (on file as Weiser Aff. Ex. 2); *see also* SLC's Supplemental Br. at 5 (identifying the CD-ROM's video clip as that of a speech given by Ellison at SIEPR in February 2001).

[29] Lucas Dep. at 25.

with whether he had discussed the topic with Lucas. [30]

Candidly, this sort of discrepancy is not easy to reconcile on a paper record. My conclusion, however, is that Grundfest is being truthful in stating that he had not participated in shaping the Shoven proposal, had not agreed to teach in the Program, and could not recall participating in any discussions about the Program.

That said, I am not confident that Grundfest was entirely unaware, in 2001 andlor 2002 of the possibility of such a program or that he **[**45]** did not have a brief conversation with Lucas about it before joining the Oracle board. Nor am I convinced that the discussions about the Ellison Scholars Program were not of a very serious nature, indeed, the record evidence persuades me that they were serious. To find otherwise would be to conclude that Ellison is a man of more than ordinary whimsy, who says noteworthy things without caring whether they are true.

I say that because Ellison spoke to two of the nation's leading news outlets about the possibility of creating the Ellison Scholars Program. According to the *Wall Street Journal,* Ellison was considering the possibility of donating $ 150 million to either Harvard or Stanford for the purpose of creating an interdisciplinary (political science, economics, and technology) academic program. [31] And, according to *Fortune.* Ellison said in an interview with *Fortune* correspondent Brent Schlender: "One of the other philanthropic things I'm doing is talking to Harvard and Stanford and MIT about creating a research program that looks at how technology impacts [sic] economics, and in turn how economics impacts the way we govern ourselves." [32] It is significant that the **[**46]** latter article was published in mid-August 2001 -- around the same time that the SLC members were considering whether to join the Oracle board and within a calendar year of the formation of the SLC itself. Importantly, these public statements supplement other private communications by Stanford officials treating the Ellison Scholars Program as an idea under serious consideration by Ellison.

Ultimately, it appears that Ellison decided to abandon **[**47]** the idea of making a major donation on the Rhodes Scholarship model to Stanford or any other institution. At least, that is what he now says by affidavit. According to Shoven of SIEPR, the Ellison Scholars Program idea is going nowhere now, and all talks with Ellison have ceased on that front.

Given the nature of this case, it is natural that there must be yet another curious **[*935]** fact to add to the mix. This is that Ellison told the *Washington Post* in an October 30, 2000 article that he intended to leave his Woodside, California home -- which is worth over $ 100 million -- to Stanford upon his death. [33] In an affidavit, Ellison does not deny making this rather splashy public statement. But, he now (again, rather conveniently) says that he has changed his testamentary intent. Ellison denies having "bequeathed, donated or otherwise conveyed the Woodside property (or any other real property that I own) to Stanford University." [34] And, in the same affidavit, Ellison states unequivocally that he has no intention of ever giving his Woodside compound (or any other real property) to Stanford. [35] Shortly before his deposition in this case, Grundfest asked Ellison about the Woodside property **[**48]** and certain news reports to the effect that he was planning to give it to Stanford. According to Grundfest, Ellison's reaction to his inquiry was one of "surprise." [36] Ellison admitted to Grundfest that he said something of that sort, but contended that whatever he said was merely a "passing" comment. [37] Plus, Ellison said, Stanford would, of course, not want his $ 100 million home unless it came with a "dowry" -- *i.e.,* an endowment to support what is sure to be a costly maintenance budget. [38] Stanford's Vice President for Development, John

[30] *See* Grundfest Dep. at 517-18.

[31] *See* David Bank, *Oracle CEO Ellison Will Decide Which School Gets Millions, Wall St. J.,* June 11, 2001, *available at* 2001 WL-WSJ 2866209 ("Mr. Ellison, chairman and chief executive officer of Oracle Corp., said he is deciding between Harvard University and Stanford University as the site for an interdisciplinary center he has dubbed PET, for politics, economics and technology.").

[32] Brent Schlender, *Larry Ellison: The Playboy Philanthropist, Fortune,* Aug. 13, 2001, *available at* http://www.fortune.com/fortune/print/0,15935,370710,00.html.

[33] *See* Mark Leibovich, *The Outsider, His Business and His Billions, Wash. Post,* Oct. 30, 2000, *available at* 2000 WL 25425247.

[34] Ellison Aff. P 15.

[35] *See id.*

[36] *See* Grundfest Dep. at 520.

[37] *See id.*

[38] *See id.* at 520-21.

Ford, claimed that to the best of his knowledge Ellison had not promised anyone at Stanford that he would give Stanford his Woodside home. [39]

[49]** In order to buttress the argument that Stanford did not feel beholden to him, Ellison shared with the court the (otherwise private) fact that one of his children had applied to Stanford in October 2000 and was not admitted. [40] If Stanford felt comfortable rejecting Ellison's child, the SLC contends, why should the SLC members hesitate before recommending that Oracle press insider trading-based fiduciary duty claims against Ellison? [41]

But the fact remains that Ellison was still talking very publicly and seriously about the possibility of endowing a graduate interdisciplinary studies program at Stanford during **[**50]** the summer *after* his child was rejected from Stanford's undergraduate program. [42]

C. The SLC's Argument

The SLC contends that even together, these facts regarding the ties among Oracle, the Trading Defendants, Stanford, and the SLC members do not impair the SLC's independence. In so arguing, the SLC places great weight on the fact that none **[*936]** of the Trading Defendants have the practical ability to deprive either Grundfest or Garcia-Molina of their current positions at Stanford. Nor, given their tenure, does Stanford itself have any practical ability to punish them for taking action adverse to Boskin, Lucas, or Ellison -- each of whom, as we have seen, has contributed (in one way or another) **[**51]** great value to Stanford as an institution. As important, neither Garcia-Molina nor Grundfest are part of the official fundraising apparatus at Stanford; thus, it is not their on-the-job duty to be solicitous of contributors, and fundraising success does not factor into their treatment as professors.

In so arguing, the SLC focuses on the language of previous opinions of this court and the Delaware Supreme Court that indicates that a director is not independent only if he is dominated and controlled by an interested party, such as a Trading Defendant. [43] The SLC also emphasizes that much of our jurisprudence on independence focuses on economically consequential relationships between the allegedly interested party and the directors who allegedly cannot act independently of that director. Put another way, much of our law focuses the bias inquiry on whether there are economically material ties between the interested party and the director whose impartiality is questioned, treating the possible effect on one's personal wealth as the key to the independence inquiry. Putting a point on this, the SLC cites certain decisions of Delaware courts concluding that directors who are personal friends **[**52]** of an interested party were not, by virtue of those personal ties, to be labeled non-independent. [44]

More subtly, the SLC argues that university professors simply are not inhibited types, unwilling to make tough decisions even as to fellow professors and large contributors. What is tenure about if not to provide professors **[**53]** with intellectual freedom, even in non-traditional roles such as special litigation committee members? No less ardently -- but with no record evidence that reliably supports its ultimate point -- the SLC contends that Garcia-Molina and Grundfest are extremely distinguished in their fields and were not, in fact, influenced by the facts identified heretofore. Indeed, the SLC argues, how could they have been influenced by many of these facts when they did not learn them until the post-Report discovery process? If it boils down to the simple fact that both share with Boskin the status of a Stanford professor, how material can this be when there are 1,700 others who also occupy the

[39] *See* Ford Aff. P 9.

[40] I mention this fact only with the greatest of reluctance. Ellison and the SLC injected this into the record, despite the fact that Stanford itself would have been legally prohibited from disclosing it. Because it is an argument advanced by the SLC, I must address it, although that necessarily furthers the intrusion on the privacy of Ellison's child.

[41] *See* SLC's Reply Br. at 31-32.

[42] *See* David Bank, *Oracle CEO Ellison Will Decide Which School Gets Millions, Wall St. J.,* June 11, 2001, *available at* 2001 WL-WSJ 2866209; Brent Schlender, *Larry Ellison: The Playboy Philanthropist, Fortune,* Aug. 13, 2001, *available at* *http://www.fortune.com/fortune/print/0,15935,370710,00.html*.

[43] *E.g., In re Walt Disney Co. Derivative Litig., 731 A.2d at 355*.

[44] *"See, e.g., Crescent/Mach I Partners, L.P. v. Turner, 2000 Del. Ch. LEXIS 145, 2000 WL 1481002 at *11 (Del. Ch. Sept. 29, 2000)* (stating that an allegation of a fifteen-year professional and personal relationship between a CEO and a director does not, in itself, raise a reasonable doubt about the director's independence); *In re Walt Disney Co. Derivative Litig., 731 A.2d at 354 n.18* ("Demand is not excused, however, just because directors would have to sue 'their family, friends and business associates.'" (quoting *Abrams v. Koether, 766 F. Supp. 237, 256 (D.N.J. 1991))*.

same position?

D. The Plaintiffs' Arguments

The plaintiffs confronted these arguments with less nuance than was helpful. Rather than rest their case on the multiple facts I have described, the plaintiffs chose to emphasize barely plausible constructions of the evidence, such as that Grundfest was lying when he could not recall being asked to participate in the Ellison Scholars Program. From these more extreme arguments, however, one can distill a reasoned core that emphasizes what academics might call the **[**54]** "thickness" of the social and institutional connections among **[*937]** Oracle, the Trading Defendants, Stanford, and the SLC members. These connections, the plaintiffs argue, were very hard to miss -- being obvious to anyone who entered the SIEPR facility, to anyone who read the *Wall Street Journal, Fortune,* or the *Washington Post,* and especially to Stanford faculty members interested in their own university community and with a special interest in Oracle. Taken in their totality, the plaintiffs contend, these connections simply constitute too great a bias-producing factor for the SLC to meet its burden to prove its independence.

Even more, the plaintiffs argue that the SLC's failure to identify many of these connections in its Report is not an asset proving its independence, but instead a fundamental flaw in the Report itself, which is the document in which the SLC is supposed to demonstrate its own independence and the reasonableness of its investigation. By failing to focus on these connections when they were obviously discoverable and when it is, at best, difficult for the court to believe that at least some of them were not known by the SLC -- *e.g.,* Boskin's role at SIEPR **[**55]** and the fact that the SIEPR Conference Center was named after Lucas -- the SLC calls into doubt not only its independence, but its competence. If it could not ferret out these things, by what right should the court trust its investigative acumen?

In support of its argument, the plaintiffs note that the Delaware courts have adopted a flexible, fact-based approach to the determination of directorial independence. This test focuses on whether the directors, for any substantial reason, cannot act with only the best interests of the corporation in mind, and not just on whether the directors face pecuniary damage for acting in a particular way.

E. The Court's Analysis of the SLC's Independence

Having framed the competing views of the parties, it is now time to decide.

I begin with an important reminder: the SLC bears the burden of proving its independence. It must convince me.

But of what? According to the SLC, its members are independent unless they are essentially subservient to the Trading Defendants -- *i.e.*, they are under the "domination and control" of the interested parties. [45] If the SLC is correct and this is the central inquiry in the independence determination, **[**56]** they would win. Nothing in the record suggests to me that either Garcia-Molina or Grundfest are dominated and controlled by any of the Trading Defendants, by Oracle, or even by Stanford. [46]

But, in my view, an emphasis on "domination and control" would serve only to fetishize much-parroted language, at the cost of denuding the independence inquiry of its intellectual integrity. Take an easy example. Imagine if two brothers were on a corporate board, each successful **[**57]** in different businesses and not dependent in any way on the other's beneficence in order to be wealthy. The brothers are brothers, they stay in touch and consider each other family, but each is opinionated and strong-willed. A derivative action is filed targeting a transaction involving one of the brothers. The other brother is put **[*938]** on a special litigation committee to investigate the case. If the test is domination and control, then one brother could investigate the other. Does any sensible person think that is our law? I do not think it is.

And it should not be our law. Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement. *Homo sapiens* is not merely *homo economicus.* We may be thankful that an array of other motivations exist that influence human behavior; not all

---

[45] *See, e.g.,* In re Walt Disney Co. Derivative Litig., 731 A.2d at 355.

[46] This is not to say that the facts could not be simply read as providing a basis for a professor interested in promotion within the University to be less than aggressive as an SLC member. Even tenured professors and department chairs sometimes seek different chairs, duties, or even to climb to positions like Provost, which chart the path towards a university presidency. I do not consider this factor to be of weight here, however, but note it.

are any better than greed or avarice, think of envy, to name just one. But also think of motives like love, friendship, and collegiality, think of those among us who direct their behavior as best they can on a guiding creed or set of moral values. [47]

[58]** Nor should our law ignore the social nature of humans. To be direct, corporate directors are generally the sort of people deeply enmeshed in social institutions. Such institutions have norms, expectations that, explicitly and implicitly, influence and channel the behavior of those who participate in their operation. [48] Some things are 'just not done," or only at a cost, which might not be so severe as a loss of position, but may involve a loss of standing in the institution. In being appropriately sensitive to this factor, our law also cannot assume -- absent some proof of the point -- that corporate directors are, as a general matter, persons of unusual social bravery, who operate heedless to the inhibitions that social norms generate for ordinary folk.

[59]** For all these reasons, this court has previously held that the Delaware Supreme Court's teachings on independence can be summarized thusly:

> At bottom, the question of independence turns on whether a director is, *for any substantial reason,* incapable of making a decision with only the best interests of the corporation in mind. That is, the Supreme Court cases ultimately focus on impartiality and objectivity. [49]

This formulation is wholly consistent with the teaching of *Aronson,* which defines independence as meaning that "a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences." [50] As noted by Chancellor Chandler recently, a **[**60]** director may be compromised if he is beholden to an interested person. [51] Beholden in this sense does not **[*939]** mean just owing in the financial sense, it can also flow out of "personal or other relationships" to the interested party. [52]

Without backtracking from these general propositions, it would be less than candid if I did not admit that Delaware courts have applied these general standards in a manner that has been less than wholly consistent. Different decisions take a different view about the bias-producing potential of family relationships, not all of which can be explained by mere degrees **[**61]** of consanguinity. [53] **[**62]** Likewise, there is admittedly case law that gives little weight to ties of friendship in the independence inquiry. [54] In this opinion, I will not venture to do what I believe to be impossible: attempt to rationalize all these cases in their specifics. [55] Rather, I

---

[47] In an interesting work, Professor Lynn Stout has argued that there exists an empirical basis to infer that corporate directors are likely to be motivated by altruistic impulses and not simply by a concern for their own pocketbooks. *See* Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of Smith v. VanGorkom and the Business Judgment Rule,* 96 Nw. U. L. Rev. 675, 677-78 (2002).

[48] *See, e.g.,* Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law,* 149 U. Pa. L. Rev. 1735, 1780 (2001) ("There is reason to believe that trust may pay an important role in the success of many business firms."); Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Laws, Norms, and the Self-Governing Corporation,* 149 U. Pa. L. Rev. 1619, 1640 (2001) ("The myriad transactions that take place inside the firm are largely (but not entirely) protected by a . . . governance mechanism . . . that is almost entirely not legally enforceable.").

[49] Parfi Holding AB v. Mirror Image Internet, Inc., 794 A.2d 1211, 1232 (Del. Ch. 2001) (footnotes omitted) (emphasis in original), *rev'd in part on other grounds,* 817 A.2d 149 (Del. 2002), *cert. denied,* ***123 S. Ct. 2076 (2003)***.

[50] Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984).

[51] *See* Orman v. Cullman, 794 A.2d 5, 24 (Del. Ch. 2002).

[52] *See* id. at 24 n.47 (citing Aronson, 473 A.2d at 815); *see also* Patfi Holding, 794 A.2d at 1232 n.55 (citing definitions of beholden as meaning "owing something . . . to another" and "under obligation").

[53] *Compare*Harbor Fin. Partners v. Huizenga, 751 A.2d 879, 889 (Del. Ch. 1999) (CEO's brother-in-law could not impartially consider demand to sue him), *and* Mizel v. Connelly, 1999 Del. Ch. LEXIS 157, 1999 WL 550369 at *4 (Del. Ch. Aug. 2, 1999) (grandson could not impartially determine whether company should accept demand that required company to sue his grandfather for rescission of an interested transaction), *with* Seibert v. Harper & Row, Publishers, Inc., 1984 Del. Ch. LEXIS 523, 1984 WL 21874 at *3 (Del. Ch. Dec. 5, 1984) (a director was not disabled from considering a demand where the director's cousin was a fellow director and a corporate manager).

[54] *E.g.,* Crescent/Mach I Partners, L.P. v. Turner, 2000 Del. Ch. LEXIS 145, 2000 WL 1481002 at *11-12 (Del. Ch. Sept. 29, 2000).

[55] I readily concede that the result I reach is in tension with the

undertake what I understand to be my duty and what is possible: the application of the independence inquiry that our Supreme Court has articulated in a manner that is faithful to its essential spirit.

1. The Contextual Nature of the Independence Inquiry Under Delaware Law

In examining whether the SLC has met its burden to demonstrate that there is no material dispute of fact regarding its independence, the court must bear in mind the function of special litigation committees under our jurisprudence. Under Delaware law, the primary means by which corporate defendants may obtain a dismissal of a derivative suit is by showing that the plaintiffs have not met their pleading burden under the test of *Aronson v. Lewis,* [56] or the related standard set forth in **[**63]** *Rales v. Blasband*. [57] In simple terms, these tests permit a corporation to terminate a derivative suit if its board is comprised of directors who can impartially consider a demand. [58]

Special litigation committees are permitted as a last chance for a corporation to control a derivative claim in **[**64]** circumstances when a majority of its directors cannot **[*940]** impartially consider a demand. By vesting the power of the board to determine what to do with the suit in a committee of independent directors, a corporation may retain control over whether the suit will proceed, so long as the committee meets the standard set forth in *Zapata.*

In evaluating the independence of a special litigation committee, this court must take into account the extraordinary importance and difficulty of such a committee's responsibility. It is, I daresay, easier to say no to a friend, relative, colleague, or boss who seeks assent for an act *(e.g.*, a transaction) that has not yet occurred than it would be to cause a corporation to sue that person. This is admittedly a determination of so-called "legislative fact," but one that can be rather safely made. [59] **[**65]** Denying a fellow director the ability to proceed on a matter important to him may not be easy, but it must, as a general matter, be less difficult than finding that there is reason to believe that the fellow director has committed serious wrongdoing and that a derivative suit should proceed against him. [60]

The difficulty of making this decision is compounded in the special litigation committee context because the weight of making the moral judgment necessarily falls on less than the full board. A small number of directors feels the moral gravity -- and social pressures -- of this duty alone.

For all these reasons, the independence inquiry is critically important if the special litigation committee process is to retain its integrity, a quality that is, in turn, essential to the utility of that process. As this Court wrote recently:

> One of the obvious purposes for forming a special litigation committee is to promote confidence in the integrity of corporate decision making by vesting the company's power to respond to accusations of serious misconduct by high officials in an impartial group of independent directors. By forming a committee whose fairness **[**66]** and objectivity cannot be reasonably questioned . . . the company can assuage concern among its stockholders and retain, through the SLC, control over any claims belonging to the company itself.

* * *

Zapata presents an opportunity for a board that

---

specific outcomes of certain other decisions. But I do not believe that the result I reach applies a new definition of independence; rather, it recognizes the importance *(i.e.,* the materiality) of other bias-creating factors other than fear that acting a certain way will invite economic retribution by the interested directors.

[56] 473 A.2d 805 (Del. 1984).

[57] 634 A.2d 927 (Del. 1993).

[58] This is a simplified formulation of a more complex inquiry. One way for a plaintiff to impugn the impartiality of the board is to plead particularized facts creating a reasonable doubt that the board complied with its fiduciary duties. In that circumstance, the danger is that the board might be influenced by its desire to avoid personal liability in a lawsuit in which the plaintiffs have stated a claim under a heightened pleading burden. For a more thorough discussion *of Aronson* and *Rales,* see Guttman v. Huang, 823 A.2d 492, 2003 Del. Ch. LEXIS 48, 2003 WL 21058185 (Del. Ch. May 5, 2003).

[59] *See* Kenneth Culp Davis, *An Approach to Problems of Evidence in the Administrative Process,* 55 Harv. L. Rev. 364, 402-03 (1942); Leo E. Strine, Jr., *The Inescapably Empirical Foundation of the Common Law of Corporations,* 27 Del. J. Corp. L. 499, 502-03 (2002).

[60] The parties have not cited empirical social science research bearing on any of the factual inferences about human behavior within institutional settings upon which a ruling on this motion, one way or the other, necessarily depends.

> cannot act impartially as a whole to vest control of derivative litigation in a trustworthy committee of the board -- *i.e.,* one that is not compromised in its ability to act impartially. The composition and conduct of a special litigation committee therefore must be such as to instill confidence in the judiciary and, as important, the stockholders of the company that the committee can act with integrity and objectivity. [61]

Thus, in assessing the independence of the Oracle SLC, I necessarily examine the question of whether the SLC can independently make the difficult decision entrusted to it: to determine whether the Trading Defendants should face suit **[**67]** for insider trading-based allegations of breach of fiduciary duty. An affirmative answer by the SLC to that question would have potentially huge negative consequences **[*941]** for the Trading Defendants, not only by exposing them to the possibility of a large damage award but also by subjecting them to great reputational harm. To have Professors Grundfest and Garcia-Molina declare that Oracle should press insider trading claims against the Trading Defendants would have been, to put it mildly, "news." Relatedly, it is reasonable to think that an SLC determination that the Trading Defendants had likely engaged in insider trading would have been accompanied by a recommendation that they step down as fiduciaries until their ultimate culpability was decided.

The importance and special sensitivity of the SLC's task is also relevant for another obvious reason: investigations do not follow a scientific process like an old-fashioned assembly line. The investigators' mindset and talent influence, for good or ill, the course of an investigation. Just as there are obvious dangers from investigators suffering from too much zeal, so too are dangers posed by investigators who harbor reasons not to pursue **[**68]** the investigation's targets with full vigor.

The nature of the investigation is important, too. Here, for example, the SLC was required to undertake an investigation that could not avoid a consideration of the subjective state of mind of the Trading Defendants. Their credibility was important, and the SLC could not escape making judgments about that, no matter how objective the criteria the SLC attempted to use.

Therefore, I necessarily measure the SLC's independence contextually, and my ruling confronts the SLC's ability to decide impartially whether the Trading Defendants should be pursued for insider trading. This contextual approach is a strength of our law, as even the best minds have yet to devise across-the-board definitions that capture all the circumstances in which the independence of directors might reasonably be questioned. By taking into account all circumstances, the Delaware approach undoubtedly results in some level of indeterminacy, but with the compensating benefit that independence determinations are tailored to the precise situation at issue. [62]

[69]** **[*942]** Likewise, Delaware law requires courts to consider the independence of directors based on the facts known to the court about them specifically, the so-called "subjective 'actual person' standard." [63] That said,

[61] *Biondi v. Scrushy, 820 A.2d 1148, 1156, 1166 (Del. Ch. 2003)* .

[62] The recent reforms enacted by Congress and by the stock exchanges reflect a narrower conception of who they believe can be an independent director. These definitions, however, are blanket labels that do not take into account the decision at issue. Nonetheless, the definitions recognize that factors other than the ones explicitly identified in the new exchange rules might compromise a director's independence, depending on the circumstances. *See* Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the New York Stock Exchange, Inc. Relating to Corporate Governance, 68 Fed. Reg. 19,051, 19,053 (Apr. 17, 2003) ("It is not possible to anticipate, or explicitly provide for, all circumstances that might signal potential conflicts of interest, or that might bear on the materiality of a director's relationship to a listed company. Accordingly, it is best that boards making 'independence' determinations broadly consider all relevant facts and circumstances. In particular, when assessing the materiality of a director's relationship with the company, the board should consider the issue not merely from the standpoint of the director, but also from that of persons or organizations with which the director has an affiliation. Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others."); Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the National Association of Securities Dealers, Inc. Relating to Proposed Amendments to NASD Rules 4200 and 4350 Regarding Board Independence and Independent Committees, 68 Fed. Reg. 14,451, 14,452 (Mar. 25, 2003) ("'Independent director' means a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship, which, in the opinion of the company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.").

[63] *Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1167*

it is inescapable that a court must often apply to the known facts about a specific director a consideration of how a reasonable person similarly situated to that director would behave, given the limited ability of a judge to look into a particular director's heart and mind. This is especially so when a special litigation committee chooses, as was the case here, to eschew any live witness testimony, a decision that is, of course, sensible lest special litigation committee termination motions turn into trials nearly as burdensome as the derivative suit the committee seeks to end. But with that sensible choice came an acceptance of the court's need to infer that the special litigation committee members are persons of typical professional sensibilities.

[70]** 2. The SLC Has Not Met Its Burden to Demonstrate the Absence of a Material Dispute of Fact About Its Independence

Using the contextual approach I have described, I conclude that the SLC has not met its burden to show the absence of a material factual question about its independence. I find this to be the case because the ties among the SLC, the Trading Defendants, and Stanford are so substantial that they cause reasonable doubt about the SLC's ability to impartially consider whether the Trading Defendants should face suit. The concern that arises from these ties can be stated fairly simply, focusing on defendants Boskin, Lucas, and Ellison in that order, and then collectively.

As SLC members, Grundfest and Garcia-Molina were already being asked to consider whether the company should level extremely serious accusations of wrongdoing against fellow board members. As to Boskin, both SLC members faced another layer of complexity: the determination of whether to have Oracle press insider trading claims against a fellow professor at their university. Even though Boskin was in a different academic department from either SLC member, it is reasonable to assume that the fact that Boskin **[**71]** was also on faculty would -- to persons possessing typical sensibilities and institutional loyalty -- be a matter of more than trivial concern. Universities are obviously places of at-times intense debate, but they also see themselves as communities. In fact, Stanford refers to itself as a "community of scholars." [64] To accuse a fellow professor -- whom one might see at the faculty club or at inter-disciplinary presentations of academic papers -- of insider trading cannot be a small thing -- even for the most callous of academics.

As to Boskin, Grundfest faced an even more complex challenge than Garcia-Molina. Boskin was a professor who had taught him and with whom he had maintained contact over the years. Their areas of academic interest intersected, putting Grundfest in contact if not directly with Boskin, then regularly with Boskin's colleagues. **[**72]** Moreover, although I am told by the SLC that the title of senior fellow at SIEPR is an honorary one, the fact remains that Grundfest willingly accepted it and was one of a select number of faculty who attained that status. And, they both just happened to also be steering committee members. Having these ties, Grundfest **[*943]** (I infer) would have more difficulty objectively determining whether Boskin engaged in improper insider trading than would a person who was not a fellow professor, had not been a student of Boskin, had not kept in touch with Boskin over the years, and who was not a senior fellow and steering committee member at SIEPR.

In so concluding, I necessarily draw on a general sense of human nature. It may be that Grundfest is a very special person who is capable of putting these kinds of things totally aside. But the SLC has not provided evidence that that is the case. In this respect, it is critical to note that I do not infer that Grundfest would be less likely to recommend suit against Boskin than someone without these ties. Human nature being what it is, it is entirely possible that Grundfest would in fact be tougher on Boskin than he would on someone with whom he did not **[**73]** have such connections. The inference I draw is subtly, but importantly, different. What I infer is that a person in Grundfest's position would find it difficult to assess Boskin's conduct without pondering his own association with Boskin and their mutual affiliations. Although these connections might produce bias in either a tougher or laxer direction, the key inference is that these connections would be on the mind of a person in Grundfest's position, putting him in the position of either causing serious legal action to be brought against a person with whom he shares several connections (an awkward thing) or not doing so (and risking being seen as having engaged in favoritism toward his old professor and SIEPR colleague).

The same concerns also exist as to Lucas. For

(Del. 1995).

[64] *See* Stanford University, *Stanford Facts 2003* (last modified Apr. 3, 2003), *available at* http://www.stanford.edu/home/stanford/facts/faculty.html.

Grundfest to vote to accuse Lucas of insider trading would require him to accuse SIEPR's Advisory Board Chair and major benefactor of serious wrongdoing - of conduct that violates federal securities laws. Such action would also require Grundfest to make charges against a man who recently donated $ 50,000 to Stanford Law School after Grundfest made a speech at his request. [65]

[74]** And, for both Grundfest and Garcia-Molina, service on the SLC demanded that they consider whether an extremely generous and influential Stanford alumnus should be sued by Oracle for insider trading. Although they were not responsible for fundraising, as sophisticated professors they undoubtedly are aware of how important large contributors are to Stanford, and they share in the benefits that come from serving at a university with a rich endowment. A reasonable professor giving any thought to the matter would obviously consider the effect his decision might have on the University's relationship with Lucas, it being (one hopes) sensible to infer that a professor of reasonable collegiality and loyalty cares about the well-being of the institution he serves.

In so concluding, I give little weight to the SLC's argument that it was unaware of just how substantial Lucas's beneficence to Stanford has been. I do so for two key reasons. Initially, it undermines, rather than inspires, confidence that the SLC did not examine the Trading Defendants' ties to Stanford more closely in preparing its Report. The Report's failure to identify these ties is important because it is the SLC's burden to **[**75]** show independence. In forming the SLC, the Oracle board should have undertaken a thorough consideration of the facts bearing on the independence of the proposed SLC members from the key objects of the investigation.

[*944] The purported ignorance of the SLC members about all of Lucas's donations to Stanford is not helpful to them for another reason: there were too many visible manifestations of Lucas's status as a major contributor for me to conclude that Grundfest, at the very least, did not understand Lucas to be an extremely generous benefactor of Stanford. It is improbable that Grundfest was not aware that Lucas was the Chair of SIEPR's Advisory Board, and Grundfest must have known that the Donald L. Lucas Conference Center at SIEPR did not get named that way by coincidence. And, in February 2002 -- incidentally, the same month the SLC was formed -- Grundfest spoke at a meeting of "SIEPR Associates," a group of individuals who had given $ 5,000 or more to SIEPR. [66] Although it is not clear if Lucas attended that event, he is listed -- in the same publication that reported Grundfest's speech at the Associates' meeting -- as one of SIEPR's seventy-five "Associates." [67] Combined with **[**76]** the other obvious indicia of Lucas's large contributor status (including the $ 50,000 donation Lucas made to Stanford Law School to thank Grundfest for giving a speech) and Lucas's obviously keen interest in his alma mater, Grundfest would have had to be extremely insensitive to his own working environment not to have considered Lucas an extremely generous alumni benefactor of Stanford, and at SIEPR and the Law School in particular.

Garcia-Molina is in a somewhat better position to disclaim knowledge of how generous an alumnus Lucas had been. Even so, the scope of Lucas's activities and their easy discoverability gives me doubt that **[**77]** he did not know of the relative magnitude of Lucas's generosity to Stanford. [68] **[**78]** Furthermore, Grundfest comprised half of the SLC and was its most active member. His non-independence is sufficient

---

[65] As noted, Lucas has contributed $ 149,000 to the Law School, $ 424,000 to SIEPR, and millions more to other Stanford institutions.

[66] *See Joseph Grundfest Talks About Enron and Auditing Process Ethics,* SIEPR Persp., Spring 2002, at 9, 9, *available at http://siepr.stanford.edu/about/newsletter_spring2002.pdf*.

[67] *See id.* at 15. Notably, Lucas is not listed as a "new donor," which suggests that he attained the rank of SIEPR Associate in a previous year or years, as well. *See id.*

[68] Professor Garcia-Molina denied in his deposition any specific knowledge of whether any of the Trading Defendants were donors to Stanford. He might well have told the truth despite the fact that there was evidence of it around Stanford's (admittedly large) campus and in the news at the same time as he was joining Oracle's board. As I have discussed, however, the purported ignorance of the SLC does not give me confidence, given the objective and discoverable facts available to the SLC members at the time. Even if I was convinced that Garcia-Molina was totally unaware of, for example, Lucas's status as an important alumni contributor -- which I am not -- that would not help the SLC, because Grundfest clearly was and the Report acknowledges both SLC members' knowledge that Lucas had made contributions. Moreover, Garcia-Molina clearly knew Boskin was a fellow professor, and the objective circumstances cause me to doubt that Garcia-Molina did not also suspect that Ellison was, if not already a major donor, then, at the very least, a major target for Stanford's development officers.

alone to require a denial of the SLC's motion. [69]

[*945] In concluding that the facts regarding Lucas's relationship with Stanford are materially important, I must address a rather odd argument of the SLC's. The argument goes as follows. Stanford has an extremely large endowment. Lucas's contributions, while seemingly large, **[**79]** constitute a very small proportion of Stanford's endowment and annual donations. Therefore, Lucas could not be a materially important contributor to Stanford and the SLC's independence could not be compromised by that factor.

But missing from that syllogism is any acknowledgement of the role that Stanford's solicitude to benefactors like Lucas might play in the overall size of its endowment and campus facilities. Endowments and buildings grow one contribution at a time, and they do not grow by callous indifference to alumni who (personally and through family foundations) have participated in directing contributions of the size Lucas has. Buildings and conference centers are named as they are as a recognition of the high regard universities have for donors (or at least, must feign convincingly). The SLC asks me to believe that what universities like Stanford say in thank you letters and public ceremonies is not in reality true; that, in actuality, their contributors are not materially important to the health of those academic institutions. This is a proposition that the SLC has not convinced me is true, and that seems to contradict common experience.

Nor has the SLC convinced me that **[**80]** tenured faculty are indifferent to large contributors to their institutions, such that a tenured faculty member would not be worried about writing a report finding that a suit by the corporation should proceed against a large contributor and that there was credible evidence that he had engaged in illegal insider trading. The idea that faculty members would not be concerned that action of that kind might offend a large contributor who a university administrator or fellow faculty colleague *(e.g.,* Shoven at SIEPR) had taken the time to cultivate strikes me as implausible and as resting on an narrow-minded understanding of the way that collegiality works in institutional settings.

In view of the ties involving Boskin and Lucas alone, I would conclude that the SLC has failed to meet its burden on the independence question. The tantalizing facts about Ellison merely reinforce this conclusion. The SLC, of course, argues that Ellison is not a large benefactor of Stanford personally, that Stanford has demonstrated its independence of him by rejecting his child for admission, and that, in any event, the SLC was ignorant of any negotiations between Ellison and Stanford about a large contribution. **[**81]** For these reasons, the SLC says, its ability to act independently of Ellison is clear.

I find differently. The notion that anyone in Palo Alto can accuse Ellison of insider trading without harboring some fear of social awkwardness seems a stretch. That being said, I do not mean to imply that the mere fact that Ellison is worth tens of billions of dollars and is the key force behind a very important social institution in Silicon Valley disqualifies all persons who live there from being independent of him. Rather, it is merely an acknowledgement of the simple fact that accusing such a significant person in that community of such serious wrongdoing is no small thing.

Given that general context, Ellison's relationship to Stanford itself contributes to my overall doubt, when heaped on top of the ties involving Boskin and Lucas. During the period when Grundfest and Garcia-Molina were being added to the Oracle board, Ellison was publicly considering making extremely large contributions to Stanford. Although the SLC denies **[*946]** knowledge of these public statements, Gmndfest claims to have done a fair amount of research before joining the board, giving me doubt that he was not somewhat aware of **[**82]** the possibility that Ellison might bestow large blessings on Stanford. This is especially so when I cannot rule out the possibility that Grundfest had been told by Lucas about, but has now honestly forgotten, the negotiations over the Ellison Scholars Program.

Furthermore, the reality is that whether or not Ellison eventually decided not to create that Program and not to

---

[69] *See* In re Walt Disney Co. Derivative Litig., 731 A.2d at 354 *("Under Aronson's* first prong -- director independence -- for demand to be futile, the Plaintiffs must show a reasonable doubt as to the disinterest of at least half of the directors."); Beneville v. York, 769 A.2d 80, 82 (Del. Ch. 2000) (concluding that "when one member of a two-member board of directors cannot impartially consider a stockholder litigation demand" demand is excused); In re The Limited, Inc. S'holders Litig., 2002 Del. Ch. LEXIS 28, 2002 WL 537692 at *7 ("Where the challenged actions are those of a board consisting of an even number of directors, plaintiffs meet their burden of demonstrating the futility of making demand on the board by showing that half of the board was either interested or not independent.").

bequeath his house to Stanford, Ellison remains a plausible target of Stanford for a large donation. This is especially so in view of Oracle's creation of the Oracle Help Us Help Foundation with Stanford and Ellison's several public indications of his possible interest in giving to Stanford. And, while I do not give it great weight, the fact remains that Ellison's medical research foundation has been a source of nearly $ 10 million in funding to Stanford. Ten million dollars, even today, remains real money.

Of course, the SLC says these facts are meaningless because Stanford rejected Ellison's child for admission. I am not sure what to make of this fact, but it surely cannot bear the heavy weight the SLC gives it. The aftermath of denying Ellison's child admission might, after all, as likely manifest itself in a **[**83]** desire on the part of the Stanford community never to offend Ellison again, lest he permanently write off Stanford as a possible object of his charitable aims -- as the sort of thing that acts as not one, but two strikes, leading the batter to choke up on the bat so as to be even more careful not to miss the next pitch. Suffice to say that after the rejection took place, it did not keep Ellison from making public statements in *Fortune* magazine on August 13, 2001 about his consideration of making a huge donation to Stanford, at the same time when the two SLC members were being courted to join the Oracle board.

As an alternative argument, the SLC contends that neither SLC member was aware of Ellison's relationship with Stanford until after the Report was completed. Thus, this relationship, in its various facets, could not have compromised their independence. Again, I find this argument from ignorance to be unavailing. An inquiry into Ellison's connections with Stanford should have been conducted before the SLC was finally formed and, at the very least, should have been undertaken in connection with the Report. In any event, given how public Ellison was about his possible donations **[**84]** it is difficult not to harbor troublesome doubt about whether the SLC members were conscious of the possibility that Ellison was pondering a large contribution to Stanford. In so concluding, I am not saying that the SLC members are being untruthful in saying that they did not know of the facts that have emerged, only that these facts were in very prominent journals at the time the SLC members were doing due diligence in aid of deciding whether to sign on as Oracle board members. The objective circumstances of Ellison's relations with Stanford therefore generate a reasonable suspicion that seasoned faculty members of some sophistication -- including the two SLC members -- would have viewed Ellison as an active and prized target for the University. The objective circumstances also require a finding that Ellison was already, through his personal Foundation and Oracle itself, a benefactor of Stanford.

Taken in isolation, the facts about Ellison might well not be enough to compromise the SLC's independence. But that is not the relevant inquiry. The pertinent question is whether, given *all* the facts, the SLC has met its independence burden.

[*947] When viewed in that manner, the facts about **[**85]** Ellison buttress the conclusion that the SLC has not met its burden. Whether the SLC members had precise knowledge of all the facts that have emerged is not essential, what is important is that by any measure this was a social atmosphere painted in too much vivid Stanford Cardinal red for the SLC members to have reasonably ignored it. Summarized fairly, two Stanford professors were recruited to the Oracle board in summer 2001 and soon asked to investigate a fellow professor and two benefactors of the University. On Grundfest's part, the facts are more substantial, because his connections -- through his personal experiences, SIEPR, and the Law School -- to Boskin and to Lucas run deeper.

It seems to me that the connections outlined in this opinion would weigh on the mind of a reasonable special litigation committee member deciding whether to level the serious charge of insider trading against the Trading Defendants. As indicated before, this does not mean that the SLC would be less inclined to find such charges meritorious, only that the connections identified would be on the mind of the SLC members in a way that generates an unacceptable risk of bias. That is, these connections generate **[**86]** a reasonable doubt about the SLC's impartiality because they suggest that material considerations other than the best interests of Oracle could have influenced the SLC's inquiry and judgments.

Before closing, it is necessary to address two concerns. The first is the undeniable awkwardness of opinions like this one. By finding that there exists too much doubt about the SLC's independence for the SLC to meet its *Zapata* burden, I make no finding about the subjective good faith of the SLC members, both of whom are distinguished academics at one of this nation's most prestigious institutions of higher learning. [70] Nothing in this record leads me to conclude that either of the SLC members acted out of any conscious desire to favor the Trading Defendants or to do anything other than discharge their duties with fidelity. But that is not the purpose of the independence inquiry.

[87]** That inquiry recognizes that persons of integrity and reputation can be compromised in their ability to act without bias when they must make a decision adverse to others with whom they share material affiliations. To conclude that the Oracle SLC was not independent is not a conclusion that the two accomplished professors who comprise it are not persons of good faith and moral probity, it is solely to conclude that they were not situated to act with the required degree of impartiality. *Zapata* requires independence to ensure that stockholders do not have to rely upon special litigation committee members who must put aside personal considerations that are ordinarily influential in daily behavior in making the already difficult decision to accuse fellow directors of serious wrongdoing.

Finally, the SLC has made the argument that a ruling against it will chill the ability of corporations to locate qualified independent directors in the academy. This is overwrought. If there are 1,700 professors at Stanford alone, as the SLC says, how many must there be on the west coast of the United States, at institutions without ties to Oracle and the Trading Defendants as substantial as Stanford's? **[**88]** Undoubtedly, a corporation of Oracle's market capitalization could have found prominent academics willing to serve as **[*948]** SLC members, about whom no reasonable question of independence could have been asserted.

Rather than form an SLC whose membership was free from bias-creating relationships, Oracle formed a committee fraught with them. As a result, the SLC has failed to meet its *Zapata* burden, and its motion to terminate must be denied. Because of this reality, I do not burden the reader with an examination of the other *Zapata* factors. In the absence of a finding that the SLC was independent, its subjective good faith and the reasonableness of its conclusions would not be sufficient to justify termination. Without confidence that the SLC was impartial, its findings do not provide the assurance our law requires for the dismissal of a derivative suit without a merits inquiry.

V. Conclusion

The SLC's motion to terminate is DENIED. IT IS SO ORDERED.

End of Document

[70] *Lewis v. Fuqua, 502 A.2d at 964-65* (noting that a non-independence finding should not be equated with a determination that an SLC member acted improperly).

In re Pattern Energy Grp. Inc. Stockholders Litig.

Court of Chancery of Delaware

December 10, 2020, Submitted; May 6, 2021, Decided

C.A. No. 2020-0357-MTZ

Reporter

2021 Del. Ch. LEXIS 90 *; 2021 WL 1812674

IN RE PATTERN ENERGY GROUP INC. STOCKHOLDERS LITIGATION

Notice: THIS OPINION HAS NOT BEEN RELEASED FOR PUBLICATION. UNTIL RELEASED, IT IS SUBJECT TO REVISION OR WITHDRAWAL.

Counsel: [*1] Ned Weinberger and Mark Richardson, LABATON SUCHAROW LLP, Wilmington, Delaware; David MacIsaac and John Vielandi, LABATON SUCHAROW LLP, New York, New York; Chad Johnson, Noam Mandel, and Desiree Cummings, ROBBINS GELLER RUDMAN & DOWD LLP, New York, New York; Brian Schall and Rina Restaino, THE SCHALL LAW FIRM, Los Angeles, California, Attorneys for Lead Plaintiff Jody Britt.

A. Thompson Bayliss and April M. Kirby, ABRAMS & BAYLISS LLP, Wilmington, Delaware; Alan S. Goudiss, K. Mallory Brennan, and Deke Shearon SHEARMAN & STERLING LLP; Christina Urhausen, SHEARMAN & STERLING LLP, San Francisco, California; Attorneys for Defendants Alan R. Batkin, Edmund John Philip Browne, Richard A. Goodman, Douglas G. Hall, Patricia M. Newson, Mona K. Sutphen, Michael Garland, Hunter Armistead, Daniel Elkort, Michael Lyon, and Esben Pedersen.

Rudolf Koch, Matthew D. Perri, and Andrew L. Milam, RICHARDS, LAYTON & FINGER, P.A., Wilmington, Delaware; Matthew A. Schwartz, Y. Carson Zhou, John-Francis S. Flynn, SULLIVAN & CROMWELL LLP, New York, New York; Attorneys for Defendants Riverstone Holdings LLC, Riverstone Pattern Energy II Holdings, L.P., and Pattern Energy Group, Holdings 2 LP.

Judges: ZURN, Vice Chancellor. **[*2]**

Opinion by: ZURN

Opinion

MEMORANDUM OPINION

ZURN, Vice Chancellor.

The sales process of Pattern Energy Group Inc. (the "Company") was run by an undisputedly disinterested and independent special committee that recognized and nominally managed conflicts, proceeded with advice from an unconflicted banker and counsel, and conducted a lengthy process attracting tens of suitors that the special committee pressed for value. But, even having acknowledged that one eager bidder offered superior value, the special committee ultimately selected a different bidder as the buyer. The buyer was preferred by a private equity investor, who formed the Company and its upstream supplier, which the investor controlled; appointed the Company's management team; and held a consent right over Company changes of control. The investor favored the buyer because its proposal, as shaped by the investor, accomplished the investor's goals of taking the Company private and consolidating it with the upstream supplier, while permitting the investor to retain its equity stake in the new company.

In apportioning fault for the selection of the buyer's inferior bid, the plaintiff primarily points to three forces: (1) the investor's control over **[*3]** the Company together with the upstream supplier and management; (2) the Company's CEO, who was conflicted in favor of the investor yet ran point on the sales process to stockholders' detriment; and (3) the special committee's prioritization of the investor's goals over stockholder value and inability to say "no." In her post-closing class action complaint, the plaintiff seeks entire fairness review due to the investor's alleged control group standing on both sides of the transaction, or due to the CEO's alleged fraud on the board. She claims the special committee and management breached their fiduciary duties in a cash-out merger, and that the investor and supplier either controlled that process or participated as third-party tortfeasors. The defendants—the investor, the supplier, the conflicted directors, the special committee, and conflicted management—contend that the cash-out merger with Buyer was cleansed by an informed stockholder vote; that the directors were exculpated; and that no breaches of fiduciary duty or third-party liability torts have been pled.

On the defendants' motion to dismiss, the plaintiff prevails on most of her arguments. Recognizing that neither the investor **[*4]** nor the supplier owned Company stock, I leave open the possibility that the plaintiff may establish the investor, supplier, and management stockholders formed a control group, given the investor's consent right and other pervasive sources of soft power over the Company and its sales process. Thus, it remains possible that the transaction may be subject to the entire fairness standard of review under a controller theory—but not a fraud on the board theory.

At a minimum, the plaintiff has pled the special committee and management failed to manage conflicts and prioritized the investor's goals over stockholder value in bad faith (as distinguished from dereliction of duty), and so states nonexculpated claims for breach of fiduciary duty that will be reviewed under enhanced scrutiny. All but two management defendants allegedly contributed to flaws in the process. The sales process is not presumptively subject to the business judgment rule: the votes in favor fall below a majority of disinterested stockholders because the block at the tipping point was subject to a voting agreement that compelled favorable votes that were not informed, disinterested, or voluntary. Plaintiff has also pled **[*5]** the special committee improperly and completely delegated drafting the merger proxy (the "Proxy") to conflicted management, and that the Proxy was inadequate.

I. BACKGROUND[1]

The Verified Stockholder Class Action Complaint, filed on May 28, 2020 (the "Complaint"), challenges the March 16, 2020 all-cash acquisition (the "Merger") of Pattern Energy Group Inc. by Canada Pension Plan Investment Board ("Buyer").[2] Lead Plaintiff Jody Britt ("Plaintiff") was a Company stockholder at all relevant times, and brings her claims on behalf of all other similarly situated former public Company stockholders.[3]

A. The Company's Longstanding Relationship To Riverstone Contextualizes And Bears On The Sales Process At Issue.

The Company was formed by Riverstone to operate energy projects developed by another Riverstone entity.[4] Riverstone "is a private equity fund investing primarily in energy, power, and infrastructure," including renewable energy. The developer entity's structure and ties to the Company changed with the energy market. The chronology of those changes is helpful background to this matter, as the Company's ties to Riverstone and the developer loom large **[*6]** in the Company's sales process.

Riverstone has owned and controlled Pattern Energy Group LP ("Developer 1") at all times.[5] In October 2012, Riverstone, via Developer 1, incorporated the Company

---

[1] I draw the following facts from the Verified Consolidated Stockholder Class Action Complaint, available at Docket Item ("D.I.") 101 [hereinafter "Compl."], as well as the documents attached and integral to it. *See, e.g.,* Himawan v. Cephalon, Inc., 2018 Del. Ch. LEXIS 585, 2018 WL 6822708, at *2 (Del. Ch. Dec. 28, 2018); In re Gardner Denver, Inc. S'holders Litig., 2014 Del. Ch. LEXIS 27, 2014 WL 715705, at *2 (Del. Ch. Feb. 21, 2014). Citations in the form of "Kirby Decl. --" refer to the exhibits attached to the Declaration of April M. Kirby, Esq. in Support of the Opening Brief in Support of Defendants' Motion to Dismiss, available at D.I. 75 and D.I. 76. Citations in the form of "Weinberger Decl. --" refer to the exhibits attached to the Transmittal Declaration of Ned Weinberger in Support of Plaintiff's Answering Brief in Opposition to Defendants' Motions to Dismiss, available at D.I. 82. Citations in the form of "Proxy --" refer to the Company's Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934, filed February 4, 2020, attached as Exhibit 1 to the Kirby Declaration and available at D.I. 75. On the Motion, the Court may consider the Proxy, as well as other publicly filed documents regarding the Merger. *See* Orman v. Cullman, 794 A.2d 5, 15-16 (Del. Ch. 2002); In re Lukens Inc. S'holders Litig., 757 A.2d 720, 727 (Del. Ch. 1999), *aff'd sub nom.* ***Walker v. Lukens, Inc., 757 A.2d 1278 (Del. 2000)***; Omnicare, Inc. v. NCS Healthcare, Inc., 809 A.2d 1163, 1168 n.3 (Del. Ch. 2002).

[2] *See generally* Compl.

[3] *Id.* ¶ 23.

[4] *Id.* ¶¶ 37, 43. Riverstone Pattern Energy II Holdings, L.P. is an affiliate of Riverstone Holdings LLC; this opinion refers to those entities collectively as "Riverstone." *Id.* ¶ 39.

[5] *Id.* ¶¶ 42, 46.

and thereafter controlled the Company through Riverstone's stake in Developer 1.[6] Riverstone arranged the Company and Developer 1 in a symbiotic business relationship, in which Developer 1 created and constructed renewable energy projects, but did not operate them, and the Company had a right of first offer to purchase and operate Developer 1's projects.[7] Developer 1 and the Company were run as a single entity out of the same offices, and Developer 1 enjoyed the benefits of a management services agreement with the Company.[8]

In 2013, Developer 1 took the Company public via an initial public offering (the "IPO").[9] After the IPO, Riverstone still indirectly controlled the Company via Developer 1, which retained a 67.9% majority interest; public investors and Company management held the other third.[10] Developer 1 also executed a shareholder agreement with the Company in connection with the IPO. That agreement gave Developer 1, and therefore Riverstone, a consent right over the Company's **[*7]** major corporate transactions, including sales and acquisitions worth more than 10% of the Company's market capitalization, so long as Developer 1 owned at least one third of the Company's shares.[11] Developer 1 continued to develop new projects.[12] The Company paid steady dividends and attracted long-term investors, but its share price remained flat.[13]

In 2017, inspired by record demand for renewable energy,[14] Riverstone restructured its relationship with the Company, as Developer 1 seemingly lacked the capital resources needed to develop projects to keep up with demand.[15] Developer 1 was replaced with a Riverstone-sponsored and controlled private equity fund, Pattern Energy Group Holdings 2, LP (together with any subsidiaries, "Developer 2"). Developer 2 was funded and owned by Riverstone, the Company, and Company management, with total capital commitments of nearly $1 billion.[16] The Company became Developer 2's limited partner with the goal of "[c]reat[ing] strong, lasting alignment between [Developer 2] and [the Company]."[17] Developer 2 acquired Developer 1's assets and replaced Developer 1 as the Company's symbiotic counterpart.[18] The Company primarily acquired its operating assets **[*8]** from Developer 2, while Developer 2 retained development assets,[19] and the Company held a downstream right of first offer on all projects Developer 2 sold.[20] Crucially, Developer 2 acquired a consent right over the Company's transfer of its Developer 2 stake (the "Consent Right"); in view of its domination over Developer 2, Riverstone ultimately controlled the Consent Right.[21]

As Developer 2 took the stage, Developer 1 wound down, selling its equity in the Company between late 2017 and October 2018 such that Riverstone no longer held any direct interest in the Company at the time of the Merger.[22] Still, Riverstone and the Company remained intertwined operationally (as the Company bought and operated the projects Riverstone's Developer 2 operated) and structurally (as the Company and its management were minority owners in Developer 2, and as Riverstone controlled the Consent Right over a transfer of the Company's minority interest). Their investments also aligned: at the time of the Merger, Riverstone held approximately 71% of Developer 2's equity; the Company held 29%; and Company management held the remaining 1% interest.[23]

---

[6] *Id.* ¶ 47.

[7] *Id.* ¶ 46 n.2.

[8] *Id.* ¶¶ 51-52.

[9] *Id.* ¶ 47.

[10] *Id.* ¶¶ 47, 49.

[11] *Id.* ¶ 50. By February 2015, Developer 1's ownership had dipped below the one-third threshold, so its consent right lapsed. *Id.*

[12] *Id.* ¶¶ 2, 38, 43-44, 46.

[13] *Id.* ¶ 53.

[14] *Id.* ¶ 54.

[15] *Id.* ¶ 55.

[16] *Id.* ¶¶ 2, 38, 57, 58.

[17] *Id.* ¶ 60.

[18] *Id.* ¶¶ 2, 38, 57.

[19] Proxy at 36.

[20] Compl. ¶¶ 57, 62.

[21] *Id.* ¶¶ 62-63.

[22] *See id.* ¶¶ 76-80.

[23] *Id.* ¶¶ 58-59; Proxy at 36.

Riverstone and the Company also had a great **[*9]** number of overlapping fiduciaries, including Michael Garland, Hunter Armistead, Daniel Elkort, Michael Lyon, and Esben Pedersen (collectively, the "Officer Defendants").[24] The Officer Defendants have a long history with Riverstone: "[f]or over a decade Riverstone has been their co-investor, partner, employer, sponsor, and financial patron."[25] Riverstone and the Officer Defendants formed Developer 1 together, buying Developer 1's portfolio from the Officer Defendants' previous employer.[26] Riverstone and the Officer Defendants also co-created the Company and Developer 2.[27]

Garland served as Developer 2's President, as well as Developer 1's President and director.[28] Armistead took over as Developer 2's President in April 2019, after having served as Developer 1's Executive Director.[29] Garland and Armistead would also serve as Company officers, alongside Elkort, Lyon, and Pedersen.[30] Garland was the Company's first Chief Executive Officer, and Armistead was the Company's Executive Vice President, Business Development.[31] Elkort has held multiple roles at the Company, but most recently acted as its Executive Vice President and Chief Legal Officer.[32] Lyon was the Company's **[*10]** Chief Financial Officer since 2012, and he took over as Company President in April 2019.[33] Pedersen assumed the Chief Financial Officer role at that time, after having served as the Company's Chief Investment Officer.[34] In addition to their roles at the Company, Elkort, Lyon, and Pedersen served Developer 1 and Developer 2. Elkort served as Developer 1's Director of Legal Services and Co-Head of Finance since June 2009 and also served as a Developer 2 officer.[35] Lyon served as Developer 1's Head of Structured Finance since May 2010.[36] And Pedersen served as Developer 2's Chief Financial Officer since May 2018 and Developer 1's Co-Head of Finance since June 2009.[37]

Thus, the Officer Defendants were simultaneously tethered to Riverstone, Developer 1 and then Developer 2, and the Company, facing potential conflicts of interest as dual fiduciaries of the Company and Developer 1 or 2.[38] The Company repeatedly noted in public filings these potential conflicts and the likelihood that they would manifest.[39]

The entities also had overlapping directors. Of Developer 2's five directors, Riverstone appointed three,[40] and the Company appointed two: Garland and Armistead.[41] As **[*11]** for the Company's directors, Riverstone, via Developer 1, appointed at least four of the initial directors on the Company's seven-member

[24] *See* Compl. ¶¶ 32-36, 51.

[25] *Id.* ¶ 45; *see also id.* ¶¶ 32-36.

[26] *Id.* ¶¶ 44-45. Riverstone purchased the portfolio from Babcock & Brown LLP, a now-defunct Australian global investment and advisory firm. *Id.* ¶ 44. In 2009, Riverstone and the management team of Babcock & Brown's North American Energy Group, which included the Officer Defendants, acquired Babcock & Brown's wind development portfolio to form Developer 1. *Id.* Defendant Hunter Armistead touted Riverstone's acquisition, stating that Babcock & Brown's management team, including the Officer Defendants, was "free of Babcock, which is a great thing[.]" *Id.* ¶ 45 (emphasis omitted). Armistead stated "[i]t was clear we needed to find another party that was interested in investing in renewables and valued our team . . . . We found the perfect partner in Riverstone—we have a new backer." *Id.*

[27] *See id.* ¶¶ 42, 46, 57.

[28] *Id.* ¶ 24.

[29] *Id.* ¶ 32.

[30] *Id.* ¶¶ 24, 32, 51.

[31] *Id.* ¶¶ 24, 32.

[32] *Id.* ¶ 33. Elkort also served as the Company's General Counsel and Chief Compliance Officer. *Id.*

[33] *Id.* ¶ 34.

[34] *Id.* ¶ 35.

[35] *Id.* ¶ 33.

[36] *Id.* ¶ 34.

[37] *Id.* ¶ 35.

[38] *Id.* ¶ 52 & n.5.

[39] *Id.* ¶ 52.

[40] *Id.* ¶ 38. Riverstone appointed longtime colleagues of Company director Edmund John Philip Browne, The Lord Browne of Madingley: Chris Hunt, Robin Duggan, and Alfredo Marti. *Id.* ¶ 37.

[41] *Id.* ¶¶ 58-59, 63.

board of directors (the "Board"), including Garland.[42] Riverstone itself appointed Edmund John Philip Browne, The Lord Browne of Madingley, who was hired as a Riverstone Managing Director and Partner in 2007 to help expand its existing energy practice and identify Company opportunities in the alternative and renewable energy markets.[43] Browne served as a director through the Merger and was involved in the sales process.[44] Riverstone also appointed Patricia Bellinger, who had previously worked under Browne from 2000 through 2007 and left the Board by the time of the Merger.[45] Finally, Developer 1 initially appointed Michael Hoffman, who left the Board by the time of the Merger.[46] In addition to Garland and Browne, Alan R. Batkin, Richard A. Goodman, Douglas G. Hall, Patricia M. Newson, and Mona K. Sutphen (collectively, the "Director Defendants," and together with the Officer Defendants, the "Individual Defendants") served as Company directors at the time of the Merger.[47] Batkin, Goodman, Hall, Newson, and Sutphen never held and do not currently hold positions **[*12]** at Riverstone, Developer 1, or Developer 2.[48]

The interconnectedness of Riverstone, Developers 1 and 2, and the Company significantly influenced the Merger process, which lasted from June 2018 through November 2019. In the end, the two competing bidders were Brookfield Asset Management Inc. ("Brookfield") and Buyer, Riverstone's preferred bidder. Buyer, a pension fund that had previously invested over $700 million in Riverstone funds, was a financial acquirer offering cash that would not disturb Riverstone and Developer's operational and structural relationship with the Company. Rather, Buyer funded Riverstone's goals of taking the Company private, internalizing Developer 2, and maintaining the roles of Riverstone, the Officer Defendants, and the and Director Defendants—all for a low price.

Brookfield, a strategic acquirer, offered a stock-for-stock combination with its subsidiary, a successful business in the energy sector.[49] This offered superior value to Company stockholders, but nothing for Riverstone and Developer 2. While Brookfield contemplated internalizing Developer 2 and meeting Riverstone's other wants, in the end, Brookfield envisioned **[*13]** and specifically offered the Company and its public stockholders a clean break from Riverstone and its affiliates. In the end, Brookfield walked away and Buyer emerged victorious.

According to Plaintiff, Buyer prevailed because Riverstone, armed with insider Individual Defendants, a conflicted advisor, and the Consent Right, put the Company up for sale; partnered with Buyer to present a bid for both the Company and Developer 2 that would cash out the Company's public stockholders (except for certain preferred and interested stockholders) at an inadequate price, while capturing a premium for Developer 2; tilted the scale in favor of Buyer's bid and against Brookfield's premium bid; and failed to adequately disclose material conflicts and process flaws to Company stockholders. Plaintiff disputes the fairness of the Merger consideration received from the all-cash transaction; contends that Company fiduciaries breached their duties to stockholders by agreeing to the Merger, prioritizing Riverstone over Company stockholders, and issuing a supposedly false and misleading proxy statement; and alleges that the Company's non-stockholder affiliates, Riverstone and Developer 2, influenced **[*14]** and controlled the Merger process to steer the Company toward Buyer and away from more favorable bidders.

With this overview of the Company's relationship with Riverstone and the allegedly resultant outcome of the sales process, our story begins in 2017 with the details of Developer 2's creation.

B. The Company Launches Pattern Vision 2020 To Meet Record Demand; Riverstone Obtains The Consent Right Over Transfers Of The Company's Stake In Developer 2; And Company Fiduciaries

---

[42] *Id.* ¶¶ 47, 323.

[43] *Id.* ¶ 37.

[44] *Id.* ¶ 47.

[45] *Id.* Bellinger resigned from the Board on December 28, 2018. *Id.* ¶ 47 n.4.

[46] *Id.* ¶ 47. Hoffman resigned from the Board on August 6, 2018. He founded one of the bidders that would go on to express interest in the Company and participate in the Merger process. *Id.* ¶ 47 n.3.

[47] *Id.* ¶¶ 24-31. Because of Garland's dual role as director and officer, he is included in references to both the Director and Officer Defendants. *See id.* ¶¶ 31, 36.

[48] *See id.* ¶¶ 25, 27-30.

[49] *See, e.g., id.* ¶ 194.

Tout Excellent Performance.

Riverstone and the Company leveraged the public focus on renewable energy to improve the Company's supply chain and capital structure.[50] In June 2017, the Officer Defendants announced "Pattern Vision 2020," a strategic initiative to double the Company's size and revamp its capital structure within three years, with positive results beginning in 2020.[51] The first part of the plan was to wind down Developer 1's operational relationship with the Company, replacing Developer 1 with Developer 2.[52] The Company pitched its investment in Developer 2 as aligning the Company's interests with Developer 2 based, at least in part, on the Company's rights of first offer.[53]

Riverstone and the Company **[*15]** became Developer 2 limited partners under its Second Amended and Restated Limited Partnership Agreement (the "Partnership Agreement").[54] Section 12.01 of the Partnership Agreement gave Developer 2 the Consent Right over transfers of any limited partner's interests in Developer 2 by a limited partner other than Riverstone—such as the Company.[55] Developer 2's board could withhold its consent in its "sole discretion"; was "entitled to consider only such interests and factors as it desires and shall have no duty or obligation to give any consideration to any interest of, or factors affecting, the Partnership, any Partner or any Transferee"; and could exercise its discretion without being "subject to any other or different standards imposed by this Agreement or any other agreement contemplated hereby or under the Act or any other law, rule or regulation."[56] The Consent Right restricted transfers only if the Company *sold* its stake via merger or consolidation. It did not restrict the Company's right to *acquire* a third party, and therefore left an opportunity to structure a potential Company merger to avoid triggering the Consent Right.[57] Because Riverstone dominated over Developer 2 and its board, **[*16]** Developer 2's Consent Right effectively gave Riverstone power over any third-party acquisition of the Company, even if Riverstone liquidated its Company stake.[58]

The second part of Pattern Vision 2020 involved selling a significant stake in the enterprise to a third party, Public Sector Pension Investment Board ("PSP").[59] PSP purchased 9.9% of the Company directly from Developer 1.[60] PSP also indirectly acquired 22% of Developer 2 through Riverstone funds, which was not publicly disclosed at the time of the acquisition or later in connection with the Merger.[61] Thus, PSP became both the Company's largest individual stockholder and a significant undisclosed Developer 2 stakeholder alongside Riverstone.[62]

---

[50] *See id.* ¶¶ 53-54.

[51] *Id.* ¶ 56.

[52] *Id.* ¶¶ 2, 38, 57-59.

[53] *Id.* ¶ 60.

[54] *Id.*

[55] Riverstone is the only limited partner exempted from the Consent Right. *Id.* ¶ 62. The Company also had substantial leverage over Developer 2 under the Partnership Agreement. Under Section 3.2, if Developer 2 proposed to "Transfer any material portion of the Equity Interests or all or substantially all of the assets of [Developer 2]," the Company had a right to receive notice and offer to purchase those equity interests or assets within 45 days. *Id.* ¶ 69. If the Company's offer was rejected, Developer 2 could only sell the equity interests or assets within six months for an amount greater than or equal to 110% of the Company's offer price. *Id.* And under Section 9.06(g), Developer 2 was required to obtain the Company's consent before initiating or settling litigation concerning over $10 million. *Id.* ¶ 70 (emphasis omitted).

[56] *Id.* ¶ 63 (emphasis omitted).

[57] *Id.* ¶¶ 62, 67-68; Proxy at 36.

[58] Compl. ¶¶ 62-64. The Company and Developer 2 acknowledged this reality in the Amended and Restated Purchase Rights Agreement dated as of June 16, 2017 (the "Purchase Rights Agreement"). *Id.* ¶ 66. At this time, Developer 1's consent right lapsed under the shareholder agreement Developer 1 and the Company executed in connection with the IPO, and therefore Riverstone could not use Developer 1 as a vehicle to block the Company mergers. *Id.* ¶ 64.

[59] *Id.* ¶ 71.

[60] *Id.* ¶¶ 71-72.

[61] *Id.* ¶¶ 71-75, 277.

[62] *Id.* ¶ 71. PSP also entered into a joint venture agreement with the Company where it received the right to co-invest in renewable energy projects alongside the Company up to an aggregate amount of $500 million. *Id.* ¶ 72. The joint venture agreement contained a twelve-month standstill provision. *Id.* ¶ 73. Thus, despite the fact that the Company's strategic plan was a three-year plan and forecasted positive results beginning in 2020, PSP was free to facilitate a sale of the

The Company assured investors that Pattern Vision 2020 was progressing as planned.[63] In November 2017, Garland told public investors that the Company had "a plan for creating long-term value for investors."[64] Garland pressed that the Company's June 2017 Developer 2 investment, along with an October 2017 equity raise, "allows us to begin the next phase of our growth strategy" with "excellent growth opportunities," including "the near-term iROFO [identified **[*17]** right of first refusal] assets . . ., our investment in [Developer 2], and the expanded development pipeline of more than 10 gigawatts at [Developer 2]."[65]

Garland made similar assurances to Company investors throughout 2018, repeating that the Company continued to execute on Pattern Vision 2020 and expected resultant and substantial benefits as early as 2020.[66] Among those assurances was the representation that "that the operating portfolio can sustain the existing level without raising common equity any time soon."[67]

Company management continued to crow about Pattern Vision 2020 and its trajectory through 2019.[68] In particular, on March 1, May 10, and August 6, Garland and Pederson told investors there was limited risk that the Company would need to access additional capital to keep its asset portfolio operating; that the Company did not intend to raise common equity capital; that even so, the Company had ample liquidity and financing options for future growth, including ready access to outside capital; and that the Company's investment in Developer 2 would break even and net positive by 2020.[69] In August, Garland projected that gains realized from Developer 2's third-party sales **[*18]** would come to subsidize future development projects and reduce the Company's future capital contributions to Developer 2 and concluded that the Company's investment in Developer 2 "secure[d] [the Company] access to continued growth opportunities as well as material and durable returns that [the Company] anticipate[d] [would] begin next year."[70]

Thus, throughout 2018 and 2019, Company investors repeatedly heard about the Company's stable and promising liquidity and growth as a standalone entity under Pattern Vision 2020, with no need to raise common equity capital through acquisition. Peddling these upward projections, the Company did not face an exigent need to be acquired. But, unbeknownst to the investors, in June 2018, Riverstone and the Officer Defendants had commenced a sales process with the Board's full cooperation.[71]

C. The Company Commences A Sales Process With Riverstone's Involvement.

At some time prior to June 2018, Riverstone considered taking the Company private, retaining Goldman Sachs & Co. ("Goldman") and using the Company's confidential information in the process.[72] Riverstone did not follow through on taking the Company private. Rather, on June 5, 2018, the **[*19]** Board held its annual meeting, during which it resolved to commence a sales process, despite the Company's strong independent performance.[73] Without raising the issue to the Board's disinterested and independent members, Garland and Riverstone-affiliated management had contacted an advisor, Evercore Group LLC ("Evercore"), in time to get a complete presentation that "included preliminary potential valuations for various strategic options."[74] Before the June 5 meeting, management circulated Evercore's presentation, together with a memo outlining its view on the Company's strategic alternatives.[75]

Company by June 16, 2018. *Id.*

[63] *Id.* ¶ 76.

[64] *Id.* ¶ 78 (emphasis omitted).

[65] *Id.* (first alteration in original).

[66] *Id.* ¶ 79.

[67] *Id.*

[68] *Id.* ¶¶ 81-90.

[69] *Id.* ¶¶ 81-89.

[70] *Id.* ¶ 89 (four of five alterations in original). The projections that formed the basis of the Merger's fairness opinion projected hundreds of millions of dollars in distributions from Developer 2 and only $11 million of future investments from the Company into Developer 2. *Id.* ¶ 82 n.9.

[71] *Id.* ¶ 90.

[72] *Id.* ¶ 93; Proxy at 36.

[73] Compl. ¶¶ 98, 106-07.

[74] *Id.* ¶ 95 (emphasis omitted).

[75] *Id.* The Company refused to produce both the management memo and the Evercore presentation in response to Plaintiff's Section 220 Demand.

Garland led the meeting, and advocated that the Board "consider a potential sale of the business."[76] The Board discussed "the value which investors and potential buyers ascribed to development activities" and "the assumptions made in the Evercore valuation materials[.]"[77] Chris Hunt, a Developer 2 director and Riverstone partner, but not a Company fiduciary, attended the meeting and accessed Evercore's evaluation.[78] The Board solicited Riverstone's views on a potential transaction, while simultaneously identifying Riverstone as a prospective acquirer that "may be interested in participating in **[*20]** a potential transaction."[79] Despite having the opportunity to speak, Riverstone did not disclose to the Board that it had tinkered with the idea of a take-private before the June 5 meeting. The Board concluded that the Company should begin to engage in negotiations with interested parties.[80] The Board recognized at the outset that Riverstone was conflicted with respect to any sale, including because Riverstone was a potential acquirer.[81]

D. The Board Forms The Special Committee, Which Kicks Off The Sales Process.

On June 5, the Board adopted a resolution creating a special committee (the "Special Committee") comprised of Bellinger, Batkin (chairperson), Hall, and Newson.[82] The resolution stated that the Board "determined that it is in the best interests of the Company and its shareholders to conduct a strategic review and consider and evaluate possible strategic transactions outside of the ordinary course of business with the potential to increase value to the Company's shareholders," and that "the Board believes that it is in the best interests of the Company and its shareholders to establish a special committee of the Board comprised solely of disinterested and independent **[*21]** directors . . . to consider and evaluate Strategic Transactions and all matters pertaining thereto on behalf of the Company."[83] The Board exclusively delegated to the Special Committee "all the power and authority of the Board to consider and evaluate Strategic Transactions and all matters pertaining thereto on behalf of the Company," as well as the authority to appoint advisors and Company officers to assist in the process.[84]

In December 2018, Bellinger resigned from the Board, and Goodman and Sutphen were appointed to the Board.[85] Goodman and Sutphen were then appointed to the Special Committee.[86] Accordingly, the Special Committee that ultimately oversaw the sales process from December 2018 until the Merger's closing consisted of Batkin as chairperson, Hall, Newson, Goodman, and Sutphen, all of whom the Company characterized as disinterested and independent.[87]

Garland and Browne were disqualified from serving on the Special Committee because they harbored obvious conflicts arising out of their relationships with Riverstone: Garland was a Developer 2 officer, director, and investor, and Browne was a longtime Riverstone partner and managing director.[88] Even so, the Special Committee **[*22]** allowed Browne to attend the majority of Special Committee meetings in his capacity as Riverstone's representative and to attend the Special Committee's executive sessions where Company management was specifically excluded due to conflicts.[89] The Special Committee also permitted Garland to have substantial involvement in its process.[90] The Special Committee delegated primary responsibility for engaging with the Company's potential suitors to Garland, despite his status as a Riverstone fiduciary and the risk he would disclose material sales

[76] *Id.* ¶ 94.

[77] *Id.* ¶ 96 (emphasis omitted) (alteration in original).

[78] *Id.* ¶¶ 93, 97. Hunt's attendance at the June 5 meeting was not disclosed in the Proxy. *Id.* ¶ 93.

[79] *Id.* ¶ 97 (emphasis omitted).

[80] *Id.* ¶ 92; Proxy at 36-37.

[81] Compl. ¶ 105.

[82] *Id.* ¶¶ 99-100; Weinberger Decl. Ex. 1; Proxy at 37.

[83] Weinberger Decl. Ex. 1 at PEGI-00000472.

[84] *Id.* at PEGI-00000472, -73.

[85] Compl. ¶ 100.

[86] *Id.*

[87] *Id.* ¶¶ 99-100; Proxy at 36, 38.

[88] Compl. ¶¶ 101-02.

[89] *Id.* ¶¶ 102-04. The Proxy does not disclose Browne's attendance at any Special Committee meeting. *Id.* ¶ 104.

[90] *Id.* ¶ 103.

process information to Riverstone.[91]

The Special Committee met for the first time on July 13, 2018 and considered retaining financial advisors.[92] Before that meeting, Batkin and Hall discussed potential advisors with Garland and Lyon.[93] Garland and Lyon preferred Goldman, which had a longstanding relationship with Riverstone.[94] Riverstone was founded and operated by Goldman alumni; Goldman owned at least a 12% stake in Riverstone that entitled certain Goldman funds to a proportional cut of management fees and profits; and in the years before the Merger, Goldman received tens of millions of dollars in fees from Riverstone.[95] Furthermore, Goldman had **[*23]** advised Riverstone on its exploration of taking the Company private, which was disclosed in a July 2, 2018 letter to the Special Committee.[96]

Despite Garland and Lyon's push for Goldman, the Special Committee decided to retain only Evercore and to revisit the possibility of retaining Goldman at a later time.[97] The Special Committee also engaged Paul, Weiss, Rifkind, Wharton & Garrison LLP ("Paul Weiss") as independent legal counsel.[98]

The Special Committee met again on August 2.[99] Batkin proposed the Special Committee approach "both Riverstone and [PSP] . . . at the outset, given their current investments in the Company and the Pattern Development Companies, . . . their knowledge of potential partners and their familiarity with management."[100] In accordance with Batkin's suggestion, when the Special Committee met next on October 29, a PSP representative attended, as well as Browne, as Riverstone's representative.[101] At that meeting, an Evercore presentation reviewed the Company's projections and valuations under different strategic alternatives.[102] With Riverstone and PSP at the table, meeting participants also discussed the "potential for a transaction with PSP, Riverstone, or another **[*24]** party."[103] Garland also explained that he had been approached by both Brookfield and Party B about a potential transaction.[104] Paul Weiss outlined a number of process.[105]

The Special Committee, plus Browne, met again the following day, October 30.[106] The Special Committee authorized Garland to meet with both Brookfield and Party B and solicit their interest in making a strategic proposal for the Company.[107]

In early November 2018, the Special Committee established conduct guidelines for management and Board members who were not members of the Special Committee "in order to help ensure that the Special Committee would be able to function independently and effectively execute its mandate."[108] These guidelines prohibited Company management from engaging with any potential parties to a strategic transaction without the Special Committee's express consent.[109]

On November 19, the Board met, and Garland informed the Board that meetings and negotiations were progressing with Brookfield, but Party B was not interested in pursuing a transaction at that time.[110]

E. The Special Committee Engages With Numerous Bidders.

[91] *Id.* ¶ 105.

[92] *Id.* ¶ 106.

[93] *Id.*

[94] *Id.* ¶¶ 98, 106-07.

[95] *Id.* ¶ 107.

[96] *Id.* ¶ 98.

[97] *Id.* ¶ 108; Proxy at 37.

[98] Proxy at 37.

[99] Compl. ¶ 109; Proxy at 37.

[100] Compl. ¶ 109.

[101] *Id.* ¶ 110; Proxy at 37.

[102] Compl. ¶ 111.

[103] *Id.* (alteration omitted).

[104] *Id.* This opinion and the Proxy refer to other bidders as "Party—" for confidentiality purposes. *See* D.I. 69 at 13-17.

[105] Proxy at 37.

[106] *Id.*; Compl. ¶ 112.

[107] Compl. ¶ 112.

[108] Proxy at 37.

[109] *Id.* at 37-38.

[110] *Id.* at 38.

Over the next year, the Special Committee would engage with several bidders, gaining **[*25]** momentum in the summer of 2019. While the Complaint's allegations focus primarily on the tale of two bidders—Buyer and Brookfield—other bidders' indications of interest and the Special Committee's response are important to a full understanding of the sale process. The Special Committee's engagement with these other bidders, referred to in the Proxy as Party B and Party D, was interspersed with its engagement with Brookfield and Buyer.[111] Each bidder was pressed for a premium, and Party B and Party D received confidential information and executed confidentiality agreements with both the Company and Riverstone, just as Brookfield and Buyer would do.[112]

And, just as Brookfield and Buyer would, Party B and Party D demonstrated an understanding that any transaction needed to include Developer 2 and to satisfy Riverstone. Party D's first offer, on July 8, 2019, was to acquire the Company for $25 in cash and Developer 2 at a multiple of 1.6x invested capital in either cash or equity.[113] On July 15, Party D revised its offer for Developer 2 to 1.8x invested capital plus a potential earn-out, in response to feedback that an attractive and competitive offer would offer a premium **[*26]** for Developer 2.[114] On August 15, reaffirming its interest to cash out the Company's public stockholders and merge the Company with Developer 2 in an equity-based transaction, Party D noted that, "[a]s you are aware, we are engaged in productive discussions with [Riverstone] on the terms under which we would govern the new combined company."[115] Bidders were under the impression that any post-closing entity would be subjected to Riverstone's continued presence.

On August 19, the Special Committee discussed Party D's offer and authorized Evercore and Goldman to request written proposals based on publicly available information.[116] At an August 26 Special Committee meeting, Evercore reported Party D orally raised its offer for the Company to $26.50 per share.[117] The next day, August 27, Party B submitted to a non-binding letter of interest to acquire the Company in an all-cash transaction for $25 to $28 per share, and 100% of Developer 2 at an unspecified price.[118]

On September 20, Party D upped its cash offer for the Company to $26.75 per share, which included Developer 2 at a valuation of approximately $800 million plus an earnout for the 71% not owned by the Company.[119] Party D would have allowed **[*27]** Riverstone to hold equity in the combined entity.[120] Party D stated it had reached an agreement on all key terms with Riverstone, describing Riverstone as one of "the three legs of the stool that are critical to accomplishing our objective of acquiring and combining [the Company] and [Developer 2]."[121] On September 23, Evercore sent Party D a draft merger agreement, and eventually arranged a meeting with Party D, the Company, and Riverstone to discuss the transaction.[122]

In the final weeks of the process, the Special Committee was considering Brookfield, Buyer, Party B, and Party D. On September 29, the Special Committee determined to proceed cautiously with Party B, given that Party B was a competitor and its "indicative price did not exceed prices offered by other potential buyers."[123] By mid-October, Party B had determined it was not willing to move forward.[124] On October 17, Evercore instructed Brookfield, Buyer, and Party D to

[111] *See id.* at 37-53. Buyer, Brookfield, Party B, and Party D emerged as the primary prospects, but other bidders also expressed interest and were considered.

[112] *See, e.g., id.* at 43, 48. After the Special Committee noted it could not give competitively sensitive due diligence to Party B because Party B was a significant competitor, on September 6, Party B and the Company entered into a confidentiality agreement; the Company, Party B, and a Riverstone affiliate entered into a side letter. *See* Compl. ¶¶ 170; Proxy at 47, 48.

[113] Compl. ¶ 149; Proxy at 38.

[114] Compl. ¶ 149; *see also* Proxy at 43.

[115] Compl. ¶ 160.

[116] Proxy at 45.

[117] Compl. ¶ 168 n.20.

[118] *Id.* ¶ 169; Proxy at 46.

[119] Compl. ¶ 181.

[120] *Id.*

[121] *Id.*

[122] Proxy at 49; *see also id.* at 50 (noting the Company met with Party B and Riverstone on September 25).

[123] *Id.* at 50.

[124] *Id.* at 51.

submit their "best and final" offers by October 28.[125] Party D did not submit a best and final offer and ultimately withdrew.[126]

F. Brookfield Proposes A Merger With The Company; The Special Committee Seeks A Premium; And The Parties Begin Due Diligence [*28] .

Throughout January and February 2019, Garland and other members of Company management continued discussions with Brookfield.[127] On January 14 and January 15, management met with Brookfield representatives.[128]

On January 16, the Board met with Company management.[129] Garland informed the Board that at the Special Committee's direction, he and other members of Company management had met with Brookfield and engaged in initial discussions regarding a potential strategic transaction involving the Company, Brookfield, and TerraForm Power, Inc. ("TerraForm").[130] TerraForm is publicly traded and Brookfield-controlled.[131] At that time, none of the Company's material confidential information had been shared with Brookfield and TerraForm.[132]

On January 25, the Special Committee met for an update on management's discussions with Brookfield.[133] Management developed and summarized a stock-for-stock combination of the Company and TerraForm at an at-market exchange ratio (*i.e.*, no premium).[134] The Special Committee excused management from the meeting and held an executive session to further evaluate the TerraForm proposal and consider next steps.[135] The Special Committee asked its advisors, Paul Weiss and Evercore, **[*29]** to evaluate an at-market share exchange as a potential transaction.[136]

On February 7, Garland revisited Brookfield and TerraForm.[137] On February 15, at the Special Committee's direction, Batkin, Garland and Evercore representatives met with Brookfield representatives, and Brookfield proposed an at-market all-stock merger of the Company and TerraForm.[138] On February 21, Brookfield submitted a term sheet. Brookfield expressly indicated that its offer was not conditioned an acquisition of Developer 2: under the proposal as submitted, Riverstone could be excluded from the transaction.[139]

That same day, after receiving Brookfield's proposal, the Special Committee met.[140] At that meeting, Garland flagged Developer 2's Consent Right, telling the Special Committee that Brookfield's proposed transaction could "trigger existing consent rights held by" Riverstone.[141] The Special Committee also considered that Brookfield's offer did not include a premium, but decided to respond to the offer. It directed Paul Weiss and Evercore "to analyze the proposed transaction's structure and terms, including with respect to issues relating to [the Company's] relationship with [Developer 2] and the absence of any **[*30]** premium to be offered to holders of Company Common Stock,"[142] and to prepare a response.[143] The Special Committee also authorized mutual due diligence, subject to a confidentiality agreement.[144] Accordingly, on February 28, the Company executed a confidentiality agreement with Brookfield and TerraForm that included standstill

---

[125] *Id.*; Compl. ¶ 191.

[126] Proxy at 52.

[127] Compl. ¶ 113.

[128] Proxy at 38.

[129] *Id.*

[130] *Id.*

[131] *Id.*

[132] *Id.*

[133] *Id.*; Compl. ¶ 113.

[134] Proxy at 38.

[135] *Id.*

[136] *Id.*

[137] *Id.*

[138] *Id.*

[139] Compl. ¶ 114.

[140] *Id.* ¶ 116; Proxy at 39.

[141] Compl. ¶ 116.

[142] Proxy at 39.

[143] Compl. ¶ 118.

[144] Proxy at 39.

provisions.[145]

The Special Committee met again on March 9 to review Brookfield's term sheet, joined by Paul Weiss, Evercore, Garland, Browne, and Elkort, Chief Legal Officer for the Company and Developer 2.[146] Batkin and Garland updated the Special Committee regarding recent discussions with Brookfield. Garland told the Special Committee that it would need to evaluate the Consent Right.[147] Elkort was even more explicit.[148] The meeting minutes state that Elkort "emphasized" to the Special Committee that "the need for [Riverstone's] support for any potential . . . transaction should not be underestimated because [Riverstone's] rights to consent that would likely be implicated by the proposed transaction appeared to be very broad."[149] Nonetheless, based on Evercore's advice, the Special Committee determined to seek from Brookfield a 15% premium to the trading price of Company common **[*31]** stock.[150]

At the meeting's conclusion, the Special Committee met in executive session, with management "excused from the meeting," but with Browne still in attendance.[151] During that session, the Special Committee directed Paul Weiss and Evercore to revise Brookfield's term sheet.[152] The Special Committee also established "guidelines for management's discussions with the various parties."[153] The Special Committee determined that the Company would deliver the revised term sheet to Brookfield; Batkin would continue to coordinate, and have the option to be involved in, discussions with Brookfield and any other potential transaction parties; and Batkin would continue to serve as the Special Committee's representative.[154] The Special Committee authorized Garland to "notify" Developer 2 and Riverstone about the Company's discussions with Brookfield, but directed that Garland was not to "divulg[e] any specific terms" to Developer 2 or Riverstone.[155] At the close of the executive session, the Special Committee instructed Paul Weiss to inform management of the following:

> The Committee noted that it shall continue to be informed of developments arising from any of the discussions that it had authorized, that **[*32]** management and the advisors shall refrain from taking any further steps or engaging in any further discussions without the express authorization of the Committee and that the Committee shall retain final decision-making authority with respect to [the sales process].[156]

These instructions bolstered the instructions the Special Committee provided management and Browne in November 2018. The Special Committee did not formally meet again until May.[157]

Paul Weiss and Evercore revised the Brookfield term sheet as instructed; management did not assist.[158] On March 11, the Company provided Brookfield with a revised term sheet that contemplated a Company-TerraForm merger with a 15% premium for Company stockholders.[159] The revised term sheet recognized the Consent Right was readily circumvented, stating that the parties would "need to structure the transaction as a merger of [TerraForm] into a subsidiary of [the Company] due to" the Consent Right and that that the "structure" would "not affect the economic terms of the transaction."[160] On March 20—with the Special Committee's authorization—Batkin, Company management, Evercore, and Paul Weiss met with Brookfield to discuss the potential Company-TerraForm **[*33]** merger.[161] They decided to move forward with due diligence.[162]

After it became evident that a Company-Terraform

145 *Id.*

146 Compl. ¶¶ 116-17; Proxy at 39.

147 Compl. ¶ 116.

148 *Id.* ¶ 117.

149 *Id.*

150 Proxy at 39.

151 Compl. ¶ 117; Proxy at 39.

152 Compl. ¶ 118.

153 *Id.*

154 Proxy at 39.

155 Compl. ¶ 119.

156 *Id.* ¶ 120 (emphasis omitted).

157 *Id.* ¶ 122.

158 *Id.* ¶ 121.

159 *Id.*; Proxy at 39.

160 Compl. ¶ 121 (emphasis omitted).

161 Proxy at 39-40.

162 *See id.* at 40.

merger could be accomplished without including Developer 2 or triggering the Consent Right, Garland engaged in discussions with Brookfield, Riverstone, and Buyer that were not sanctioned by the Special Committee.[163] On March 12, Garland had an unauthorized communication with representatives of Brookfield and TerraForm about a potential transaction involving the Company, Brookfield, and TerraForm.[164] And on April 11, the Company, Brookfield, and a Riverstone affiliate entered into a three-party side letter to the Company-Brookfield confidentiality agreement to facilitate Brookfield's due diligence review of Developer 2.[165] The Company and Riverstone's affiliate entered into a mutual confidentiality agreement.[166] From this timeline, it is reasonable to infer that Company representatives revealed to Brookfield the sales process' goal of internalizing Developer 2 and including Riverstone. This conclusion is consistent with Brookfield's later statement that "it had been told early in the process that [the Company] believed it was desirable for [Company]'s senior management to maintain **[*34]** their positions in the combined company, including their dual positions at [Developer] 2" and "that it was a priority for [the Company] to internalize [Developer] 2 as part of a transaction."[167]

Aware that Developer 2 was in play, on April 16, Brookfield met with Batkin, Company management met, and the "Riverstone Representatives"—specifically, two Developer 2 directors[168]—"to discuss how [Developer 2] would be affected by a transaction."[169] The Riverstone Representatives indicated Riverstone would be open to considering any proposals from Brookfield involving Developer 2 and the Company.[170] Brookfield responded that would be potentially interested in a combination of the Company and TerraForm, with the surviving company directly acquiring Developer 2.[171] Throughout April 2019, at the direction of the Special Committee, the Company continued due diligence into Brookfield's proposal.[172]

G. The Special Committee Hires Goldman; Garland Identifies Buyer As A Potential Bidder.

As due diligence progressed with Brookfield, Goldman resurfaced. In early April, the Special Committee retained Goldman as "a second financial advisor" with respect to evaluating **[*35]** proposals for a potential transaction, notwithstanding the fact that Goldman had long-term and lucrative relationships with Buyer and Riverstone,[173] and had advised Riverstone on a potential take-private of the Company using confidential information provided by Riverstone shortly before the sales process began.[174] The Special Committee never requested access to the materials Goldman prepared for Riverstone, even after Goldman offered to provide them.[175]

Interestingly, the Special Committee retained Goldman only informally in April and, as alleged, involved Goldman in the sales process throughout April and May.[176] It did not formally engage Goldman to evaluate

[163] Compl. ¶¶ 120, 123-24.

[164] Compl. ¶ 123; *compare* Proxy at 39 ("On March 12, 2019, Mr. Garland spoke with representatives of [Brookfield] and [TerraForm] about a potential transaction involving Pattern, [Brookfield] and [TerraForm]."), *with* Compl. ¶ 123 ("On March 20, 2019, *as authorized by the Special Committee*, Mr. Batkin, [Company] management and representatives of Evercore and Paul Weiss met with representatives of Party A to discuss the terms of a potential transaction involving [the Company] and Company A." (emphasis added)).

[165] Proxy at 40.

[166] *Id.*

[167] Compl. ¶ 174.

[168] *Id.* ¶ 124.

[169] Proxy at 40.

[170] *Id.*

[171] *Id.*

[172] *Id.*

[173] Compl. ¶ 271 & n.26.

[174] *Id.* ¶¶ 107, 134, 136; Proxy at 40.

[175] Compl. ¶ 107. The Partnership Agreement restricted Riverstone from using any confidential information relating to, among others, the Company, which had been entrusted to Developer 2 with the expectation that the information be kept confidential. Kirby Decl. Ex. 25 § 15.06. Plaintiff alleges that the Board did nothing to prevent Riverstone from leveraging its access to the Company's confidential information and that no information regarding Riverstone's allegedly impermissible information sharing with Goldman was disclosed in the Proxy. Compl. ¶ 98.

[176] *Compare* Proxy at 40 ("In early April 2019, the members of the Special Committee determined to continue to engage Evercore with respect to evaluating proposals with respect to a

a potential transaction and execute an engagement letter until May 24.[177] Goldman's engagement letter provided it stood to receive $2 million upon the announcement of a Merger and an additional $4 million upon the execution of the Merger.[178] The Company, Riverstone, and Buyer also retained the right to provide Goldman with an additional $3 million following the execution of the merger if they saw fit.[179] This information was not disclosed in the Proxy, and neither the Proxy nor the *Section 220* production explain why the Special Committee decided to belatedly **[*36]** retain Goldman.[180]

Throughout April, the push to satisfy Riverstone and Developer 2 continued. In addition to expanding the scope of the potential Brookfield transaction to include Developer 2, Garland turned his attentions to another potential bidder: Buyer, which had established investment ties to Riverstone investment funds and would ultimately prevail in purchasing the Company and Developer 2.[181] On April 15, Garland had an unauthorized meeting with the Riverstone Representatives and Buyer (the "April 15 Meeting").[182] There, Buyer "indicated that [it] was potentially interested in acquiring [the Company]."[183] According to Merger disclosures, while Garland eventually disclosed the April 15 Meeting to Batkin and the Special Committee, it took him a month to do so.[184]

The Special Committee met on May 2 with Company management, Paul Weiss, Evercore, and Goldman.[185] While the Proxy states Garland disclosed the April 15 Meeting at the May 2 Special Committee meeting, this is unsupported by the meeting minutes.[186] The meeting minutes do not mention Buyer, let alone that Garland had met with Riverstone and Buyer weeks earlier to discuss Buyer potentially acquiring the Company. **[*37]** [187] In another wrinkle, the minutes state Garland told the Special Committee that Riverstone had suggested taking the Company private, but "dropped the suggestion following consideration of conflicts and certain contractual obligations."[188] According to Plaintiff, Riverstone had not "dropped the suggestion" as Garland represented.[189] Rather, Riverstone, with Garland's active involvement, sought a deal by which it would take the Company private along with Buyer.[190]

On May 15, a month after Garland's April 15 Meeting, Batkin informed the Special Committee that Garland had spoken to Buyer via a memo (the "Batkin Memo").[191] The Batkin Memo stated that Garland had discussions with Riverstone and Buyer concerning a potential acquisition by Buyer and that Garland "spoke to" a Buyer representative who Garland "knew when this person worked at General Electric."[192] The Batkin Memo did not disclose to the Special Committee that Garland's unauthorized discussions had occurred a full month earlier.[193] It also gave the impression that Garland spoke to Buyer independently, while the Proxy discloses Garland met with Buyer and Riverstone together.[194] This was the only memo Batkin sent to the Special Committee **[*38]** throughout the sales process.

A May 24 Special Committee meeting focused on

potential transaction. The Special Committee also determined to retain Goldman . . . ."), *with id.* at 41 (stating that "[o]n May 24, 2019," Goldman attended a Special Committee meeting, and after being excused from that meeting, the Special Committee "considered amending its formal engagement of Evercore and formally engaging Goldman Sachs" and ultimately "adopted resolutions to amend its formal engagement letter with Evercore and to execute an engagement letter with Goldman Sachs with respect to evaluating a potential transaction").

[177] *Id.* at 41.

[178] Compl. ¶ 271.

[179] *Id.*

[180] *Id.*

[181] *Id.* ¶ 124.

[182] *Id.*

[183] *Id.*; Proxy at 40.

[184] Proxy at 40.

[185] Compl. ¶¶ 126-27; Proxy at 40.

[186] *Compare* Compl. ¶¶ 125-27, 137, *with* Proxy at 40.

[187] Compl. ¶ 126.

[188] *Id.* ¶ 127.

[189] *Id.*

[190] *Id.*

[191] *Id.* ¶ 128.

[192] *Id.*

[193] *Id.*

[194] *Compare id., with* Proxy at 40.

Buyer's arrival.[195] The meeting minutes state that Garland "noted that in addition to meeting with [Brookfield], there would also be meetings the following week with [Buyer] and [Riverstone], as [Buyer] had expressed interest in potentially structuring a strategic transaction," and that Buyer's "approach to the Company . . . had come about indirectly."[196] Garland still did not fully disclose to the Special Committee that he had met with Buyer and Riverstone together over a month earlier, and that Buyer's interest as a potential bidder was piqued more directly than Garland suggested.[197]

On May 28, Buyer and the Company entered into a confidentiality agreement, and Riverstone entered into a side letter to facilitate sharing Developer 2 information.[198] By June, Buyer and Riverstone were believed to be working together on a proposal.[199] At some point, without the Special Committee's approval, Goldman joined these discussions which included talk of a take-private action.[200]

After receiving the Batkin Memo and learning of Garland's unauthorized communications, the Special Committee took no steps **[*39]** to reestablish control of the merger process; rather, it continued delegating substantial authority and responsibility to Garland.[201] The Special Committee permitted Garland to continue meeting alone with Brookfield, Buyer, and Riverstone.[202] And he continued wielding authority in the sales process.[203] Plaintiff alleges this passivity suspiciously followed Brookfield's expression of interest in proceeding with a transaction that might exclude Developer 2, as well as the tension between (1) Garland and Elkort's insistence to the Special Committee that Riverstone had a "broad" Consent Right such that Riverstone would have to approve of any merger, and (3) Paul Weiss and Evercore's statements that the Consent Right was easily circumvented.[204]

H. The Special Committee Continues Considering Brookfield.

The Special Committee continued to court Brookfield. At the May 2 meeting, Batkin and Garland summarized recent discussions with Brookfield and Riverstone, and Garland detailed the ongoing due diligence process.[205] The meeting minutes indicate that Brookfield remained interested, regardless of whether the transaction included Developer 2.[206] But Garland noted that Riverstone preferred any merger **[*40]** to involve Developer 2.[207] The Special Committee excused management and commenced an executive session to evaluate potential issues with Brookfield, including the Consent Right.[208] The Special Committee reiterated the "potential conflicts involving certain members of senior management."[209] Yet the minutes show Browne attended the entire meeting, including the executive session.[210]

Brookfield was also considered at the May 24 meeting. Goldman and Evercore noted that Brookfield had "indicated a desire to seek" Riverstone's consent to any transaction with the Company, but that a "[Company]-on-top triangular merger may not trigger [Riverstone's] consent right."[211] Goldman and Evercore also listed the benefits of a Brookfield transaction: the creation of a leading renewables platform with enhanced scale and diversification; a strong sponsor in Brookfield that would team with best-in-class management at the Company; synergies that would drive cash flow and support dividend growth; an expanded project development portfolio; a reduced reliance on external financing with no need to raise common equity through 2023; a stronger credit profile; and a better governance structure

[195] Compl. ¶ 139.

[196] *Id.* ¶ 140.

[197] *Id.*

[198] Proxy at 41.

[199] Compl. ¶ 143.

[200] *See id.* ¶¶ 306, 311(a)-(b).

[201] *Id.* ¶ 133.

[202] *Id.* ¶ 141.

[203] *Id.* ¶ 133.

[204] *Id.* ¶ 130.

[205] Proxy at 40.

[206] Compl. ¶ 138.

[207] *Id.*

[208] Proxy at 40.

[209] Compl. ¶ 138.

[210] *Id.* ¶ 134 n.14.

[211] *Id.* ¶ 139.

that aligns the incentives **[*41]** of the sponsor and public stockholders.[212]

On May 29, at the Special Committee's direction, Garland met again with Brookfield; Riverstone attended that meeting, despite having started working with Buyer on a potential acquisition.[213] Garland and Riverstone "provide[d] an overview of [Developer 2] and its business plan to [Brookfield]" and answered questions.[214] That same day, at the Special Committee's direction, Garland met with representatives of Buyer and Riverstone to do the same.[215]

On May 30, Batkin met with Company management, Paul Weiss, Evercore, and Brookfield "to discuss key open issues identified by the Special Committee with respect to a combination of [the Company] and [TerraForm], including price and the need to insulate holders of Company Common Stock from the risks associated with" litigation TerraForm was embroiled in.[216] Those conversations proved productive. On May 31, Brookfield submitted a revised term sheet reflecting not only TerraForm's all-stock acquisition at the 15% premium that the Company had contemplated back in March, but also a concurrent acquisition of Developer 2 for a cash price to be negotiated by the Company and Riverstone, such that Riverstone would **[*42]** be cashed out and no longer have any ownership interest in the Company or Developer 2 post-closing.[217]

The Special Committee met on the next day to review Brookfield's submission and "discuss[] next steps with respect to [Brookfield]'s recent proposal";[218] consistent with ongoing practice, Browne was present for the entire meeting.[219] Garland reported to the Special Committee that "[Riverstone] had indicated it would work with all parties potentially interested in [Developer 2] to provide information," but that "it also appeared that [Buyer and Riverstone] may be working with each other regarding a potential proposal."[220] As alleged, this statement was a half-truth: Garland had known since at least mid-April that Buyer and Riverstone were working together.[221]

Nonetheless, the Special Committee pressed forward with Brookfield.[222] On June 4, at the Special Committee's direction, Paul Weiss sent Brookfield a marked-up term sheet, along with a request that Brookfield confirm that the 15% premium was not subject to continued due diligence.[223] The revised term sheet reflected certain structural changes designed to insulate the Company's common stockholders from potential liabilities associated with ongoing **[*43]** litigation involving TerraForm.[224] On June 5, Paul Weiss and Company management met with Brookfield and its outside counsel; they met again on June 7.[225]

I. The Special Committee Entertains Competitive Bids From Brookfield, Buyer, And Others.

Between May and October 2019, Brookfield presented "several updated and enhanced offers" to the Special Committee and Riverstone.[226] The terms of Brookfield's offers were economically superior to Buyer's.[227] But Buyer stayed in the running with Riverstone's vote of confidence, Garland's support, and the Special Committee's active interest.[228]

On June 12, the Special Committee and Browne reconvened.[229] The Special Committee noted that, among other things, Buyer and Riverstone had been negotiating directly without the Special Committee's

---

[212] *Id.*

[213] *Id.* ¶ 141.

[214] Proxy at 41.

[215] *Id.*

[216] *Id.*

[217] Compl. ¶ 142; Proxy at 41.

[218] Proxy at 41.

[219] Compl. ¶ 143 & n.16.

[220] *Id.* ¶ 143 (emphasis omitted); Proxy at 41 ("The Special Committee also discussed [Buyer]'s interest in a potential transaction.").

[221] Compl. ¶ 143.

[222] Proxy at 41.

[223] *Id.*

[224] *Id.*

[225] *Id.* at 41-42.

[226] D.I. 82 at 20; *see* Compl. ¶¶ 142-97.

[227] *See* Compl. ¶¶ 142-97.

[228] D.I. 82 at 20.

[229] Compl. ¶ 144 & n.17.

involvement.[230] Yet, to the extent those negotiations were relevant to acquiring the Company, the Special Committee did not attempt to intervene.[231]

The Special Committee met again on June 18.[232] Batkin reported that Riverstone contacted Garland and stated that Buyer had offered to purchase Developer 2 for a 2x multiple of Riverstone's invested capital.[233] But Buyer had not yet made an offer to acquire the Company: it was focused **[*44]** on Developer 2.[234]

The Special Committee consulted with its advisors and, on June 27, gave management instructions and guidelines regarding next steps.[235] Management was authorized and requested to seek written proposals from Buyer and Brookfield.[236] Management could not discuss "role or compensation arrangements in connection with any potential transaction without specific authorization from the Special Committee, except for limited non-compensation related discussions regarding potential key personnel, operational integration, or staffing in the event a transaction were to occur."[237]

On June 28, Buyer finally submitted a nonbinding proposal to purchase the Company for $25.50 per share, a 14% premium over the volume weighted average price ("VWAP") for the three month period ending June 27, 2019.[238] Buyer contemplated merging the Company and Developer 2 and allowing Riverstone and the Officer Defendants to maintain or receive an equity interest in the combined company.[239] Buyer's offer specifically assumed it would reach a separate agreement with Riverstone with respect to Developer 2, as well as separate agreements with the Company's senior management.[240] Buyer also stressed that it needed **[*45]** to continue its discussions with Riverstone and to discuss the matter with PSP.[241]

On July 1, Brookfield submitted a competitive bid, disclosing it had completed its due diligence and proposing that TerraForm acquire the Company in an all stock merger representing a 15% premium based on trading prices leading up to the time of the announcement.[242] The offer contemplated that the combined entity concurrently acquire Developer 2 for cash at a 1.75x multiple of invested capital, cashing Riverstone out.[243] Brookfield also disclosed it was open to providing Company stockholders with a cash option.[244] The offer hedged that Brookfield needed to reach an agreement with the Company and Riverstone on Developer 2's valuation.[245] With competitive offers on the table, the Special Committee began probing other bidders, and received interest as described above.

On July 12, Brookfield's counsel sent Paul Weiss a draft merger agreement, which provided that Brookfield, but not the Company, would have a termination right in the event that a proposed Developer 2 acquisition failed to close with or before the proposed Company-TerraForm merger.[246] And on July 15, Batkin met with Buyer, which reiterated **[*46]** its interest.[247]

On July 16, Batkin, Paul Weiss, Company management, Evercore, and Brookfield met.[248] They reviewed specifics of the pro forma business plan of the combined company that would result from any Company-TerraForm merger.[249] The parties met again on July

[230] *Id.* ¶ 144.

[231] *Id.*

[232] *Id.* ¶ 145.

[233] *Id.*

[234] *Id.*

[235] Proxy at 42.

[236] *Id.*

[237] *Id.*

[238] *Id.*; Compl. ¶ 147.

[239] Compl. ¶ 147.

[240] *Id.*

[241] *Id.*

[242] *Id.* ¶ 148.

[243] *Id.*

[244] *Id.* ¶ 148 n.18.

[245] *Id.* ¶ 148.

[246] Proxy at 43.

[247] *Id.*

[248] *Id.*

[249] *Id.*

17.[250] On July 16 and 17, Brookfield and the Company exchanged revised term sheets that reflected the same economic terms as Brookfield's July 1 offer, and additionally addressed the "governance of the pro forma combined company."[251]

Brookfield submitted a new offer on July 23.[252] Acknowledging Riverstone's influence, Brookfield noted that the Company's "Board and management wish to also internalize [Developer 2] as part of this transaction" and reiterated that it was open to buying Developer 2 for partial cash in a deal that included a 15% premium to Company stockholders.[253] Brookfield also stated that it would be willing to offer a 20% premium to Company stockholders in a simpler transaction that did not include acquiring Developer 2.[254] This laid bare that including Developer 2 in a transaction would result in less consideration for the Company's public stockholders, and that Riverstone and the Officer Defendants, as Developer **[*47]** 2 stockholders, were competing with Company stockholders for value.[255]

The Special Committee met on July 31 and August 1 to discuss the pending offers, including Brookfield's offer to pay more for the Company alone, without Developer 2.[256] The Special Committee noted that the two offers internalizing Developer 2 provided similar value to Company stockholders; but in a key difference, Brookfield would cash out Riverstone, while Buyer would allow Riverstone to continue to own an equity interest.[257] In addition, the Special Committee weighed "the complexity of [Brookfield]'s proposal" against the proposals from Buyer and Party D, as well as "the certainty of value of [Buyer]'s and [Party D]'s all-cash proposals relative to [Brookfield]'s proposed all-stock transaction with an option to include up to $750 million in cash."[258] The Special Committee recognized that Brookfield's offers exceeded Buyer's then-current offer, estimating that Brookfield's offer at a 15% premium equated to a 1.8413 exchange ratio, or approximately $28.25 per share, based on a 90-day VWAP.[259]

But Evercore flagged that Buyer was already in "advanced stages of negotiation" with Riverstone, and that a combination **[*48]** of the Company and Developer 2 was "in line with management's vision."[260] The Special Committee also discussed PSP's conflicts of interests in any transaction, allegedly recognizing that PSP was not similarly situated to the Company's public stockholders.[261]

According to Plaintiff, at the August 1 meeting, the Special Committee decided to see if Buyer would increase its offer, while holding off on further substantive negotiations with Brookfield.[262] The Special Committee determined that, when it did re-engage with Brookfield, it would convey the importance of reaching an agreement with Riverstone that included Developer 2 and was therefore consistent with management's expectations.[263]

Even so, between August 1 and August 12, the Special Committee directed Evercore and Goldman to encourage Buyer, Brookfield, and Party D to improve their previous proposals.[264] Around this time, Buyer asked for exclusivity.[265] Evercore and Goldman indicated to Buyer that the Special Committee would consider exclusivity only if Buyer raised its offer price for

[250] *Id.*

[251] *Id.*; Compl. ¶ 150.

[252] Compl. ¶ 151.

[253] *Id.*

[254] *Id.*

[255] *Id.*

[256] *Id.* ¶ 152. The July 31 meeting was unusual in that Paul Weiss and Evercore did not attend the meeting, but Goldman did. *Id.*

[257] *Id.* ¶ 154; Proxy at 44.

[258] Proxy at 44.

[259] Compl. ¶ 158.

[260] *Id.* ¶ 157.

[261] *Id.* ¶ 153.

[262] *Id.* ¶ 156.

[263] *Id.* ¶ 157.

[264] Proxy at 44 (providing the Special Committee determined that Evercore and Goldman should encourage each bidder to "improve their offers and to accelerate their work"); *id.* ("Between August 1 and August 12, 2019, at the direction of the Special Committee, representatives of Evercore and Goldman Sachs contacted representatives of [Brookfield], [Buyer] and [Party D] to encourage each potential buyer to improve its previous proposal.").

[265] *Id.*

the Company.[266] Buyer declined.[267]

The market soon caught wind of the Company's suitors. On August 12, *Bloomberg* reported that Brookfield and TerraForm **[*49]** were in merger discussions with the Company.[268] That day Company stock closed at $25.15 per share, representing an increase of $1.85 per share over the closing price on August 9—the last full trading day prior to the *Bloomberg* report.[269] The next day, as requested by Canadian regulators, the Company issued a press release stating that "it had responded to inquiries from third parties, but that no definitive agreement had been reached with respect to a strategic transaction with any party and that there was no assurance that [the Company] would agree to any strategic transaction."[270]

That same day, August 13, Batkin met with Company management, Paul Weiss, Evercore, and Goldman to discuss structuring a Company-TerraForm transaction, including excluding Developer 2.[271] They met again on August 16.[272] Garland reported that, since August 12, the Company received indications of interest from at least seven new potential buyers.[273] After Evercore and Goldman's consideration, Batkin authorized Garland and the advisors to contact these parties.[274]

Later that day, Buyer submitted an updated offer to purchase both the Company and Developer 2 in a transaction that valued the Company in range of $26.25 **[*50]** to $26.50 per share.[275] At that time, this reflected a 15.8% premium over the three-month weighted average price for the Company, which was lower than the 20% premium Brookfield offered to pay in a deal that did not include Developer 2.[276] Buyer did not indicate its valuation of Developer 2.[277] But Buyer expressed its confidence that it could negotiate a definitive price with Riverstone, as they had already engaged in productive discussions.[278] Buyer's offer also assumed that it would reach satisfactory agreements with Company management for their roles in the post-closing entity.[279] In conjunction with the offer and these assumptions, Buyer reiterated its desire to discuss the proposed transaction with PSP.[280]

The Special Committee met on August 19.[281] Buyer had offered to acquire Developer 2 at a price equal to 1.8x of Riverstone's invested capital, subject to an earn-out that could increase the total purchase price to up to 2.25x Riverstone's invested capital; Riverstone believed this offer acceptable.[282] The Special Committee recognized that an integrated offer for both the Company and Developer 2 meant an increase in consideration for the Company would result in a decrease in consideration **[*51]** for Developer 2 and vice versa, requiring the companies to compete for value.[283] Specifically, the Special Committee noted that the Developer 2 earn-out made it less likely Buyer would pay more for the Company, acknowledging that the Company's public stockholders were competing with Developer 2's owners (including Riverstone, PSP, and management) for merger consideration.[284]

Despite this tension, the Special Committee decided to progress with Buyer, authorizing a meeting between Buyer and PSP and instructing Paul Weiss to send Buyer a draft merger agreement.[285] The Special Committee authorized Company management to begin discussing their compensation and post-transaction

[266] *Id.*

[267] *Id.*

[268] *Id.*; Compl. ¶ 159.

[269] Proxy at 44.

[270] *Id.*

[271] *Id.* at 45.

[272] *Id.*

[273] *Id.*

[274] *Id.*

[275] *Id.*; Compl. ¶ 161.

[276] Compl. ¶ 161.

[277] *Id.*

[278] *Id.*

[279] *Id.*

[280] *Id.*

[281] *Id.* ¶ 162.

[282] *Id.* ¶ 163.

[283] *Id.* ¶ 162.

[284] *Id.* ¶ 163.

[285] *Id.*; Proxy at 45.

roles with Buyer "provided that representatives of financial advisors to the Special Committee were in attendance."[286]

As instructed, Paul Weiss sent the draft merger agreement to Buyer's outside counsel.[287] The draft provided that the closing would not be conditioned upon closing a Developer 2 acquisition; it also included a go-shop provision.[288] Paul Weiss also brought Riverstone into the fold, contacting Riverstone's outside counsel to discuss a transaction with Buyer, the Company, and Developer 2.[289] Paul Weiss pressed **[*52]** that any Company-Buyer transaction should not be cross-conditioned with any potential transaction involving Developer 2.[290] In addition, Company management, Evercore, Goldman and Buyer engaged in "high-level discussions regarding arrangements relating to compensation and post-transaction roles for [Company] management."[291] Buyer requested exclusivity, but the Special Committee, in consultation with its advisors, declined to grant exclusivity to any party at that time.[292]

In mid-to late-August, the Company's advisors reached out to all interested parties, including Brookfield.[293] Of those bidders that came forward after the August 12 *Bloomberg* article, one requested to pursue a transaction and negotiate a confidentiality agreement; six others decided to forego a transaction with the Company.[294]

J. Brookfield Attempts To Accommodate The Company's Shifting Goals And Riverstone's Demands, But The Special Committee Proceeds With Buyer.

Brookfield submitted an updated offer letter on August 26.[295] Brookfield revealed that, on August 20, the Special Committee's advisors had indicated an unwillingness to move forward with Brookfield. Curiously, the advisors had told Brookfield that (1) the **[*53]** Board no longer supported a transaction that internalized Developer 2, which was inconsistent with their representations to Buyer in the same time period; (2) Riverstone would use the Consent Right to block a TerraForm acquisition; and (3) the Board prioritized deal certainty and price.[296]

Undeterred, Brookfield proposed a Company-on-top transaction in which the Company would acquire TerraForm, "so that no Riverstone consent is required in connection with the transaction," at a ratio of two TerraForm shares for each Company share.[297] Brookfield's proposal did not include Developer 2 or any side benefits for Riverstone or the Officer Defendants; nor did it require any concessions from Riverstone or amendments to the Company's contractual agreements with Developer 2.[298] Special Committee meeting minutes provide that Brookfield's updated proposal "was not dependent upon any transaction with [Developer 2.]"[299] But the Proxy stated that Brookfield said it would require concessions from Developer 2.[300]

Brookfield's offer valued the Company at $33.38 per share, representing a 45% premium—far above Buyer's offer and the final Merger price.[301] As Brookfield indicated, this strategic transaction would **[*54]** allow Company stockholders "the opportunity to continue to participate in the upside embedded in the shares of a world class renewable power leader that will have a dividend payout ratio," which "is [a] more compelling opportunity than having their upside capped in a privatization transaction."[302] Brookfield stated its offer would expire if it were not granted exclusivity by August

[286] Proxy at 45; Compl. ¶ 163.

[287] Proxy at 46.

[288] *Id.*

[289] *Id.*

[290] *Id.*

[291] *Id.*

[292] *Id.*

[293] *Id.* at 45.

[294] *Id.*

[295] Compl. ¶ 164; *see* Weinberger Decl. Ex. 5.

[296] Compl. ¶¶ 164-65, 174, 209.

[297] *Id.* ¶ 166.

[298] *Id.* ¶¶ 166, 168.

[299] *Id.* ¶ 168.

[300] Proxy at 46.

[301] Compl. ¶¶ 167, 171.

[302] *Id.* ¶ 167 (emphasis omitted).

30.[303]

On August 26, the Special Committee discussed Brookfield's revised proposal.[304] The Special Committee and Browne met again on August 28.[305] The Special Committee noted Brookfield's offer represented a 45% premium,[306] and contemplated potential litigation risks from TerraForm, as well as "the uncertain value of the all-stock consideration offered by [Brookfield] as compared to the all-cash offers received from other bidders."[307] In view of these concerns, the Special Committee determined that it needed to further evaluate Brookfield's offer and that it would be "premature" to grant exclusivity.[308]

On August 29, at the Special Committee's direction, Evercore asked Brookfield to clarify its proposal with respect to Developer 2 and what Brookfield envisioned for the combined company's relationship with Developer **[*55]** 2.[309] In response to those discussions, on August 30, Brookfield submitted an updated offer letter.[310] It recapped the changing messages it had received about Developer 2. Brookfield stated that it had been told early in the process that the Company believed it was desirable for senior management to maintain their positions in the combined company, including their dual positions at Developer 2.[311] The Company had also been telling Brookfield that it prioritized internalizing Developer 2.[312] But by August 20, the Company flipped the script, and Brookfield responded by restructuring its proposal to make the Company the acquirer and surviving parent company to avoid the Consent Right, and to address the Board's supposed disinterest in internalizing Developer 2.[313] Brookfield emphasized its willingness to move forward, stating that its due diligence was complete so that it could sign final deal documents in September, but stated its offer would expire unless the Company granted exclusivity by September 4.[314] It is reasonable to infer that contrary to its representations to Brookfield, the Special Committee and management (and Riverstone) supported an internalization of Developer 2; they just did not support **[*56]** a deal that cashed out Riverstone.

The Special Committee decided "to progress the transaction" with Buyer, and authorized management to obtain their own legal counsel with respect to the proposed Buyer transactions, including their interest in Developer 2, and to engage in further discussions with Buyer relating to such interests and post-closing management arrangements.[315]

Batkin discussed the competing offers with management and the Company's advisors on September 1.[316] On September 2, Paul Weiss received a revised draft merger agreement from Buyer.[317] Among other things, the draft removed the go-shop provision and capped damages in the event of termination, but did not condition the proposed merger on involving Developer 2.[318] That same day, Batkin spoke with Brookfield to discuss the possibility of adding downside protection for Company stockholders in the form of a cash option or exchange ratio collar; the implications for Brookfield's proposal if Riverstone did not support the transaction; and Brookfield's request for exclusivity.[319]

On September 3, Paul Weiss sent a draft merger agreement to Brookfield's counsel, by which closing would not be conditioned on a transaction **[*57]** with Developer 2.[320] Batkin suggested that Brookfield arrange a meeting with Company management and

303 Proxy at 46.

304 *Id.*

305 Compl. ¶¶ 170-71.

306 *Id.* ¶ 171.

307 Proxy at 47.

308 *Id.*

309 *Id.*

310 *Id.*; Compl. ¶¶ 173-74; Kirby Decl. Ex. 27.

311 Compl. ¶ 174.

312 *Id.*

313 *Id.* ¶¶ 173-74; Proxy at 47; Kirby Decl. Ex. 27 at PEGI-00000982.

314 Compl. ¶ 175; Proxy at 47.

315 Proxy at 47.

316 *Id.*

317 *Id.*

318 *Id.*

319 *Id.*

320 *Id.* at 47-48.

Riverstone to discuss Developer 2.[321] Accordingly, the next day, September 4, Brookfield's CEO, Sachin Shah, met with Garland and Riverstone's representative, Hunt.[322] Riverstone insisted that its consent was required for the Company to acquire TerraForm and that it would require amendments to the contracts between the Company and Developer 2 before providing such consent.[323]

Brookfield indicated that it did not intend to proceed with a transaction that Riverstone did not support, and offered to consider Riverstone's proposed amendments.[324] Shah emailed Batkin later that day, noting that "Riverstone needed to consider matters to see if there was a path forward on a potential deal" and that "the ball was in Riverstone's court on the issue, not Brookfield's, as Brookfield still believed in the merits of a transaction."[325]

Batkin followed up with Brookfield and Riverstone.[326] Brookfield flagged that its August 30 offer letter had expired and that Brookfield planned to terminate discussions unless and until it received acceptable proposals regarding the Company's relationship with Developer 2.[327] Batkin **[*58]** and the Special Committee's advisors considered granting Brookfield exclusivity, but declined.[328]

On September 10, Brookfield sent a revised proposal, addressed to the full Board, to Batkin and the Special Committee.[329] Brookfield recognized the complex relationship between the Company, Developer 2, and Riverstone and its bearing on the sales process:

> Our understanding is that the relationship between the [Company] Board and Riverstone is complex. The Board has a fiduciary duty to shareholders of [Company] but is not free to accept certain types of transactions without prior Riverstone consent or, as we understand, any transaction not supported by Riverstone without attracting Riverstone litigation risk. We also understand that Riverstone is not necessarily economically aligned with [Company] shareholders given that it holds no (or negligible) equity in [Company]. Further, given the interrelated nature of the arrangements between [Company], its management, and Riverstone, there could be potential multiple competing interests. This is a unique and difficult scenario.[330]

Brookfield went on to say that "we do not believe it is in anyone's best interests to engage with Riverstone in a manner **[*59]** that creates animosity or material litigation risk."[331] Brookfield was willing to resume discussions if Riverstone consented to the deal and if the parties agreed to Riverstone's requested amendments to the entities' existing contractual, operational, and structural arrangements.[332] Brookfield was also willing to negotiate with Riverstone and Developer 2 if it was granted exclusivity by both entities.[333]

On September 12, Riverstone and Developer 2 informed Batkin that they were willing to resume talks with Brookfield and present Brookfield with suggested amendments to the documents governing the relationship between the Company and Developer 2.[334] Batkin asked Riverstone to send Brookfield a written proposal of preferred terms, which Riverstone did on September 18.[335]

As for Buyer, on September 8, the Special Committee directed Paul Weiss to send a revised draft merger agreement to Buyer's counsel.[336] Buyer returned a marked-up agreement on September 19; it included a 35-day go-shop period subject to carve-outs for specific parties, including Brookfield.[337] Thereafter, the parties discussed open issues, including the go-shop provision,

---

[321] *Id.* at 48.

[322] *Id.*; Compl. ¶ 176.

[323] Compl. ¶ 177.

[324] Proxy at 48.

[325] Compl. ¶ 178.

[326] Proxy at 48.

[327] *Id.*

[328] *Id.*

[329] *Id.*; Compl. ¶¶ 179-80; Weinberger Decl. Ex. 6.

[330] Compl. ¶ 179 (emphasis omitted); Weinberger Decl. Ex. 6 at PEGI-00000881.

[331] Compl. ¶ 180.

[332] *Id.*; Proxy at 48.

[333] Compl. ¶ 180; Proxy at 48.

[334] Proxy at 48.

[335] *Id.* at 49; Compl. ¶ 180.

[336] Proxy at 48.

[337] *Id.* at 49.

developments with Developer 2, and financing.[338] The Special Committee **[*60]** also continued probing the Company's remaining bidders, advancing discussions, and denying any particular bidder exclusivity.[339]

On September 23, Batkin met with the Special Committee's advisors and Company management to discuss Riverstone's demanded and "fairly expansive" contract amendments.[340] Brookfield indicated that "there were realistic options to resolve the issues presented in Riverstone's recent proposal, but that [Brookfield] would only continue discussions regarding a transaction if granted exclusivity by [the Company]."[341] Batkin denied exclusivity, but offered to pay Brookfield's going-forward expenses "to entice [Brookfield] to advance discussions with Riverstone."[342]

Over the next three days, the Special Committee strategized to keep Brookfield in the running.[343] Batkin and the Special Committee's advisors sought to arrange a meeting between Brookfield and Riverstone "to ensure that there was a shared understanding of the terms in Riverstone's September 18, 2019 proposal."[344] Batkin contacted Brookfield on September 25, and Brookfield agreed to the meeting.[345] With Batkin's assistance, Brookfield and Riverstone scheduled a meeting for October 1.[346] But on September 27, Brookfield **[*61]** cancelled the meeting.[347]

On September 29, the Special Committee met to evaluate the remaining bidders: Brookfield, Buyer, Party B, and Party D.[348] The Special Committee considered Brookfield's offer and Riverstone's demand, which included a right to buy back the Company's 29% stake in Developer 2.[349] Batkin advised the Special Committee that Brookfield was willing to agree to Riverstone's demanded terms "as-is."[350] But Garland warned that a Company-TerraForm merger would alter the Company's relationship with Developer 2,[351] even if those changes were the result of Riverstone's demands. Given Brookfield's potentially higher bid, the Special Committee noted its duty to "maximize value for shareholders."[352] It ultimately determined that it would grant neither Buyer or Brookfield exclusivity, "given the continued interest in [the Company] expressed by multiple credible parties."[353]

K. Garland Drives Issuance Of Preferred Stock That Must Vote In Favor Of The Merger.

Also at the Special Committee's September 29 meeting, with all directors in attendance, Garland pressured the Board to authorize the issuance of a new class of voting preferred shares, purportedly to fund the purchase of **[*62]** two renewable energy projects.[354] In June 2019, while the sales process was underway, the Board had laid the groundwork for a potential preferred issuance and formed a transaction committee.[355] Despite having no apparent relationship to the sales process and a specifically-designated committee to carry out any such issuance, Garland told the Board to move quickly, noting his "concern that the Preferred Issuance had already been delayed for months" due to the sales process "and indicated that it had reached a point where it could not be delayed any further without risk of the Company's counterparty walking away from the proposed deal."[356] Garland "reminded the Committee of the importance to the Company of

[338] *Id.*

[339] *Id.* at 49-50.

[340] Compl. ¶ 183.

[341] Proxy at 49.

[342] *Id.*

[343] *Id.* at 49-50.

[344] *Id.* at 50.

[345] *Id.*

[346] *Id.*

[347] *Id.*

[348] *Id.*

[349] Compl. ¶ 183.

[350] *Id.* ¶¶ 183-85.

[351] *Id.* ¶ 186.

[352] *Id.* ¶ 188.

[353] Proxy at 50.

[354] Compl. ¶ 187.

[355] *See* D.I. 94, Ex. A ¶ 5 (noting that on June 12, 2019, the Board appointed a transaction committee to authorize and approve a new series of preferred stock).

[356] Compl. ¶ 187.

consummating the Preferred Issuance."[357]

On September 30, the transaction committee approved the preferred stock (the "Preferred Issuance").[358] Thereafter, on October 10, the Company sold 10,400,000 preferred shares with a par value of $260 million for $256.1 million, or $24.625 per share, to CBRE Caledon Capital Management Inc. affiliates ("CBRE") in a private placement pursuant to a Securities Purchase and Rights Agreement (the "Purchase Agreement").[359] The CBRE sale closed on October 25, raising **[*63]** roughly $75 million more than Garland claimed the Company needed to fund the cited projects.[360]

The preferred shares entitled CBRE to favorable dividends and distributions in the years following the merger of the two entities.[361] They entitled CBRE to one vote per share, subject to a cap, such that they represented 9.99% of the vote on the Merger, which occurred shortly after the sale closed.[362] Importantly, the Securities Purchase and Rights Agreement required CBRE's preferred shares to be voted in favor of the Merger—which had not yet been guaranteed, finalized, or signed at the time the CBRE sale closed.[363]

L. The Special Committee Accepts Buyer's Offer And Rejects Brookfield's Premium.

By October, Brookfield and Buyer emerged as the Company's remaining serious bidders.[364] Since late August 2019, Brookfield labored to secure the Special Committee's and Riverstone's approval of its premium bid, continuing to entertain Company management's and Riverstone's demands. In contrast, Buyer's offer moved forward smoothly with little to no enhancement to its offer price.[365] Despite Brookfield's efforts and the 45% premium, and with the preferred stock sale on the horizon, Batkin and Company **[*64]** management determined that the Brookfield offer would ultimately be inadequate for Riverstone.[366]

On October 3, Batkin again encouraged Brookfield to engage with Riverstone.[367] Brookfield once more demanded exclusivity and stood firm that, without it, Brookfield "would not be willing to devote time and resources to discussions with Riverstone."[368] Batkin told Brookfield that the Company could not grant exclusivity, as the Special Committee was still in discussions with other parties, including Buyer and Party D.[369]

Between October 13 and 16, Batkin and the Special Committee's advisors continued speaking with Brookfield.[370] They recognized and reiterated that Brookfield's August 26 proposal was "competitive," but to move forward, Brookfield had to confirm that either (1) Brookfield's proposal was not conditioned on Brookfield entering into an agreement with Developer 2 or Riverstone, so that those entities could not hold up a transaction; or (2) Brookfield had negotiated definitive drafts of such agreements.[371] The Special Committee warned Brookfield that "other parties had entered more advanced stages of negotiations" and that the Company "would be seeking definitive **[*65]** offers from all interested parties."[372]

The Special Committee then pushed all remaining bidders.[373] On October 17, Evercore instructed Brookfield, Buyer, and Party D to submit their "best and

---

[357] *Id.*

[358] *Id.* ¶¶ 190, 235.

[359] *Id.* ¶ 235.

[360] *Id.* ¶ 244.

[361] *Id.* ¶ 242.

[362] *Id.* ¶ 236.

[363] *Id.* ¶ 237. The Purchase Agreement required the shares to be voted in accordance with the recommendation of the Board so long as the special meeting took place on or before May 10, 2021.

[364] *See id.* ¶¶ 188-96.

[365] *See id.*; Proxy at 52.

[366] *See* Compl. ¶ 201.

[367] Proxy at 51.

[368] *Id.*

[369] *Id.*; *see also id.* at 50.

[370] *Id.* at 51.

[371] *Id.*

[372] *Id.*

[373] *Id.*

final" offers by October 28.[374] On October 28, after months of negotiation that led to an small increase of $1.25 per share from its original offer, Buyer submitted a definitive all-cash offer to purchase the outstanding shares of Company Common Stock for $26.75 per share.[375] While still lower than Brookfield's offer, Buyer also agreed to simultaneously acquire Developer 2 and allow Riverstone to retain equity in the combined company; it also offered the benefit of keeping the Company and Developer 2's management in place.[376]

That same day, Brookfield submitted a letter reaffirming its prior stock-exchange proposal, noting that its "proposal has a clear path to execution" and that "we have been advised by you and your advisors that our proposal is superior from a value perspective to the others that you have received and that you will receive in this sales process."[377] Brookfield reiterated that it could agree to Riverstone's demands,[378] but acknowledged that "the situation vis-à-vis Riverstone continues **[*66]** to be problematic for the [Company] Board and that Riverstone's interests are likely not aligned with those of the [Company] shareholders," and expressed that it was confident in its ability to grow the post-closing entity in the face of Riverstone's demands and consequent separation.[379] Brookfield explained,

> As requested, we have carefully reviewed Riverstone's list of demands to potentially support a merger of [the Company] with [TerraForm]. Those demands effectively require a separation of the Riverstone business from [the Company]. The list from Riverstone, as you know, requires that all of [the Company]'s development expertise, systems, people and the Pattern name itself revert back to Riverstone, in exchange for their support.
>
> As we have stated, we could agree to these requests. Brookfield has over 3,000 professionals focused on power operations, marketing, investment, development, and finance around the world. Our bench strength in management is deep. We have people and operations globally with the capabilities to manage, operate, grow, fund and deliver value to [the Company]'s shareholders, with a public track record of over 20 years. We also have a demonstrated expertise in carve-out **[*67]** transactions. . . . Therefore, we believe it would be possible to successfully execute such a separation to achieve the proposed merger at the value we have ascribed.
>
> Further, we believe executing on certain of the Riverstone demands may leave [the Company] as a far better company in the future than it currently is. If we separate the inter-related management, systems and eliminate the conflicts that Riverstone brings to [the Company] and merge the Company with [TerraForm], we will leave the merged entity with clear alignment between the Board, shareholders, management and its sponsor, Brookfield. All constituents will then have a singular focus on creating value for [the Company].[380]

The Company determined that Brookfield's October 28 letter did not meet the conditions set by the Special Committee, nor did it include a proposed merger agreement.[381] The Company extended the deadline for submitting definitive transaction documentation to October 30, and requested that Brookfield confirm its willingness to enter into and consummate a merger with the Company at the proposed exchange ratio regardless of any agreement (or lack thereof) between Brookfield and Riverstone. **[*68]** [382]

On October 30, Brookfield submitted a revised draft merger agreement, which included a condition that Brookfield be permitted to engage in discussions with Riverstone prior to executing it.[383] It also conditioned closing on Riverstone's consent to certain amendments to Developer 2's existing contractual relationships with the Company.[384] Brookfield did not submit definitive documentation or terms relating to governance of the combined company or detail any requested

[374] *Id.*; Compl. ¶ 191.

[375] Compl. ¶ 195; Proxy at 52.

[376] Compl. ¶ 195.

[377] *Id.* ¶ 192 (emphasis omitted); *accord* Weinberger Decl. Ex. 7; *see* Proxy at 52.

[378] Compl. ¶ 194; *accord* Weinberger Decl. Ex. 7.

[379] Compl. ¶ 194; *accord* Weinberger Decl. Ex. 7.

[380] Compl. ¶ 194 (emphasis omitted); *accord* Weinberger Decl. Ex. 7.

[381] Proxy at 52.

[382] *Id.*

[383] *Id.*

[384] *Id.*

arrangements with Developer 2.[385] The Special Committee extended its definitive offer deadline again to November 2.[386]

On October 30 and 31, the Special Committee met to evaluate Buyer's and Brookfield's final offers; Browne attended.[387] Evercore presented an analysis indicating that a Company-TerraForm merger would result in a combined company with a stock valued in the range of at least $29.71 to $32.94 per share: well above Buyer's offer of $26.75 per share.[388] Nonetheless, Evercore stressed that a TerraForm transaction would undermine the "purpose and commercial viability" of Developer 2.[389] But management had projected that Developer 2 was on the cusp of being self-funding, and nothing in the Company-TerraForm transaction **[*69]** endangered Developer 2's continued performance of its contractual obligations.[390] Goldman contributed by describing Riverstone's confidence in the Company-Buyer-Developer 2 proposal.[391]

On November 1, Brookfield told Paul Weiss it could negotiate any necessary amendments with Riverstone within thirty days.[392] Paul Weiss demanded that Brookfield submit definitive documents the next day, which Brookfield could not do without Riverstone's cooperation, which it did not believe it would receive.[393] As a result, Brookfield decided its efforts were futile and withdrew its bid.[394] Buyer was the last bidder standing.

On November 3, the Special Committee voted to recommend that the Board approve the all-cash Merger with Buyer at $26.75 per share, which was $1.05 less than the $27.80 closing trading price of the Company's stock the previous day, but represented a 14.8% premium to the Company's closing price on August 9, the last trading day before rumors of a potential acquisition leaked.[395] Under the Merger agreement with Buyer (the "Merger Agreement"), Buyer's offer of $26.75 per share implied an enterprise value for the Company of $6.1 billion, including debt.[396] Evercore issued a fairness opinion **[*70]** confirming that the Merger was fair from a financial point of view; Goldman did not issue an opinion.[397] The Board approved the Merger that day.[398]

During the Merger Agreement's go-shop period, the Special Committee's financial advisors contacted sixteen additional potential bidders.[399] The contacted parties either did not respond or declined to pursue a transaction.[400] Plaintiff alleges that the go-shop process was a sham in light of the Merger Agreement's $52.7 million termination fee and the discretionary power of Riverstone, Buyer, and the Company to award to or withhold from Goldman an additional $3 million dollars upon consummation of the Merger.[401] On November 4, the Company officially announced that it had entered into the Merger Agreement with Buyer.[402]

Around this time, Buyer, Riverstone, the Officer Defendants, and Developer 2 entered into a Contribution and Exchange Agreement (the "Contribution Agreement") pursuant to which the Company and Developer 2 would be united under common ownership.[403] The Contribution Agreement valued Developer 2 at $1.06 billion.[404] According to its terms, the parties would "make certain contributions

---

385 *Id.*

386 *Id.*

387 *Id.*; Compl. ¶¶ 196-97.

388 Compl. ¶¶ 198-99. Plaintiff alleges that even those values for the combined company were depressed because Evercore did not use consistent or updated dividend yields across its analyses, and if corrected, Evercore's analysis would have shown the combined company would trade in the range of $32.69 to $36.15 per share.

389 *Id.* ¶¶ 201-04.

390 *Id.* ¶¶ 82, 202-04.

391 *Id.* ¶ 197.

392 *Id.* ¶ 205; Proxy at 52.

393 Compl. ¶ 205; Proxy at 52.

394 Compl. ¶ 205; Proxy at 53.

395 Compl. ¶¶ 206-07, 222.

396 *Id.* ¶ 207.

397 Proxy at A-24.

398 Compl. ¶ 206.

399 Proxy at 54.

400 *Id.*

401 Compl. ¶¶ 216, 271.

402 *See* D.I. 74 at 10 (citing Compl. ¶ 206).

403 Compl. ¶ 208.

404 *Id.*

contemplated by the Contribution Agreement, including with **[*71]** respect to their interests in [Developer 2] in exchange for equity interests in [the surviving entity]."[405]

Each of Riverstone, the Officer Defendants, PSP, and CBRE continue to hold equity in the new combined company, whereas the Company's public stockholders were cashed out.[406] The Officer Defendants are also eligible to earn up to $51 million in earnout payments and were given new employment agreements with generous compensation for a minimum of three-year terms with automatic one-year renewals.[407]

M. The Officer Defendants Prepare The Merger Disclosures.

Concurrently with approving the Merger, the Board adopted resolutions that delegated full authority to prepare and disseminate the Proxy to Company management.[408] Management had unbridled discretion to include or omit information as "deemed necessary, appropriate or advisable."[409] The Board did not reserve authority to review, alter, or discuss the Proxy's disclosures before filing.[410] As a result of leaving the Merger disclosures in the hands of the Officer Defendants—particularly Garland—Plaintiff contends that the Proxy omitted or misrepresented numerous categories of material information.[411]

On February 4, 2020, the Company filed the **[*72]** Proxy recommending that Company stockholders vote in favor of the Merger.[412] Including annexes, the Proxy spanned 231 pages and, among other things, disclosed a detailed summary of the Merger process, including details about the bids by and negotiations with competitive bidders;[413] the valuation metrics employed; the Consent Right; the concurrent Developer 2 acquisition and Contribution Agreement and that certain members of Company management stood to benefit under the Contribution Agreement; and that certain directors and officers had potential conflicts of interest, and the Board was aware that these interests existed and considered them, among other matters, when it approved the Merger Agreement.[414] After negative commentary by proxy advisory firms and disclosure suits by stockholders,[415] but before the stockholder vote, the Company issued further disclosures in a supplemental definitive proxy statement filed on March 4, 2020 (the "Supplemental Proxy").[416]

However, as alleged, the Proxy and Supplemental Proxy failed to disclose, among other things, that Riverstone used the Consent Right to block a more valuable deal with Brookfield and TerraForm; that Garland had unauthorized **[*73]** discussions with potential bidders in violation of the Special Committee's instructions, including an unauthorized in-person meeting with Buyer and representatives of Riverstone in April 2019; that Goldman faced conflicts of interest, including that Goldman owns a substantial stake in Riverstone, had advised Riverstone on a take-private of the Company, and had earned fees totaling over $100 million from Riverstone and Buyer in recent years; that Browne, a representative of Riverstone, attended a majority of the Special Committee's meetings and Executive Sessions; and that the Company's largest stockholder, PSP, held a 22% interest in Developer 2, and therefore was interested in the Merger.[417]

N. The Market Reacts, And Company Stockholders Marginally Vote To Approve The Merger.

Following the Merger announcement, nine sets of plaintiffs filed pre-merger lawsuits alleging that the Proxy made inadequate disclosures.[418] All but one of these lawsuits were voluntarily dismissed shortly after the Company filed the Supplemental Proxy. The remaining lawsuit was filed by Water Island Capital, LLC

---

[405] Proxy at 74.

[406] Compl. ¶¶ 209-11.

[407] *Id.* ¶¶ 209-10, 212-14.

[408] *Id.* ¶¶ 231-32; Weinberger Decl. Ex. 8 at PEGI-00000388.

[409] Compl. ¶ 231; Weinberger Decl. Ex. 8 at PEGI-00000388.

[410] Compl. ¶ 232; *see also* Weinberger Decl. Ex. 8 at PEGI-00000388.

[411] Compl. ¶¶ 253-82.

[412] Proxy at 1.

[413] *Id.* at 36-54.

[414] *Id.* at 6-7, 69-79.

[415] *See, e.g.*, Compl. ¶¶ 223-25.

[416] *See* Kirby Decl. Ex. 2; D.I. 74 at 12.

[417] *See generally* Compl.

[418] *See* D.I. 74 at 12.

and its affiliates ("Water Island"), who also launched an aggressive public campaign urging **[*74]** other stockholders to vote against the Merger based on the themes pervading the Complaint.[419]

On February 18, Water Island issued an open letter to Company stockholders, opposing the consideration paid for Company stock in the Merger as "woefully inadequate."[420] Water Island claimed that the Merger "originally offered at best a negligible premium," and, at the time of Water Island's letter, "a significant discount" due to "the recent seismic shift in the value ascribed to renewable energy companies."[421]

On February 19, the Company issued a press release responding to Water Island's claims and reiterating the Board's position that the Merger was the best path forward for the Company and its stockholders.[422] Water Island then issued a second letter on February 24, again urging stockholders to vote against the Merger and detailing the same supposedly "misleading" aspects of the Proxy that Plaintiff challenges in this litigation. Specifically, Water Island claimed that the Merger consideration represented a "low-ball management-led buyout of [the Company]"; that the Board "fail[ed] to restrain a conflicted **[*75]** management team from leveraging a previously undisclosed [Developer] 2 'consent right' in order to block any merger that did not enrich their own self-interests"; and that "the Board's claim of a robust sales process couldn't be further from the truth."[423]

On February 26, the Company responded, noting that the Company faced significant headwinds, including limited access to low-cost capital and a lack of financial sponsors, which led to it consistently trading at a discount to its peers over the last five years. The Company again reiterated that the Merger represented the best path forward for stockholders.[424]

Following Water Island's public criticism of the Merger, on February 28 and March 2, Institutional Shareholder Services ("ISS") and Glass Lewis, the two largest proxy advisory firms **[*76]** in the United States, both issued reports recommending that stockholders reject the Merger.[425] Glass Lewis expressed concern that the Board and Special Committee did not run a sufficiently independent process and believed the Company was worth more as a standalone entity.[426] While ISS also believed the Merger inadequate, it also acknowledged that some Company stockholders may have preferred a cash offer, as opposed to Brookfield's potential all-stock transaction, because it provided "certainty of value" in the face of "global pandemic fears," and the recent surge in the value attributed to renewable energy companies may not necessarily be a "resilient long-term trend."[427]

As of the Merger's record date, the Company had 98,218,625 shares of common stock outstanding and 10,400,000 shares of preferred stock outstanding, with each common and preferred share receiving one vote

[419] *See id.*; Compl. ¶¶ 224-25.

[420] *See* D.I. 74 at 12 (quoting *Water Island Capital, LLC Issues Open Letter to Shareholders of PEGI Group, Inc.*, BUSINESSWIRE (Feb. 18, 2020), https://www.businesswire.com/news/home/20200218005403/en/Water-Island-Capital-LLC-Issues-Open-Letter).

[421] *Id.*

[422] *See id.* at 13 (citing *PEGI Board of Directors Reiterates Recommendation that Stockholders Vote "FOR" Proposed Canada Pension Plan Investment Board Transaction* (Feb. 19, 2020), https://patternenergy.com/news/press-releases/pattern-energy-board-directors-reiterates-recommendation).

[423] *See id.* (quoting *Water Island Capital, LLC Issues Open Letter to Shareholders in Response to Misleading Claims Made by Pattern Energy Group, Inc. Board of Directors*, BUSINESSWIRE (Feb. 24, 2020), https://www.businesswire.com/news/home/20200224005340/en/Water-Island-Capital-LLC-Issues-Open-Letter). Water Island further suggested to stockholders that the Company was "hiding the purchase price of [Developer] 2," and that the Proxy did not disclose that the PSP, which held 9.5% of the shares in [the Company], was a "conflicted party who [should be] excluded from the majority-of-the-minority vote." *Id.* PSP's holding in the Company, as well as the investment rights that accompanied it and the potential that PSP might have interests that conflicted with the Company and its stockholders, were all disclosed in the Company's Form 10-K filings for each of 2018, 2019 and 2020. *See* Kirby Decl. Ex. 3; Kirby Decl. Ex. 4; Kirby Decl. Ex. 5.

[424] *See* D.I. 74 at 14 (citing *Pattern Energy Sets the Record Straight Regarding Water Island's False Assertions and Mischaracterizations* (Feb. 26, 2020), previously available at https://investors.patternenergy.com/news-releases/news-release-details/patternenergy-sets-record-straight-regarding-water-islands).

[425] Compl. ¶ 225; *see also* D.I. 74 at 14-15.

[426] Compl. ¶ 225.

[427] *See* D.I. 74 at 15; Compl. ¶ 225.

for a total of 108,618,625 potential votes.[428] Ultimately, on March 10, a total of 56,856,604 of the Company's outstanding shares voted in favor of the Merger by a slim majority of 52%.[429] PSP owned 9,341,035 (or approximately 8.6%) of the shares that voted in favor of the Merger; because PSP owns 22% of Developer 2, Plaintiff **[*77]** alleges PSP was interested.[430] An additional 1,210,049 (or 1.1%) shares of those voted in favor were held by members of Company management who received equity and jobs in the post-closing company.[431] CBRE's 10,400,000 preferred shares, which were rolled over into the post-closing company and remain outstanding, were required to be voted in favor of the Merger.[432] If these three blocks of votes were excluded, only 41% of the disinterested shares voted in favor of the Merger.[433]

O. This Litigation Ensues.

The Merger sparked litigation in this Court: two class action complaints challenging the adequacy of the Merger process and its consideration were filed in May 2020.[434] Those actions were consolidated into the present case,[435] and Britt was appointed lead plaintiff.[436] Her class action Complaint asserts six counts.[437]

Count I, for breach of fiduciary duty, asserts the Director Defendants "consciously disregarded their fiduciary duties by, among other things, agreeing to the unfair Merger, which failed to maximize stockholder value, but was the preferred transaction for Riverstone and a conflicted management team";[438] "knowingly and willfully allow[ed] numerous **[*78]** conflicted individuals/entities to participate in its deliberations, including Browne, Garland, Goldman, and other members of management";[439] "knowingly and intentionally failed to disclose all material information to the Company's stockholders"; and "consciously abdicated their duties by granting conflicted management sole authority to exercise its discretion to determine what material information should be included (or excluded) from the Proxy and distribute the Proxy to stockholders without prior Board and/or Special Committee review and approval."[440]

Count II, for breach of fiduciary duty, asserts the Officer Defendants "were interested in the Merger as a result of their employment with and/or substantial equity holdings in [Developer 2] and their continued employment with and equity interests in the post-closing combined entity";[441] and that they "advanc[ed] their own self-interest and the interests of Riverstone to the detriment of [Company] stockholders" by improperly wielding Riverstone's narrow consent right to improperly influence the Special Committee, manipulating their own projections, and knowingly and intentionally disseminating a materially false and misleading Proxy.[442] Count **[*79]** II alleges that Garland in particular breached his duties by disobeying the Special Committee's instructions, meeting with Buyer and Riverstone without the Special Committee's authorization, and concealing that meeting from the Special Committee, which Plaintiff contends "allowed Riverstone's preferred bidder, Buyer, to enter the sales process and propose a transaction that benefited management and Riverstone at the expense of the Company stockholders."[443]

---

[428] Compl. ¶ 247.

[429] *Id.* ¶ 248.

[430] *Id.* ¶ 249.

[431] *Id.* An additional 50,872 shares were held by other Company insiders. *Id.* ¶ 249 n.23.

[432] *Id.* ¶ 249.

[433] *Id.* ¶ 250.

[434] Plaintiff's original complaint was filed under a different case number. *See Britt v. Garland, et al.*, C.A. No. 2020-0412-MTZ. The initial complaint under this case number was filed by Gary Broz, Robert Long, Walter James Peters III, and Michael Richardson (the "Broz Plaintiffs"). *See* D.I. 1. After the actions were consolidated under this caption and Britt appointed lead plaintiff, the Broz Plaintiffs voluntarily dismissed. *See* D.I. 64.

[435] D.I. 10.

[436] D.I. 44.

[437] Plaintiff's initial Complaint is identical to the operative consolidated Complaint, which Plaintiff filed on this docket belatedly after the parties completed briefing and argument on the Motions. *See* D.I. 100; D.I. 101; D.I. 102.

[438] Compl. ¶ 292.

[439] *Id.* ¶ 293.

[440] *Id.* ¶ 294.

[441] *Id.* ¶ 299.

[442] *Id.* ¶ 300.

[443] *Id.* ¶ 301.

Count III asserts the Entity Defendants aided and abetted Company fiduciaries' breaches by, among other things, having unauthorized meetings with Goldman, Garland, and Buyer; infecting the process with conflicted individuals and entities; wrongfully exploiting the Consent Right in favor of the Merger and Riverstone; and threatening meritless litigation against Brookfield to block a transaction with it.[444] Count IV asserts the Entity Defendants tortiously interfered with the Company stockholders' prospective economic advantage in the superior Brookfield-TerraForm offer.[445] Count V asserts the Entity Defendants, Officer Defendants and Browne conspired to defeat the Brookfield-TerraForm transaction in favor of the unfair Merger and to **[*80]** ensure the Company did not disclose all material information to its stockholders, thereby inducing them to approve the Merger.[446] Count VI collects the Officer Defendants and the Entity Defendants into a group referred to as the "Controller Defendants," and asserts they owed and breached fiduciary duties as controllers.

As recourse for these alleged wrongs, Plaintiff seeks damages, fees, and costs.[447]

On September 11, 2020, the Individual Defendants and Entity Defendants moved to dismiss under *Court of Chancery Rule 12(b)(6)* (respectively, the "Individual Defendants' Motion" and the "Entity Defendants' Motion," and together, the "Motions").[448] The parties briefed the Motions as of October 26.[449] I held argument on November 5, and requested that the parties submit supplemental briefing.[450] The parties completed supplemental briefing as of December 10, and the matter was taken under advisement.[451]

II. ANALYSIS

The standards governing a motion to dismiss under *Court of Chancery Rule 12(b)(6)* for failure to state a claim for relief are well settled:

> (i) all well-pleaded factual allegations are accepted as true; (ii) even vague allegations are "well-pleaded" if they give the opposing party notice of the claim; (iii) the Court must draw all reasonable **[*81]** inferences in favor of the non-moving party; and ([iv]) dismissal is inappropriate unless the "plaintiff would not be entitled to recover under any reasonably conceivable set of circumstances susceptible to proof."[452]

Thus, the touchstone "to survive a motion to dismiss is reasonable 'conceivability.'"[453] This standard is "minimal"[454] and plaintiff-friendly.[455] "Indeed, it may, as a factual matter, ultimately prove impossible for the plaintiff to prove his claims at a later stage of a proceeding, but that is not the test to survive a motion to dismiss."[456] Despite this forgiving standard, the Court need not "accept conclusory allegations unsupported by specific facts" or "draw unreasonable inferences in favor of the non-moving party."[457] "Moreover, the court is not required to accept every strained interpretation of the allegations proposed by the plaintiff."[458]

---

[444] *Id.* ¶¶ 304-07.

[445] *Id.* ¶¶ 308-13.

[446] *Id.* ¶¶ 314-19.

[447] *Id.* ¶¶ (h)-(j).

[448] D.I. 73; D.I. 74.

[449] *See* D.I. 82; D.I. 84; D.I. 85.

[450] *See* D.I. 88; D.I. 93.

[451] *See* D.I. 91; D.I. 92; D.I. 94; D.I. 95; D.I. 96.

[452] *Savor, Inc. v. FMR Corp., 812 A.2d 894, 896-97 (Del. 2002)* (citations omitted); *accord* *In re Baker Hughes Inc. Merger Litig., 2020 Del. Ch. LEXIS 321, 2020 WL 6281427, at *5 (Del. Ch. Oct. 27, 2020)*.

[453] *Cent. Mortg. Co. v. Morgan Stanley Mortg. Cap. Hldgs. LLC, 27 A.3d 531, 537 (Del. 2011)*.

[454] *Id. at 536* (citing *Savor, 812 A.2d at 896*).

[455] *See, e.g.,* ***Clouser v. Doherty, 175 A.3d 86, 2017 Del. LEXIS 363 (Del. 2017)*** (TABLE); *In re USG Corp. S'holder Litig., 2021 Del. Ch. LEXIS 45, 2021 WL 930620, at *3-4 (Del. Ch. Mar. 11, 2021)*; *In re Trados Inc. S'holder Litig. (Trados I), 2009 Del. Ch. LEXIS 128, 2009 WL 2225958, at *8 (Del. Ch. July 24, 2009)*.

[456] *Cent. Mortg. Co., 27 A.3d at 536*.

[457] *Price v. E.I. du Pont de Nemours & Co., 26 A.3d 162, 166 (Del. 2011)* (citing *Clinton v. Enter. Rent-A-Car Co., 977 A.2d 892, 895 (Del. 2009)*).

[458] *Trados I, 2009 Del. Ch. LEXIS 128, 2009 WL 2225958, at *4* (internal quotation marks omitted) (quoting *In re Gen. Motors (Hughes) S'holder Litig., 897 A.2d 162, 168 (Del. 2006)*).

A. Plaintiff Has Stated A Claim For Breach Of Fiduciary Duty Against The Director Defendants.

The Director Defendants argue that Plaintiff's breach of fiduciary duty claims must be dismissed under *Corwin v. KKR Financial Holdings LLC*[459] because holders of a majority of disinterested shares approved the Merger in a fully informed, uncoerced **[*82]** vote, and, therefore, the business judgment rule unrebuttably applies.[460] Even if *Corwin* is inapplicable, the Director Defendants argue that Plaintiff's duty of care claims against them are barred by the exculpation provision in the Company's Certificate of Incorporation, and that Plaintiff does not plead a nonexculpated duty of loyalty claim.[461]

Plaintiff asserts that she has stated nonexculpated claims against the Director Defendants for violating their duties in bad faith; that *Corwin* does not apply to cleanse the transaction; and that the Court should review it under an entire fairness standard because controllers stood on both sides of the transaction, and/or Garland committed fraud on the Board.[462]

Plaintiff is correct that *Corwin* does not place the Merger under the ambit of the business judgment rule. Because Company stockholders were cashed out, "the merger is presumptively subject to enhanced scrutiny."[463] Through the lens of enhanced scrutiny, Plaintiff's allegations render it reasonably conceivable that the Director Defendants violated their duty of loyalty. Accordingly, the Director Defendants' Motion is denied as to Count I. Moreover, it remains possible that the transaction will **[*83]** be subject to entire fairness because discovery may reveal that a control group, consisting of the Entity and Officer Defendants, stood on both sides of the transaction.

1. *Revlon* Enhanced Scrutiny Applies At The Pleading Stage.

The board of directors has the ultimate responsibility for managing the business and affairs of a corporation.[464] "In discharging this function, the directors owe fiduciary duties of care and loyalty to the corporation and its shareholders," and "[t]his unremitting obligation extends equally to board conduct in a sale of corporate control."[465]

"When determining whether corporate fiduciaries have breached their duties, Delaware corporate law distinguishes between the standard of conduct and the standard of review."[466] "The standard of conduct describes what directors are expected to do and is defined by the content of the duties of loyalty and care. The standard of review is the test that a court applies when evaluating whether directors have met the standard of conduct."[467]

"Delaware has three tiers of review for evaluating director decision-making: the business judgment rule, enhanced scrutiny, and entire fairness."[468] Which of the three standards applies depends initially **[*84]** on whether the board members

> (i) were disinterested and independent (the business judgment rule), (ii) faced potential conflicts of interest because of the decisional dynamics present in particular recurring and recognizable situations (enhanced scrutiny), or (iii) confronted actual conflicts of interest such that the directors making the decision did not comprise a disinterested and independent board majority (entire fairness). The standard of review may change further depending on whether the directors took steps to address the potential or actual conflict, such as by creating an independent committee, conditioning the transaction on approval

---

[459] ***125 A.3d 304, 2015 Del. LEXIS 47(Del. 2015)***.

[460] *See* D.I. 74 at 2.

[461] *Id.* at 3.

[462] D.I. 82 at 32, 58-60.

[463] *Chester Cty. Empls.' Ret. Fund v. KCG Hldgs., Inc., 2019 Del. Ch. LEXIS 233, 2019 WL 2564093, at *10 (Del. Ch. June 21, 2019)* (citing *Revlon, Inc. v. MacAndrews & Forbes Hldgs., Inc., 506 A.2d 173, 184 (Del. 1986)*).

[464] *8 Del. C. § 141(a)*.

[465] *Mills Acq. Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1989)* (citations omitted).

[466] *Chen v. Howard-Anderson, 87 A.3d 648, 666 (Del. Ch. 2014)* (collecting authorities).

[467] *Id.* (internal quotation marks omitted) (quoting *In re Trados Inc. S'holder Litig. (Trados II), 73 A.3d 17, 35-36 (Del. Ch. 2013)*).

[468] *Reis v. Hazelett Strip-Casting Corp., 28 A.3d 442, 457 (Del. Ch. 2011)*.

by disinterested stockholders, or both.[469]

The business judgment rule, Delaware's default standard of review, presumes board members act "on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[470] "[W]here the business judgment presumptions are applicable, the board's decision will be upheld unless it cannot be attributed to any rational purpose."[471]

Revlon's intermediate standard of enhanced scrutiny is applied when board members face "potential conflicts of interest **[*85]** because of situational dynamics present in particular" transactions.[472] "*Revlon* enhanced scrutiny applies to 'final stage' transactions, including a 'cash sale, a break-up, or a transaction like a change of control that fundamentally alters ownership rights'"[473] because in these transactions, directors may be more prone to pursue self-interest and engage in selfish action.[474] In cash-out mergers presenting no "long run" for stockholders, "the board's duty to shareholders is inconsistent with acts not designed to maximize present share value, acts which in other circumstances might be accounted for or justified by reference to the long run interest of shareholders."[475]

Here, Buyer cashed out the Company's public stockholders in the transaction, and thus "there [exist] sufficient dangers to merit employing enhanced scrutiny."[476] Because Company stockholders "received cash for their shares, the merger is presumptively subject to enhanced scrutiny."[477]

Plaintiff asks this Court to further elevate the standard of review to entire fairness.[478] Entire fairness, Delaware's most stringent standard, applies to board action where there exists "actual conflicts of interest."[479] Under the entire fairness standard, **[*86]** the defendants must show that the transaction in question was "objectively fair, independent of the board's beliefs."[480] Entire fairness applies in certain discrete circumstances, including (1) when a plaintiff pleads facts that "call[] into question the disinterestedness and independence of a sufficient number of directors;"[481] (2) when the transaction was effectuated "by a controlling or dominating shareholder,"[482] and (3) when a plaintiff pleads a fraud-on-the-board theory and the attendant "illicit manipulation of a board's deliberative processes by self-interested corporate fiduciaries."[483]

Plaintiff has not pled facts sufficient to indicate that the Special Committee was interested and lacked independence such that its members would be

469 Chen, 87 A.3d at 666-67 (quoting Trados II, 73 A.3d at 36).

470 Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *rev'd on other grounds, Brehm v. Eisner, 746 A.2d 244 (Del. 2000)*.

471 In re Walt Disney Co. Deriv. Litig. (Disney II), 906 A.2d 27, 74 (Del. 2006) (internal quotation marks omitted) (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)).

472 Trados II, 73 A.3d at 36.

473 Huff Energy Fund, L.P. v. Gershen, 2016 Del. Ch. LEXIS 150, 2016 WL 5462958, at *13 (Del. Ch. Sep. 29, 2016) (quoting Lonergan v. EPE Hldgs., LLC, 5 A.3d 1008, 1019 (Del. Ch. 2010)).

474 Firefighters' Pension Sys. of Kan. City, Mo. Tr. v. Presidio, Inc., 251 A.3d 212, 2021 Del. Ch. LEXIS 15, 2021 WL 298141, at *12 n.13 (Del. Ch. Jan. 29, 2021) (citing Reis, 28 A.3d at 458 (explaining that parties may be more willing to cheat where they do not anticipate repeated transactions)).

475 TW Servs., Inc. v. SWT Acq. Corp., 1989 Del. Ch. LEXIS 19, 1989 WL 20290 (Del. Ch. Mar. 2, 1989).

476 Lonergan, 5 A.3d at 1019.

477 KCG Hldgs., 2019 Del. Ch. LEXIS 233, 2019 WL 2564093, at *10 (citing Revlon, 506 A.2d at 184); *accord* In re Mindbody, Inc., 2020 Del. Ch. LEXIS 307, 2020 WL 5870084, at *13 (Del. Ch. Oct. 2, 2020) ("The cash-for-stock Merger was a final-stage transaction presumptively subject to enhanced scrutiny under *Revlon*.").

478 D.I. 82 at 32.

479 Trados II, 73 A.3d at 36.

480 Presidio, 2021 Del. Ch. LEXIS 15, 2021 WL 298141, at *17 (internal quotation marks omitted) (quoting Gesoff v. IIC Indus., Inc., 902 A.2d 1130, 1145 (Del. Ch. 2006)).

481 Chen, 87 A.3d at 672.

482 Kahn v. Lynch Comms. Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994).

483 Macmillan, 559 A.2d at 1279; *see* Mindbody, 2020 Del. Ch. LEXIS 307, 2020 WL 5870084, at *25 n.229 ("[T]he presumptive standard of review in *Macmillan* was *Revlon* . . . . Yet . . . the court elevated the standard of review to entire fairness in view of the fraud-on-the-board theories advanced by the plaintiffs.").

presumably incapable of exercising their objective judgment in considering the merits of the transaction. At the time of the Merger, the Board consisted of seven directors. Only two, Garland and Browne, were allegedly conflicted with respect to the transaction; that is why they were not appointed to the Special Committee.[484] The remaining five directors, Batkin, Goodman, Hall, Newson, and Sutphen, were disinterested and independent with respect **[*87]** to the Merger, and were therefore appointed to the Special Committee.[485]

Further, Plaintiff has not pled facts sufficient to support a fraud-on-the-board theory. Still, this cash-out Merger may warrant entire fairness review under a controller theory; time and discovery will tell. At a minimum, it warrants enhanced scrutiny.

a. Plaintiff Has Failed To Plead Fraud On The Board.

Plaintiff principally contends entire fairness is warranted under a fraud-on-the-board theory. Plaintiff invokes *Mills Acquisition Co. v. Macmillan, Inc.*,[486] in which the Delaware Supreme Court elevated the standard of review to entire fairness based on the conclusion that insider officers committed fraud on the board out of self-interest. Macmillan's officers "failed to disclose that they tipped off their favored bidder in a way that tainted and manipulated the Board's deliberative process."[487] Here, Plaintiff theorizes:

> [T]he Complaint alleges that Garland—in plain violation of the Special Committee's prohibition on members of [Company] management engaging with any potential parties to a strategic transaction without the express consent of the Special Committee—commenced unauthorized sale discussions **[*88]** with Riverstone and [Buyer] in April 2019. Garland never informed the Committee of the actual substance or circumstances of his improper outreach, which was part of Garland's and the other Officer Defendants' disloyal effort to steer the Merger process in favor of [Developer 2] and Riverstone. As a result of Garland's misconduct, Riverstone inserted [Buyer] into the Merger process and ultimately blocked a more valuable transaction with Brookfield. As a matter of Delaware law, Garland's self-interested and illicit manipulation of a board's deliberative process requires the Merger be subjected to rigorous judicial scrutiny under the exacting standards of entire fairness.[488]

Plaintiff offers fraud on the board only in pursuit of entire fairness, while offering a theory of director breach that tracks the paradigmatic *Revlon* narrative of an overweening CEO and supine board.[489] I question whether I should entertain fraud on the board solely to set the standard of review, as the theory of breach should drive the standard of review inquiry. Plaintiff's theory of breach is not that Garland deceived the Special Committee into favoring Buyer. Her theory is that the Special Committee knowingly favored **[*89]** Buyer because they favored Riverstone and Developer 2 over Company stockholders. For the sake of completeness, I consider whether Plaintiff's allegations can stretch to allege fraud on the board and conclude they cannot.

In *Mills*, the board and special committee failed to engage in "planning and oversight to insulate the self-interested management" in connection with a sale of corporate control.[490] Rather, the board placed "the entire process in the hands of [a manager]" who chose the Committee's financial advisors, and acted without board oversight as the board looked on "with a blind eye."[491] "[T]he Macmillan board completely relied on"

---

[484] *See, e.g.*, Compl. ¶¶ 24, 26, 101. The allegations of Garland and Browne's interestedness and lack of independence are discussed further *infra*.

[485] *See id.* ¶ 100.

[486] 559 A.2d 1261, 1279 (Del. 1989).

[487] ***City of Fort Myers Gen. Empls.' Pension Fund v. Haley*, 235 A.3d 702, 717 n.49 (Del. 2020)** (citing Macmillan, 559 A.2d at 1279-81).

[488] D.I. 82 at 32-33 (alteration, citations, footnote, and internal quotation marks omitted) (citing Compl. ¶ 124, and then quoting Macmillan, 559 A.2d at 1279).

[489] *See infra* Section II.A.2.a; *see also* Mindbody, 2020 Del. Ch. LEXIS 307, 2020 WL 5870084, at *1 ("[T]he paradigmatic claim under *Revlon, Inc. v MacAndrews & Forbes Holdings, Inc.* arises when a supine board under the sway of an overweening CEO bent on a certain direction tilts the sales process for reasons inimical to the stockholders' desire for the best price." (alteration, footnote, and internal quotation marks omitted) (quoting In re Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975, 1002 (Del. Ch. 2005))).

[490] Macmillan, 559 A.2d at 1282.

[491] Id. at 1280.

interested management's false portrayal of a potential bidder that "served more to propagandize the board than to enlighten it."[492] Management worked intensely and furtively with Macmillan's Special Committee's financial advisor on restructuring proposals that would eventually reach the Special Committee that largely benefitted management.[493] Throughout negotiations and restructuring, "the Board and the Special Committee followed [management] in lockstep. Neither took reasonable efforts to uncover **[*90]** the facts."[494] Because of the deception in the change-of-control process, and because the board's oversight failure "afforded management the opportunity to indulge in the misconduct which occurred," entire fairness review was warranted.[495]

In recent years, Delaware courts have honed the pleading-stage distinctions between a paradigmatic *Revlon* claim and a *Mills* theory warranting entire fairness review.[496] First, the rogue fiduciary must be materially interested, as by seeking control or benefit from the company post-merger.[497] Second, the board must be "inattentive or ineffective" and permit the fiduciary's manipulation.[498] Third, so enabled, the fiduciary must commit deception or manipulation, as by "deceiving an independent board of directors into favoring a bidder"[499] or "fail[ing] to disclose his 'interest in the transaction to the board.'"[500] Fourth, that deception must be material.[501] "[A]n omission is 'material' to a board if the undisclosed fact is relevant and of a magnitude to be important to directors in carrying out their fiduciary duty of care in decisionmaking."[502] Finally, the "key issue" is whether it is reasonably conceivable that the deception "tainted the decisionmaking of [the] concededly **[*91]** independent and disinterested directors[.]"[503] The fiduciary's

[492] *Id. at 1267* (citation and internal quotation marks omitted).

[493] *Id. at 1268*.

[494] *Id. at 1269* (emphasis omitted).

[495] *Id. at 1279*.

[496] Of course, fraud on the board can also be perpetuated by an advisor. *See, e.g.,* ***RBC Cap. Mkts., LLC v. Jervis, 129 A.3d 816 (Del. 2015)***. My discussion here focuses on the line between an overweening officer and a fraudster.

[497] *See* ***Haley, 235 A.3d at 717, 719***; *City of Miami Gen. Empls.' v. Comstock, 2016 Del. Ch. LEXIS 133, 2016 WL 4464156, at *19 (Del. Ch. Aug. 24, 2016)* (noting "plaintiff must allege that [the fiduciary] was acting out of self-interest and that he deceived the rest of the board into approving the transaction," and declining to apply entire fairness because the fiduciary was not self-interested), *aff'd*, ***158 A.3d 885 (Del. 2017)***; *City of Warren Gen. Empls.' Ret. Sys. v. Roche, 2020 Del. Ch. LEXIS 352, 2020 WL 7023896, at *10 (Del. Ch. Nov. 30, 2020)* (concluding the plaintiff failed to plead that the defendant fiduciaries were tainted by self-interest with respect to the buyout).

[498] *Roche, 2020 Del. Ch. LEXIS 352, 2020 WL 7023896, at *15*; *see also* *Macmillan, 559 A.2d at 1279* (noting the board's lack of oversight afforded the opportunity for mismanagement); *Mindbody, 2020 Del. Ch. LEXIS 307, 2020 WL 5870084 at *25* (considering whether "the Board was the passive victim of a rogue fiduciary" due to an informal, ill-equipped, and tardily-formed transaction committee); ***Kahn v. Stern, 183 A.3d 715, n.4, 2018 Del. LEXIS 114 (Del. 2018)*** (TABLE) (noting that a variant of *Macmillan* claim exists where "impartial board members did not oversee conflicted members sufficiently"); *In re Xura, Inc. Stockholder Litig., 2018 Del. Ch. LEXIS 563, 2018 WL 6498677, at *4 (Del. Ch. Dec. 10, 2018)* (discussing allegations of an inert special committee formed to evaluate and negotiate a transaction with a bidder, including an allegation that one of its members "did not even realize that the Special Committee existed or that he was a member of the committee until he learned about it at his deposition").

[499] *Roche, 2020 Del. Ch. LEXIS 352, 2020 WL 7023896, at *17* (citing *Macmillan, 559 A.2d at 1279*, and also citing ***Stern, 183 A.3d 715 at n.4***, and also citing *Comstock, 2016 Del. Ch. LEXIS 133, 2016 WL 4464156, at *19*); *accord* *Comstock, 2016 Del. Ch. LEXIS 133, 2016 WL 4464156, at *20*.

[500] ***Haley, 235 A.3d at 717*** (quoting *Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1168 (Del. 1995)*); *accord* *Mindbody, 2020 Del. Ch. LEXIS 307, 2020 WL 5870084, at *23-24*.

[501] *Mindbody, 2020 Del. Ch. LEXIS 307, 2020 WL 5870084, at *23-25*.

[502] *2020 Del. Ch. LEXIS 307, [WL] at *23* (internal quotation marks omitted) (quoting ***Haley, 235 A.3d at 718***). "[T]he term 'material,' when used in the context of a director's obligation to be candid with the other members of the Board, is distinct from the use of the term 'material' in the quite different context of disclosure to stockholders in which an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." ***Haley, 235 A.3d at 719*** (alteration and internal quotation marks omitted) (quoting *Brehm, 746 A.2d at 259 n.49*).

[503] *Roche, 2020 Del. Ch. LEXIS 352, 2020 WL 7023896, at *15* (quoting *Baker Hughes, 2020 Del. Ch. LEXIS 321, 2020*

allegedly deceptive or manipulative conduct must cause the board to take action or inaction that was outcome-determinative.

Thus, to elevate the standard of review for a paradigmatic *Revlon* claim, an interested officer must be more than overweening; he must be fraudulent or outright manipulative. The board must be more than supine; it must be deceived and permit that deception. And the deception must affect the outcome. To raise the standard of review on any less risks swallowing enhanced scrutiny in every paradigmatic *Revlon* case.[504]

Garland was materially interested, and the Special Committee failed to vigorously enforce its instructions or effectively manage conflicts. Garland misled the Special Committee, failing to disclose that he met with Riverstone and Buyer together, and saying instead that meetings with Buyer and Riverstone would occur in the coming weeks, and that Buyer's "approach the company...had come about indirectly."[505] But the Special Committee's deficiencies did not facilitate Garland's deception. The Special Committee oversaw and engaged in the sale process, **[*92]** and took measures to oversee Garland, including issuing repeated instructions on how conflicted fiduciaries should behave and issuing a corrective memorandum after learning of Garland's April 15 Meeting.[506] Importantly, Plaintiff's argument seeking entire fairness review depends on the allegation that "Garland breached the Committee protocols."[507] Batkin told the Special Committee Garland had discussions with Riverstone and Buyer concerning a potential acquisition, albeit tardily and without the detail that Garland had met with them together.

The undisclosed fact that Garland had met with Riverstone and Buyer together "is relevant and of a magnitude to be important to directors in carrying out their fiduciary duty of care in decisionmaking."[508] The April 15 Meeting's materiality is evidenced by the Batkin Memo, which is the only memo sent during the process. On May 15, the Batkin Memo informed the Special Committee that Garland had discussions with Riverstone and Buyer concerning Buyer's potential acquisition of the Company. The Batkin Memo indicated that Buyer was interested in a transaction and was willing to enter into a confidentiality agreement to engage in discussions. But the Batkin **[*93]** Memo did not fully disclose that Garland met with Riverstone and Buyer together and the impetus for, circumstances surrounding, and substance of that meeting.

As for the Proxy, it discloses the fact of the meeting but is silent regarding its timing, substance, and context. It inaccurately suggests that Garland disclosed the April 15 Meeting immediately after it occurred—if Garland had so disclosed shortly after the April 15 Meeting as the Proxy suggests, there would have been no occasion to circulate the Batkin Memo weeks later. The Proxy also states that on May 2, Garland "informed the Special Committee of his recent meeting with Riverstone Representatives and [Buyer]."[509] But the May 2 meeting minutes do not mention Buyer, and state that Garland disclosed Riverstone had suggested taking the Company private in conjunction with an unidentified third-party institutional investor, but had "dropped the suggestion following consideration of conflicts and certain contractual obligations of [Riverstone]."[510] The May 2 meeting minutes were therefore also misleading, as Garland had already identified and held a meeting with Buyer.

To be sure, Garland's tardy half-truths pale in comparison to the undisclosed **[*94]** conflicts in *Haley* and *Mindbody*.[511] They more resemble the immaterial

WL 6281427, at *19).

504 *See* Macmillan, 559 A.2d at 1279 ("[J]udicial reluctance to assess the merits of a business decision ends in the face of illicit manipulation of a board's deliberative processes by self-interested corporate fiduciaries. Here, not only was there such deception, but the board's own lack of oversight in structuring and directing the auction afforded management the opportunity to indulge in the misconduct which occurred. In such a context, the challenged transaction must withstand rigorous judicial scrutiny under the exacting standards of entire fairness.").

505 Compl. ¶ 140.

506 *Id.* ¶ 128.

507 D.I. 82 at 34.

508 Mindbody, 2020 Del. Ch. LEXIS 307, 2020 WL 5870084, at *23 (internal quotation marks omitted) (quoting ***Haley, 235 A.3d at 718***).

509 Proxy at 40.

510 Compl. ¶ 127.

511 *See* ***Haley, 235 A.3d at 719*** ("Plaintiffs have adequately alleged that the Board would have found it material that its lead negotiator had been presented with a compensation proposal having a potential upside of nearly five times his compensation at Towers, and that he was presented with this

early undisclosed management employment discussion in *Comstock*, as the Special Committee would become fully aware of Riverstone and Buyer's partnership, just as the *Comstock* board would become aware of the undisclosed discussion.[512] But the Batkin Memo supports the inference that the Company's fiduciaries considered the April 15 Meeting material.

While the full story about the April 15 Meeting is material, its concealment did not impact the Special Committee's decisionmaking as Plaintiff suggests. Garland's belated half-truths about the meeting appear to have had no effect on the process. The omitted fact that he actually spoke with Riverstone and Buyer together, and the belated disclosure in the Batkin Memo, does not amount to "illicit manipulation of the board's deliberative process."[513] As in *Comstock*, Plaintiff does not allege that Riverstone's partnership with Buyer was never disclosed to the Board, or that any terms Garland may have negotiated in those discussions were hidden.[514]

While Plaintiff contends the April 15 Meeting gave Riverstone and Buyer entry to the sales process, the Board had already included **[*95]** Riverstone in the process. Riverstone's representative, Hunt, attended the first Board meeting and substantive discussions of potential strategic alternatives.[515] "The Board then solicited the views of Riverstone" who it believed "may be interested in participating in a potential transaction."[516]

Plaintiff has not alleged how the meeting, the delayed and incomplete disclosures, or the Special Committee's lukewarm response harmed Brookfield, caused the Board or Special Committee to disadvantage Brookfield, or enabled Garland to continue any meaningful unprincipled conduct. The Special Committee, with Batkin in the driver's seat, engaged with Brookfield and afforded it the opportunity to conduct extensive due diligence. Nor did Garland mislead the Special Committee as to Brookfield's bid; the Special Committee and its advisors acknowledged the superior aspects of Brookfield's bid, including its superior value. Plaintiff does not allege that Garland "deceived the rest of the board into approving the transaction" or into rejecting Brookfield.[517] Plaintiff does not plead facts to support outcome-determinative deception.[518]

I end where I began, by noting that Plaintiff's paradigmatic ***[*96]*** *Revlon* theory of breach is incompatible with her fraud-on-the-board theory for entire fairness. Under Plaintiff's own breach theory, in which the Special Committee favored Riverstone's interest over that of company stockholders, the sales process outcome would have been the same whether or not the Special Committee immediately learned the full truth of Garland's April 15 Meeting with Riverstone and Buyer.

b. Whether The Officer And Entity Defendants Form A Control Group Must Be Determined With The Benefit Of A Factual Record.

Plaintiff alleges the Officer Defendants stood on both sides of the transaction; that Riverstone and the Officer Defendants, as Developer 2 stakeholders, competed with the Company's public stockholders for consideration; and that Riverstone and the Officer Defendants retained equity in the post-Merger entity while public stockholders were cashed out. Plaintiff

---

Proposal during an atmosphere of deal uncertainty and before they authorized him to renegotiate the merger consideration."); *Mindbody, 2020 Del. Ch. LEXIS 307, 2020 WL 5870084, at *24* (offering a "catalogue[]" of "undisclosed conflicts").

[512] *Comstock, 2016 Del. Ch. LEXIS 133, 2016 WL 4464156, at *21* ("Plaintiff also alleges that Comstock deceived the board by failing to inform it of various steps he took while negotiating the transaction. For instance, plaintiff alleges that Comstock did not disclose an early discussion with Petrello regarding C&J management's potential future contracts with New C&J, or Comstock's motives for negotiating the transaction, as plaintiff interprets them. Significantly, however, plaintiff does not allege that management's eventual future roles were never disclosed to the board, or that the critical deal terms Comstock negotiated, such as the EBITDA multiple, were hidden from the board." (footnote omitted)).

[513] *2016 Del. Ch. LEXIS 133, [WL] at *19* (quoting *Macmillan, 559 A.2d at 1279*).

[514] *Compare* *2016 Del. Ch. LEXIS 133, [WL] at *21*, *with* *Macmillan, 559 A.2d at 1279*.

[515] Compl. ¶¶ 92-94.

[516] *Id.* ¶ 97 (emphasis omitted).

[517] *See* *Comstock, 2016 Del. Ch. LEXIS 133, 2016 WL 4464156, at *19*.

[518] *Roche, 2020 Del. Ch. LEXIS 352, 2020 WL 7023896, at *14-15*; *see also* *Comstock, 2016 Del. Ch. LEXIS 133, 2016 WL 4464156, at *21* (describing the type of deceitful conduct necessary to trigger entire fairness).

contends the Entity and Officer Defendants (together, the "Controller Defendants") aggregated their sources of power and influence to control the Company. Accordingly, entire fairness review may be warranted if the Entity and Officer Defendants acted as a control group.[519]

"Delaware law imposes fiduciary duties **[*97]** on those who effectively control a corporation."[520] The premise for contending that a controller owes fiduciary duties "is that the controller exerts its will over the enterprise in the manner of the board itself."[521] The controller analysis "must take into account whether the stockholder, as a practical matter, possesses a combination of stock voting power and managerial authority that enables him to control the corporation, if he so wishes."[522] If a controller or control group is present, entire fairness review arises "when the board labors under actual conflicts of interest" stemming from the controller standing on both sides of a challenged transaction or competing with the minority for consideration.[523] "The question whether a shareholder is a controlling one is highly contextualized and is difficult to resolve based solely on the complaint."[524] "[T]here is no magic formula to find control; rather, it is a highly fact specific inquiry."[525]

Delaware cases have traditionally evaluated whether stockholders wielded control over the corporation.[526] This is unsurprising, as control manifests in whether an individual or entity has the power to displace the will **[*98]** of the board,[527] and stock ownership is the

[519] Despite Plaintiff's deficient presentation of this theory for purposes of the standard of review, limited to a footnote in her answering brief, I consider whether she has pled a control group because she also asserts the Controller Defendants owe fiduciary duties and are liable for breaching them, and has briefed that those claims should survive Defendants' motion under *Rule 12(b)(6)*. *See* D.I. 82 at 34 n.66.

[520] *Voigt v. Metcalf, 2020 Del. Ch. LEXIS 55, 2020 WL 614999, at *11 (Del. Ch. Feb. 10, 2020)* (quoting *Quadrant Structured Prods. Co. Ltd. v. Vertin, 102 A.3d 155, 183-84 (Del. Ch. 2014)*).

[521] *Abraham v. Emerson Radio Corp., 901 A.2d 751, 759 (Del. Ch. 2006)*.

[522] *In re Cysive, Inc. S'holders Litig., 836 A.2d 531, 553 (Del. Ch. 2003)*.

[523] *FrontFour Cap. Gp. LLC v. Taube, 2019 Del. Ch. LEXIS 97, 2019 WL 1313408, at *20 (Del. Ch. Mar. 11, 2019)* (quoting *Reis, 28 A.3d at 457*, and citing *Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997)*, and *Kahn, 638 A.2d at 1115*, and *Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983)*, and *In re John Q. Hammons Hotels Inc. S'holder Litig., 2009 Del. Ch. LEXIS 174, 2009 WL 3165613, at *12 (Del. Ch. Oct. 2, 2009)*, and *In re Delphi Fin. Gp. S'holder Litig., 2012 Del. Ch. LEXIS 45, 2012 WL 729232, at *12 n.57 (Del. Ch. Mar. 6, 2012)*, and also citing *In re Primedia, Inc. S'holders Litig., 67 A.3d 455, 487 (Del. Ch. 2013)*).

[524] *Williamson v. Cox Commc'ns, Inc., 2006 Del. Ch. LEXIS 111, 2006 WL 1586375, at *6 (Del. Ch. June 5, 2006)*; *accord* *In re Tesla Motors, Inc. S'holder Litig., 2018 Del. Ch. LEXIS 102, 2018 WL 1560293, at *13 (Del. Ch. Mar. 28, 2018)* ("Whether a large blockholder is so powerful as to have obtained the status of a 'controlling stockholder' is intensely factual and it is a difficult question to resolve on the pleadings." (alterations and internal quotation marks omitted)); *Cysive, 836 A.2d at 550-51* (same); *see* *In re Zhongpin Inc. S'holders Litig., 2014 Del. Ch. LEXIS 252, 2014 WL 6735457, at *9 n.33 (Del. Ch. Nov. 26, 2014)* ("Whether or not a particular CEO and sizeable stockholder holds more practical power than is typical should not be decided at the motion to dismiss stage if a plaintiff pleads facts sufficient to raise the inference of control. To ignore real-world indicia of a stockholder's actual power would depart from this Court's precedent."), *rev'd on other grounds sub nom.* *In re Cornerstone Therapeutics Inc. S'holder Litig., 115 A.3d 1173 (Del. 2015)*.

[525] *Calesa Assocs., L.P. v. Am. Cap., Ltd., 2016 Del. Ch. LEXIS 41, 2016 WL 770251, at *11 (Del. Ch. Feb. 29, 2016)* (citing *In re Crimson Expl. Inc. S'holder Litig., 2014 Del. Ch. LEXIS 213, 2014 WL 5449419, at *10 (Del. Ch. Oct. 24, 2014)*); *see* *Zhongpin, 2014 Del. Ch. LEXIS 252, 2014 WL 6735457, at *6-7* (noting the inquiry of "whether or not a stockholder's voting power and managerial authority, when combined, enable him to control the corporation . . . is not a formulaic endeavor and depends on the particular circumstances of a given case" (footnote and internal quotation marks omitted) (quoting *Cysive, 836 A.2d at 553*)).

[526] *E.g.*, *In re KKR Fin. Hldgs. LLC S'holder Litig., 101 A.3d 980, 983 (Del. Ch. 2014)* ("This action involves the novel claim that a holder of less than one percent of the stock of a Delaware corporation was a controlling stockholder and thus owed fiduciary obligations to the other stockholders of the corporation."), *aff'd sub nom.* ***Corwin v. KKR Fin. Hldgs. LLC, 125 A.3d 304 (Del. 2015)***.

[527] *Superior Vision Servs., Inc. v. Reliastar Life Ins. Co., 2006 Del. Ch. LEXIS 160, 2006 WL 2521426, at *4 (Del. Ch. Aug. 25, 2006)* (considering "whether the actual control must be over the Board or whether separately negotiated contract rights can supply the requisite degree of control," and noting

original vehicle for such displacement. A majority stockholder's control flows principally from its voting power, which translates into the power to "alter materially the nature of the corporation and the public stockholders' interests."[528]

For a minority stockholder or an aggregate control group of minority stockholders, fiduciary duties flow from aggregated sources of influence, including voting power and softer sources of power.[529] "It is impossible to identify or foresee all of the possible sources of influence that could contribute to a finding of actual control."[530] The many sources of influence and of control that could contribute to a finding of actual control include:

> (i) relationships with particular directors, (ii) relationships with key managers or advisors, (iii) the exercise of contractual rights to channel the corporation into a particular outcome, and (iv) the existence of commercial relationships that provide the defendant with leverage over the corporation, such as status as a key customer or supplier.[531]

"Broader indicia of effective control also play a role,"[532] and include, but are not limited to, ownership of **[*99]** a significant equity stake; the right to designate directors; contractual augmentation of the power of a minority stockholder or board-level position; and the ability to exercise outsized influence in the board room or on committees, as through roles like CEO, Chairman, or founder.[533]

Here, Plaintiff's control group theory aggregates the Officer Defendants' stock holdings and management roles with the Entity Defendants' contractual, operational, and structural pull, even though the Entity Defendants are not stockholders. Plaintiff pegs the Entity Defendants as the group's primary source of power, pointing to the Company's formation to serve Riverstone, the importance of Developer 2's commercial relationship with the Company, Riverstone's ability to install insiders as officers and directors at both the Company and Developer 2, and the Consent Right. Accordingly, this case presents an interesting wrinkle. It is an open question under Delaware law whether the Entity Defendants' soft power alone, anchored in historical and commercial ties and the contractual Consent Right, can support including the Entity Defendants in a control group and imposing fiduciary **[*100]** duties.

This Court has dismissed fiduciary duty claims against a group of alleged controllers where some or all of the members held no stock in the company.[534] For

---

that, in evaluating whether a stockholder is a controller, "Delaware case law has focused on control of the board").

528 *Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 43 (Del. 1994)*; *see also* *Voigt, 2020 Del. Ch. LEXIS 55, 2020 WL 614999, at *11* ("One method of pleading control sufficient to impose fiduciary duties is to allege that a defendant has the ability to exercise a majority of the corporation's voting power.").

529 *See* ***Corwin, 125 A.3d at 307*** (noting the Delaware Supreme Court's "instructions" to "look[] for a combination of potent voting power and management control such that the stockholder could be deemed to have effective control of the board without actually owning a majority of stock" (footnote omitted)); *Emerald P'rs v. Berlin, 726 A.2d 1215, 1221 n.8 (Del. 1999)* (noting that minority stockholdings with "some additional allegation of domination through actual control of corporate conduct" may give rise to controller status); *In re PNB Hldg. Co. S'holders Litig., 2006 Del. Ch. LEXIS 158, 2006 WL 2403999, at *9 (Del. Ch. Aug. 18, 2006)* (considering "stockholders who, although lacking a clear majority, have such formidable voting and managerial power that they, as a practical matter, are no differently situated than if they had majority voting control"); *see also* *8 Del. C. § 203(c)(4)* (defining "[c]ontrol" as "the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting stock, by contract or otherwise"); *17 C.F.R. § 230.405* (defining "control" as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise").

530 *Voigt, 2020 Del. Ch. LEXIS 55, 2020 WL 614999, at *12* (citing *Basho Techs. Holdco B, LLC v. Georgetown Basho Invs., LLC, 2018 Del. Ch. LEXIS 222, 2018 WL 3326693, at *26 (Del. Ch. July 6, 2018)*, *aff'd sub nom.* ***Davenport v. Basho Techs. Holdco B, LLC, 221 A.3d 100, 2019 Del. LEXIS 476 (Del. 2019)*** (TABLE)).

531 *Id.* (citing *Basho, 2018 Del. Ch. LEXIS 222, 2018 WL 3326693, at *26*).

532 *Id.* (citing *Basho, 2018 Del. Ch. LEXIS 222, 2018 WL 3326693, at *27*).

533 *Id.* (citing *Basho, 2018 Del. Ch. LEXIS 222, 2018 WL 3326693, at *27*).

534 *See, e.g.*¸ *Skye Min. Inv'rs, LLC v. DXS Cap. (U.S.) Ltd., 2020 Del. Ch. LEXIS 72, 2020 WL 881544, at *24-29 (Del. Ch. Feb. 24, 2020)*; *Klein v. H.I.G. Cap., L.L.C., 2018 Del. Ch. LEXIS 577, 2018 WL 6719717, at *13 (Del. Ch. Dec. 19,

example, *Klein v. H.I.G. Capital, L.C.C.* considered a "novel" control group theory in which the group's purported members were not alleged to have owned any company stock at the time of the transaction in question.[535] Relying on the accurate observation that Delaware law looks to substance rather than form when considering who wields control sufficient to impose fiduciary duties, the plaintiff argued that the group's members "were effectively controlling stockholders of the Company."[536] The Court rejected this position: "[i]t [wa]s not alleged that [the defendant] owned *any* stock of [the company] until the Transactions closed and thus, by definition, [the defendant] could not have been part of a 'group' of Company stockholders when the Transactions were negotiated."[537]

But after remarking on the hurdle of stock ownership, the Court went on to make the "more general[]" observation that the complaint was "devoid of any allegations that [the defendant] was a party to any agreement or arrangement that controlled the votes of **[*101]** any shares of the Company's stock," or that it "otherwise took any action to exercise control over the directors of [the company] before the parties entered into the Transactions."[538] Rather, the most that could be reasonably inferred from alleged sources of power other than stock ownership was that the purported controller "had the potential to *later* exercise control over the Company," which "is not enough to impose fiduciary obligations."[539]

And *Skye Mineral Investors, LLC v. DXS Capital (U.S.) Limited* considered claims against an alleged control group of six, only two members of which held any company stock.[540] Because the alleged group owned less than 50% of the outstanding stock, the Court observed that plaintiff was required to plead facts "allow[ing] a reasonable inference that the Alleged Controllers exercised such formidable voting and managerial power that, as a practical matter, they were no differently situated than if they had majority voting control."[541] As to the four alleged nonstockholder control group members, the Court concluded it was "not reasonably conceivable they exercised actual control over the company because they "owned *no* [company] units, appointed *none* of **[*102]** [the company]'s Board members and held *no* contractual blocking rights."[542]

But as to the two minority stockholders, the Court found it reasonably conceivable that they exercised control, aggregating their stock with their contractual blocking rights.[543] The Court emphasized that "the focal point" of the control analysis was the stockholders' blocking rights and how they used them.[544] Relying on *Basho Technologies v. Georgetown Basho Investors*,[545] the defendants argued that "a mere blocking right standing

---

2018); Forsythe v. ESC Fund Mgmt. Co. (U.S.), 2007 Del. Ch. LEXIS 140, 2007 WL 2982247, at *12-13 (Del. Ch. Oct. 9, 2007).

535 2018 Del. Ch. LEXIS 577, 2018 WL 6719717, at *13.

536 *Id.*

537 *Id.*

538 *Id.*

539 *Id.* (emphasis added) (citing In re Sea-Land Corp. S'holders Litig., 1987 Del. Ch. LEXIS 439, 1987 WL 11283, at *5 (Del. Ch. May 22, 1987) (reasoning that the "potential ability to exercise control is not equivalent to the actual exercise of that ability," and only actual control over the board's decision-making process suffices to impose fiduciary duties (emphasis omitted)), and also citing Gilbert v. El Paso Co., 490 A.2d 1050, 1056 (Del. Ch. 1984) ("Plaintiffs' contention that Burlington occupied a fiduciary role because of its potential for control is subject to the same infirmity as its contract argument. . . . State law claims of breach of contract and breach of fiduciary relationship must subsist on the actuality of a specific legal relationship, not in its potential."), *aff'd*, 575 A.2d 1131 (Del. 1990)).

540 Skye Min. Inv'rs., 2020 Del. Ch. LEXIS 72, 2020 WL 881544, at *24-29.

541 2020 Del. Ch. LEXIS 72, [WL] at *26 (alterations and internal quotation marks omitted) (quoting In re Morton's Rest. Gp., Inc. S'holders Litig., 74 A.3d 656, 665 (Del. Ch. 2013)).

542 2020 Del. Ch. LEXIS 72, [WL] at *27 (emphasis in original).

543 2018 Del. Ch. LEXIS 222, [WL] at *26.

544 *Id.* (citing Basho, 2018 Del. Ch. LEXIS 222, 2018 WL 3326693, at *25 ("If a defendant wields control over a corporation" either "generally or with regard to a particular transaction," then "the defendant takes on fiduciary duties, even if the defendant is a stockholder who otherwise would not owe duties in that capacity."), 2018 Del. Ch. LEXIS 222, [WL] & *26 (noting that a plaintiff can show a minority blockholder's domination and control in various ways including personal relationships with board members, contractual rights, commercial relationships, *de facto* ability to remove directors or the company's own characterizations of the minority blockholder's influence)).

545 2018 Del. Ch. LEXIS 222, 2018 WL 3326693 (Del. Ch. July 6, 2018).

alone is highly unlikely to support either a finding or a reasonable inference of control."[546] The Court agreed with that statement, but held the plaintiff had alleged more.[547] As alleged, the blocking rights "amounted to a self-destruct button" that allowed the stockholders to "wield control by driving [the company] into the ground if it suited their interests."[548] With this "on/off switch for [the company] that could be, and allegedly was, manipulated by [the stockholders] to serve their interests at the expense of [the company],"[549] the stockholders "exercised their leverage with the Blocking Rights to steer [the company's operating subsidiary] off the cliff into the bankruptcy ravine below," by allowing **[*103]** the stockholders "to block *all* of [the company]'s efforts to finance *any* of its ongoing operations."[550] As the Court observed, "[w]hen blocking rights empower a minority investor to channel the corporation into a particular outcome, they contribute to an inference of control."[551] The *Skye* plaintiffs "ma[d]e an even stronger case as the Blocking Rights did more than channel [the company] to a particular outcome," as "the Blocking Rights gave [the stockholders] the unilateral power to shut [the company] down—full stop."[552] In the end, the Court declined to impute the stockholders' blocking right to the nonstockholders, who otherwise brought no power to the table, and so declined to find a control group.[553]

Klein and *Skye Mineral Investors* concluded that the members of a purported control group that did not own stock were not part of the group. But both looked beyond the bounds of stock ownership to other sources of soft power and left open the possibility that, if a plaintiff pleads sufficient sources of influence, controller status and its attendant fiduciary duties may extend to a nonstockholder.[554] These fact-specific evaluations of nonstockholder members of alleged control **[*104]** groups followed this Court's consideration of the possibility that fiduciary duties would extend to a nonstockholder in *In re EZCORP Inc. Consulting Agreement Derivative Litigation*.[555] That consideration built on the United States Supreme Court's decision in *Southern Pacific Co. v. Bogert*,[556] which observed that the "the doctrine under which majority stockholders exercising control are deemed trustees for the minority" was not avoided simply because the defendant "did not itself own directly any stock" in the company, but exerted its control through its subsidiary that held the majority of the company's stock.[557] The Supreme Court stated,

> [T]he doctrine by which the holders of a majority of the stock of a corporation who dominate its affairs are held to act as trustee for the minority does not rest upon such technical distinctions. It is the fact of control of the common property held and exercised, not the particular means by which or manner in which the control is exercised, that creates the fiduciary obligation.[558]

Chancellor Wolcott similarly held in the seminal decision in *Eshleman v. Keenan*;[559] affirming that decision, the Delaware Supreme Court ruled that "the formal corporate vehicle" behind **[*105]** a transaction does not necessarily matter, as "[t]he conception of corporate entity is not a thing so opaque that it cannot be seen through."[560] Drawing on *Southern Pacific* and

---

[546] *Skye Min. Inv'rs., 2020 Del. Ch. LEXIS 72, 2020 WL 881544, at *27* (internal quotation marks omitted) (referring to *Basho, 2018 Del. Ch. LEXIS 222, 2018 WL 3326693, at *26 n.315*).

[547] *Id.*

[548] *2020 Del. Ch. LEXIS 72, [WL] at *26* (internal quotation marks omitted).

[549] *Id.*

[550] *2020 Del. Ch. LEXIS 72, [WL] at *27* (emphasis in original).

[551] *Id.* (internal quotation marks omitted) (quoting *Basho, 2018 Del. Ch. LEXIS 222, 2018 WL 3326693, at *29*).

[552] *Id.* (internal quotation marks omitted) (quoting *Basho, 2018 Del. Ch. LEXIS 222, 2018 WL 3326693, at *29*).

[553] *See* *2020 Del. Ch. LEXIS 72, [WL] at *27-29*.

[554] *See id.*; *Klein, 2018 Del. Ch. LEXIS 577, 2018 WL 6719717, at *13*.

[555] *2016 Del. Ch. LEXIS 14, 2016 WL 301245, at *8-10 (Del. Ch. Jan. 25, 2016)*.

[556] *250 U.S. 483, 39 S. Ct. 533, 63 L. Ed. 1099 (1919)*.

[557] *Id. at 491-92*.

[558] *Id. at 492*.

[559] *21 Del. Ch. 259, 187 A. 25 (Del. Ch. 1936)*, *aff'd*, *23 Del. Ch. 234, 2 A.2d 904 (Del. 1938)*.

[560] *EZCORP, 2016 Del. Ch. LEXIS 14, 2016 WL 301245, at *9* (quoting *Eshleman, 2 A.2d at 908*).

Eshleman, EZCORP held that fiduciary duties extended to an individual defendant that was the company's "ultimate controller," even though he exercised control only indirectly and did not himself own stock.[561]

Fiduciary duties arise from the separation of ownership and control.[562] The essential quality of a fiduciary is that she controls something she does not own. A trustee need not (and does not) own the assets held in trust; directors need not own stock. Even a third party lender that influences extraordinary influence over a company may be liable for acting negligently or in bad faith.[563] If a stockholder, as one co-owner, can owe fiduciary duties to fellow co-owners because the stockholder controls the thing collectively owned, surely an "outsider[]" that controls something it does not own owes duties to the owner.[564] "[I]t is a maxim of equity that 'equity regards substance rather than form,'"[565] and "the application of equitable principles depends on the substance of control rather than the form[;] it does not **[*106]** matter whether the control is exercised directly or indirectly."[566] "[T]he level of stock ownership is not the predominant factor, and an inability to exert influence through voting power does not foreclose a finding of control."[567] Thus, "Delaware corporate decisions consistently have looked to who wields control in substance and have imposed the risk of fiduciary liability on that person,"[568] and "[l]iability for breach of fiduciary duty *therefore extends to outsiders* who effectively controlled the corporation."[569]

With this foundation, and considering evolving market realities and corporate structures affording effective control, Delaware law may countenance extending controller status and fiduciary duties to a nonstockholder that holds and exercises soft power that displaces the will of the board with respect to a particular decision or transaction.

Here, in the context of the Company's end-stage transaction, Plaintiff asks the Court to consider Riverstone's Consent Right, its commercial power through Developer 2, and role as the Company's creator, together with the Officer Defendants' managerial power and some stockholdings. And so, with the door left open **[*107]** by *EZCORP, Skye Mineral*

[561] 2016 Del. Ch. LEXIS 14, [WL] at *10.

[562] *See* S. Pac. Co., 250 U.S. at 492.

[563] Basho, 2018 Del. Ch. LEXIS 222, 2018 WL 3326693, at *26 (citing NVent, LLC v. Hortonworks, Inc., 2017 Del. Super. LEXIS 52, 2017 WL 449585 at *9-10 (Del. Super. Feb. 1, 2017) (applying California law)).

[564] EZCORP, 2016 Del. Ch. LEXIS 14, 2016 WL 301245, at *9 (citing S. Pac. Co., 250 U.S. at 488, and Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 93 A.2d 107, 109-10 (Del. 1952)).

[565] *Id.* (quoting Monroe Park v. Metro. Life Ins. Co., 457 A.2d 734, 737 (Del. 1983), and citing Gatz v. Ponsoldt, 925 A.2d 1265, 1280 (Del. 2007)).

Not every member of a control group needs to be similarly situated in that they each own stock. Envision a particular task that requires a truck, tools, and know-how. A first person owns a truck, a second owns the tools, and the third has the know-how. The three individuals can come together and complete the task, and are responsible for the quality of its completion. Their contributions need not be in identical ratios; that they do not each possess one truck part, one tool, and one skill is no reason to absolve them of their responsibility for the final work product. Similarly, holders of voting and soft power can work together to exert control without being similarly situated. The Officer Defendants contributed stock ownership and executive leadership positions; Developer 2 had its commercial relationship with the Company; and Riverstone had the Consent Right, the Officer Defendants, and Developer 2. When aggregated, those sources of influence enabled the Controller Defendants to complete the task: exercising control over the Company to cause a merger with Buyer. The fact that the different actors held different sources of disaggregated power does not dilute their combined effectiveness, and I can see no reason why it should absolve the actors of the consequences of their control.

[566] EZCORP, 2016 Del. Ch. LEXIS 14, 2016 WL 301245, at *9-10.

[567] FrontFour, 2019 Del. Ch. LEXIS 97, 2019 WL 1313408, at *21; *see also* Crimson Expl., 2014 Del. Ch. LEXIS 213, 2014 WL 5449419, at *10 (collecting cases and noting that "the cases do not reveal any sort of 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," but "[i]nstead, the scatter-plot nature of the holdings highlights the importance and fact-intensive nature of the actual control factor"); Calesa Assocs., 2016 Del. Ch. LEXIS 41, 2016 WL 770251, at *11 (discussing *Crimson Exploration* and noting that it "found no correlation between the percentage of equity owned and the determination of control status").

[568] EZCORP, 2016 Del. Ch. LEXIS 14, 2016 WL 301245, at *9.

[569] *Id.* (emphasis added) (citing S. Pac. Co., 250 U.S. at 488, and also citing Sterling, 93 A.2d at 109-10).

Investors, and *Klein*, I proceed with the well-established control group analysis to consider whether the Controller Defendants collectively owed duties with respect to the Merger.

To plead a control group, the plaintiff must first plead the connection among those in the purported control group was "legally significant" to subject the members to fiduciary duties.[570] Plaintiff must then allege that the control group exercised *de facto* control by actual domination or control of the board generally, or actual domination or control of the corporation, its board, or the deciding committee with respect to the challenged transaction.[571]

I first consider whether Plaintiff has alleged that the Controller Defendants were bound in a legally significant way. The Delaware Supreme Court recently addressed the requirements for pleading a control group in *Sheldon v. Pinto Technology Ventures, L.P.*, adopting the "legally significant connection" standard applied by multiple decisions of this Court:

> To demonstrate that a group of stockholders exercises control collectively, the [plaintiff] must establish that they are connected in some legally significant way—such as by contract, common **[*108]** ownership, agreement, or other arrangement—to work together toward a shared goal. To show a legally significant connection, the [plaintiff] must allege that there was more than a mere concurrence of self-interest among certain stockholders. Rather, there must be some indication of an actual agreement, although it need not be formal or written.[572]

Both historical ties and transaction-specific ties may support an inference of an actual agreement.[573] Plaintiff has alleged facts giving rise to the reasonable inference that the alleged group had an "actual agreement" to work together in connection with the sales process.[574] Plaintiff identifies relevant historical and transactional ties, reflected in the Company's inception and its capital structures and management, and the Consent Right. Plaintiff relates Riverstone's long history with the Officer Defendants and the Company, alleging that "[t]he extent and significance of the relationship between the Officer Defendants and Riverstone cannot be overstated" as "Riverstone has been their co-investor, partner, employer, sponsor, and financial patron" for over a decade.[575] In 2009, Riverstone and the Officer Defendants together established Developer **[*109]** 1, "free[ing]" the Officer Defendants of their prior employer which the Officer Defendants touted as "a great thing."[576] The Officer Defendants believed they "found the perfect partner in Riverstone," as Riverstone was similarly "interested in investing in renewables," "valued [the Officer Defendants'] team," and acted as a "new backer."[577]

Riverstone delivered, and its relationship with the Officer Defendants reverberated through the Company and its upstream developers. Riverstone appointed the Officer Defendants to a team of fiduciaries that simultaneously served the Company and Developer 1, and then Developer 2. The Officer Defendants also invested in Developer 1, the Company, and Developer 2, and retained equity in the post-Merger entity.

The connection ran deeper than overlapping appointments and investments. Riverstone, via Developer 1, and the Officer Defendants created and molded the Company to serve Riverstone's needs and purchase and operate Developer 1's projects. Riverstone and Developer 1 used the Company's spinoff and IPO to further their shifting needs, meet and profit off increased demand in the energy sector, and grow Developer 2 via Pattern Vision 2020. After the **[*110]** IPO, Riverstone retained control over the Company, as Developer 2's continued symbiotic relationship with the Company was critical to achieving Pattern Vision 2020's

---

[570] ***Sheldon v. Pinto Tech. Ventures, L.P., 220 A.3d 245, 252 (Del. 2019)***.

[571] *See* *FrontFour, 2019 Del. Ch. LEXIS 97, 2019 WL 1313408, at *22*.

[572] ***220 A.3d at 251-52*** (footnotes and internal quotation marks omitted) (quoting *Crimson Expl., 2014 Del. Ch. LEXIS 213, 2014 WL 5449419, at *15*, and also quoting *Carr v. New Enter. Assocs. Inc., 2018 Del. Ch. LEXIS 100, 2018 WL 1472336, at *10 (Del. Ch. Mar. 26, 2018)*).

[573] *See* *Garfield v. BlackRock Mortg. Ventures, LLC, 2019 Del. Ch. LEXIS 1400, 2019 WL 7168004, at *8-9 (Del. Ch. Dec. 20, 2019)* (applying the principles in *Sheldon*, as well as those in *In re Hansen Med. S'holders Litig., 2018 Del. Ch. LEXIS 197, 2018 WL 3025525 (Del. Ch. June 18, 2018)*).

[574] *See* *2018 Del. Ch. LEXIS 197, [WL] at *9-10*.

[575] Compl. ¶ 45.

[576] *Id.*

[577] *Id.*

growth targets. Via Developer 1, Riverstone controlled approximately 67.9% of the Company's stock and a majority of the Board, and retained the Consent Right over the Company's major transactions.[578]

Riverstone then tweaked its relationship with the Company. To retain veto power over a change of control at the Company after selling all its equity, Riverstone retained the Consent Right and loyal Riverstone personnel on the Board and in the Company's C-suite. The Company and Developer 2 agreed that Developer 2 had contractual control over the Company in their Purchase Rights Agreement.[579]

As transaction-specific ties, Plaintiff alleges that the Company's fiduciaries with longtime Riverstone ties, including the Officer Defendants, tipped the scales to secure a transaction with the Entity Defendants' preferred bidder.[580] Plaintiff has alleged that Browne and the Officer Defendants facilitated Riverstone's influence over the sales process. And sometime in early 2018, with access to the Company's confidential information, Riverstone **[*111]** and Goldman explored a Company take-private, but abandoned that effort; Riverstone's insiders at the Company picked up where it left off. The Officer Defendants began considering a sales process without the Board's knowledge, even retaining an advisor to prepare an analysis. With Garland taking the lead, the Officer Defendants initiated the sales process at a time when the Company was independently viable and achieving Pattern Vision 2020's milestones as planned and when there was no exigent or apparent need to sell. They did so at a Board meeting that a Riverstone representative attended, and solicited Riverstone's opinion and identified it as a potential acquirer.

During the process and without the Special Committee's authorization, Garland met secretly with Riverstone and Riverstone's preferred bidder, Buyer. The Officer Defendants introduced Riverstone-friendly Goldman into the process. Browne attended numerous Special Committee meetings, including executive sessions. Garland and Elkort pressed the Consent Right, asserting that "the need for [Riverstone's] support for any potential . . . transaction should not be underestimated because [Riverstone's] rights to consent that **[*112]** would likely be implicated by the proposed transaction appeared to be very broad."[581] And the Officer Defendants pushed the Entity Defendants' agenda, as reflected in the bidders' perception that the Company was tightly bound to Riverstone and Developer 2.[582]

Having alleged a legally significant connection, Plaintiff must also allege that the control group exercised *de facto* control by actual domination or control of the board generally, or actual domination or control of the corporation, its board, or the deciding committee with respect to the challenged transaction.[583] This need not be a "pervasive" showing.[584]

"Invariably, the facts and circumstances surrounding the particular transaction will loom large."[585] "Rarely (if ever) will any one source of influence or indication of control, standing alone, be sufficient to make the necessary showing. A reasonable inference of control at the pleading stage typically results when a confluence of multiple sources combines in a fact-specific manner to produce a particular result."[586] Therefore, the Court must holistically evaluate sources of influence and authority, as "[d]ifferent sources of influence that would not support an inference of control **[*113]** if held in isolation may, in the aggregate, support an inference of

[578] *See id.* ¶¶ 47, 49, 50.

[579] *Id.* ¶ 66.

[580] The allegations against the Officer Defendants and their potential liability are discussed further *infra*. Although this discussion refers to the Officer Defendants generally and collectively, as will be discussed, Plaintiff has failed to state claims against Armistead and Pedersen.

[581] Compl. ¶ 117.

[582] *See id.* ¶¶ 151, 180-81.

[583] *See* *FrontFour, 2019 Del. Ch. LEXIS 97, 2019 WL 1313408, at *22*.

[584] *See* *Superior Vision Servs., 2006 Del. Ch. LEXIS 160, 2006 WL 2521426, at *4* ("[P]ervasive control over the corporation's actions is not required.").

[585] *Voigt, 2020 Del. Ch. LEXIS 55, 2020 WL 614999, at *13* (citing *Basho, 2018 Del. Ch. LEXIS 222, 2018 WL 3326693, at *28*) ("A plaintiff may allege facts indicating that a defendant insisted on a particular course of action even though other fiduciaries or advisors resisted or had second thoughts. Or a plaintiff may allege that the defendant engaged in pressure tactics that went beyond ordinary advocacy to encompass aggressive, threatening, disruptive, or punitive behavior.").

[586] *Id.* (alterations omitted) (quoting *Basho, 2018 Del. Ch. LEXIS 222, 2018 WL 3326693, at *28*).

control."[587] If that authority takes the form of a contractual right, that right must give the nonstockholder power akin to "'operating the decision-making machinery of the corporation' (a 'classic fiduciary')," rather than "'an individual who owns a contractual right, and who exploits that right,' forcing a corporation to 'react' (which does not support a fiduciary status)."[588] The contractual right must confer control over the board.[589] Transaction-specific context is important: for example, a consent right to a change of control carries more transactional influence in the context of an end-stage transaction than it would in others.[590] Whether such a right translates to control also depends on what other sources of soft power may be aggregated with it.[591]

Plaintiff has not established that the Controller Defendants had the ability to exercise a majority of the corporation's voting power via stock ownership: not even close. At the time of the Merger, the owners of Developer 2, including the Officer Defendants, slightly more than 10% of the Company's common stock; Riverstone and Developer **[*114]** 2 held no stock in the Company.[592] Accordingly, Plaintiff's control theory principally relies on the Controller Defendants' soft sources of power.

The Entity Defendants had three sources of soft power. First, as explained, the long history between Riverstone, Browne, and the Officer Defendants, amplified by the officers' significant Company roles as founders, CEO, executive vice presidents, COO, chief compliance officer, and general counsel supports the reasonable inference that Riverstone and Developer 2, via the Officer Defendants, had "the ability to exercise outsized influence in the board room or on committees."[593] Second, and relatedly, Riverstone controlled Developer 2, an essential part of the Company's upstream supply chain, supporting the inference of even more Riverstone "leverage over" the outcome of the sales process.[594] With these two sources of soft power, Riverstone pervaded the Company's C-suite, boardroom, and supply chain.

---

[587] *Id.*

[588] *Skye Min. Invs., 2020 Del. Ch. LEXIS 72, 2020 WL 881544, at *27 n.330* (alterations omitted) (quoting *Thermopylae Cap. P'rs, L.P. v. Simbol, Inc., 2016 Del. Ch. LEXIS 15, 2016 WL 368170, at *14 (Del. Ch. Jan. 29, 2016)*).

[589] *See* *KKR, 101 A.3d at 994* (contemplating a contractual right "to veto any action of the board"); *Superior Vision Servs., 2006 Del. Ch. LEXIS 160, 2006 WL 2521426, at *4* (noting a contractual right must afford control over the corporate decision-making process); *Cox Commc'ns, 2006 Del. Ch. LEXIS 111, 2006 WL 1586375, at *5* (finding control in a low stockholder stake and "the ability to shut down the effective operation of the At Home board of directors by vetoing board actions"); *Acp Master, Ltd. v. Sprint Corp.*, 2016 WL 3566363, at *2 (Del. Ch. June 30, 2016) (finding control supported by "veto power over almost all important business actions at [the Company] under the company's governing documents").

[590] *See* *Cox Commc'ns, 2006 Del. Ch. LEXIS 111, 2006 WL 1586375, at *5* (noting "[t]here is no case law in Delaware, nor in any other jurisdiction that this Court is aware of, holding that board veto power *in and of itself* gives rise to a shareholder's controlling status" where such veto power was never actually wielded, but considering such veto power as "significant" to "coercive leverage" because the veto right conferred "the ability to shut down the effective operation of the . . . board", and when combined with other soft power, might also confer the power to tilt a transaction (emphasis in original)); *see* *KKR, 101 A.3d at 994* (considering "coercive power that stockholder could wield over the board's ability to independently decide whether or not to approve the merger" as distinct from constraint of the "business or strategic options available to the corporation"); *Basho, 2018 Del. Ch. LEXIS 222, 2018 WL 3326693, at *29* (considering contractual rights to limit financing wielded "to cut off the Company's access to *other sources* of financing" when the company was in a "position of maximum financial distress" (emphasis added)).

[591] *See* *Cox Commc'ns, 2006 Del. Ch. LEXIS 111, 2006 WL 1586375, at *4-5*.

[592] *See* Compl. ¶ 249 (identifying the stockholdings of PSP and Company management, which equaled roughly 10.7% of the Company's outstanding stock and 9.7% of shares voted in favor of the Merger).

[593] *Voigt, 2020 Del. Ch. LEXIS 55, 2020 WL 614999, at *12*.

[594] *Id.*; *see also* *Cox Commc'ns, 2006 Del. Ch. LEXIS 111, 2006 WL 1586375, at *5* (noting the Company's operational dependence on the defendants offered leverage and contributed to control); *Acp Master, Ltd.*, 2016 WL 3566363, at *2 (noting a stockholder that is a company's "only significant customer" may "exert control" and "have significant leverage" (alterations omitted) (quoting *Cox Commc'ns, 2006 Del. Ch. LEXIS 111, 2006 WL 1586375, at *5*)). As reflected by the Company's many third-party bidders, its structure did not appear to "limit [the Company's] value-maximizing options," and is not the source of "Plaintiff['s] real grievance" as in *KKR*. *See* *KKR, 101 A.3d at 994*; *see also* ***Corwin, 125 A.3d at 307-08*** (quoting, analyzing, and affirming the Court of Chancery's decision in *KKR*).

The third source of soft power, the Consent Right, is contractual, and is the Entity Defendants' direct source of control over the Company's fate. "[V]eto power is significant for analysis of the control issue."[595] In the context **[*115]** of a sales process, Riverstone's power to veto a transaction replicated the veto power of a majority stockholder's vote, even after Developer 1 sold off its interest in the Company. And Riverstone used it to that effect, flexing the Consent Right before the Special Committee and bidders to "channel the corporation into a particular outcome,"[596] specifically cashing out public stockholders and internalizing Developer 2.

The Consent Right's effect was outsized due to Riverstone's other sources of soft power. Even though advisors and Brookfield saw the Consent Right was readily circumvented, all understood Riverstone's approval was required, conditioned on acquisition of Developer 2, no matter the transaction's structure. The Company's advisors acknowledged early in the process that a transaction with Brookfield could be structured to avoid the Consent Right, stating that the parties would "need to structure the transaction as a merger of [TerraForm] into a subsidiary of [the Company] due to" and that doing so would "not affect the economic terms of the transaction."[597] But from the start, Garland insisted to the Special Committee that any transaction with Brookfield would trigger the Consent **[*116]** Right.[598] And Garland and Elkort suggested to the Special Committee that Riverstone had "broad" consent rights such that Riverstone would have to approve of any merger transaction involving the Company.[599]

The Consent Right loomed large in negotiations with Brookfield. When Brookfield submitted an offer that would exclude Developer 2, Evercore and Goldman told Brookfield that "Riverstone has a consent right with respect to a merger of [the Company], and Riverstone will not provide such consent to a transaction in which [TerraForm] becomes the parent company of [the Company]."[600] At first, Brookfield proposed the Company acquire TerraForm in a transaction that excluded Developer 2 "so that no Riverstone consent is required in connection with the transaction."[601] Brookfield explained:

> We had previously been notified by your advisors that Riverstone has a consent right with respect to a merger of [the Company], and Riverstone will not provide such consent to a transaction in which [TerraForm] becomes the parent company of [the Company]. As you are aware, we, at your request, restructured the proposed transaction with [the Company] as the surviving parent company so that **[*117]** no Riverstone consent is required in connection with this proposed transaction.[602]

Even with the Consent Right so circumvented, the Special Committee worried Riverstone would sue to block a transaction that did not involve Developer 2.[603] Riverstone expressed it would not consent to any transaction with Brookfield and TerraForm and would be displeased with the Company if it entered a deal that circumvented the Consent Right.[604] By September 2019, Brookfield understood the state of play, as reflected in its letter to the Special Committee after meeting with Riverstone:

> Our understanding is that the relationship between the [] Board and Riverstone is complex. The Board has a fiduciary duty to shareholders of [the

[595] *Cox Commc'ns, 2006 Del. Ch. LEXIS 111, 2006 WL 1586375, at *5*.

[596] *Voigt, 2020 Del. Ch. LEXIS 55, 2020 WL 614999, at *12*.

[597] Compl. ¶ 121; *see also id.* ¶ 139.

[598] *See, e.g., id.* ¶ 8.

[599] *Id.* ¶¶ 117, 130.

[600] *Id.* ¶ 164.

[601] *Id.* ¶ 166.

[602] *Id.* ¶ 173 (emphasis omitted).

[603] *Id.* ¶ 171. Plaintiff contends that the Entity Defendants "threaten[ed] meritless litigation in the event a merger agreement was entered with Brookfield and TerraForm that did not satisfy Riverstone's demands." D.I. 82 at 5; *see* Compl. ¶¶ 15, 171, 177, 180, 260, 306, 311(d), 317. As support for this theory, Plaintiff points to Shah's September 10 letter to the Board that acknowledged the Board was not "free to accept certain types of transactions without prior Riverstone consent or, as we understand, any transaction not supported by Riverstone without attracting Riverstone litigation risk." Compl. ¶¶ 179-80. While the Complaint and the documents integral to it suggest that Riverstone was willing to take necessary steps to enforce the Consent Right in the event of a breach, they do not support Plaintiff's sweeping allegations of overt and explicit threats. Those allegations must be developed through discovery.

[604] Compl. ¶ 15.

> Company] but is not free to accept certain types of transactions without prior Riverstone consent or, as we understand, any transaction not supported by Riverstone without attracting Riverstone litigation risk.[605]

After meeting with Riverstone, Brookfield was unwilling to proceed with a transaction structure that avoided the Consent Right, placing the Consent Right back in play. Brookfield remained willing to move forward if Riverstone consented to the deal and the parties agreed **[*118]** to Riverstone's requested amendments of existing contractual arrangements.[606]

Riverstone's outsized role is reflected in the process itself. Riverstone had the ability to meet with bidders, review and assess their offers, and weigh in, many times before the Special Committee had considered the proposal. Bidders believed that Riverstone's satisfaction was essential to closing any deal, and accurately perceived Developer 2 and the Company as a bundled buy-one-get-one package. Specifically, Party D acknowledged that Riverstone was one of "the three legs of the stool that are critical to accomplishing our objective of acquiring and combining [the Company] and [Developer] 2."[607] Brookfield stated that "the *Board and management* wish to also internalize [Developer 2] as part of this transaction."[608] Brookfield acknowledged that it was not "in anyone's best interests to engage with Riverstone in a manner that creates animosity or material litigation," and believed that "no deal could be completed without the consent of Riverstone even though it had no legal right to block a properly structured transaction."[609]

Thus, having determined that the Controller Defendants are connected in a **[*119]** legally significant way, it may be that their aggregate sources of power are sufficient to establish a control group, as they allowed the Controller Defendants to drive the outcome of the sales process and favor Buyer. But because this inquiry is highly fact intensive, I decline to make a definitive determination that the Controller Defendants operated as a control group owing fiduciary duties with respect to the transaction and that entire fairness therefore applies.[610] The Controller Defendants' duties and resultant standard of review can only be known after the record is developed through discovery.[611] I also decline to rule on the Motions to dismiss Count VI until a later stage in these proceedings.[612]

While discovery may shed light on facts that support increasing the standard of review, at this stage, Plaintiff's *Revlon* theory will be considered through the lens of enhanced scrutiny because Company stockholders received cash for their shares. This is so unless Defendants can demonstrate they should be afforded unrebuttable protection under the business

[605] *Id.* ¶ 179 (emphasis omitted).

[606] *Id.* ¶ 180.

[607] *Id.* ¶ 181.

[608] *Id.* ¶ 151 (emphasis added).

[609] *Id.* ¶ 180.

[610] *See, e.g., In re W. Nat'l Corp. S'holders Litig., 2000 Del. Ch. LEXIS 82, 2000 WL 710192, at *5-6 (Del. Ch. May 22, 2000)* (determining the controlling stockholder issue at summary judgment); Cysive, 836 A.2d at 552 (determining the controlling stockholder issue post-trial).

[611] *See In re Tesla Motors, Inc., 2018 Del. Ch. LEXIS 102, 2018 WL 2006678, at *3 (Del. Ch. Apr. 27, 2018)* (explaining the Court's intention to merely hold plaintiffs had met their pleading-stage burden, but left the standard of review to be determined).

[612] *See* Ct. Ch. R. 12(d) ("The defenses specifically enumerated *(1)-(7) in paragraph (b)* of this rule, whether made in a pleading or by motion, and the motion for judgment mentioned in paragraph (c) of this rule, shall be heard and determined before trial on application of any party, unless the Court orders that the hearing and determination thereof be deferred until the trial."); *see also Spencer v. Malik*, 2021 WL 719862, at *5 (Del. Ch. Feb. 23, 2021) ("A party does not have a right to a pleading-stage ruling. Rule 12(d) states that pleading-stage motions brought under Rule 12 shall be heard and determined before trial on application of any party, unless the Court orders that the hearing and determination thereof be deferred until the trial. Not all disputes can or should be resolved at the pleading stage. Given the importance of the issue presented, the limited briefing provided by the parties, and the early stage of the case, the question . . . is deferred until after trial. The motion for judgment on the pleadings on this issue is denied on that basis." (internal quotation marks omitted)); *Slingshot Techs., LLC v. Acacia Rsch. Corp.*, 2021 WL 1224828, at *3 (Del. Ch. March 30, 2021) ("Under Rule 12(a)(1), a court may postpone the disposition of a pleading stage motion until a later stage of the case, including until the trial on the merits. Rule 12(d) reiterates this point, noting that a court should address a Rule 12(b)(6) motion in a preliminary hearing unless the court orders that the hearing and determination thereof be deferred until the trial." (alterations and internal quotation marks omitted)).

judgment rule via a *Corwin* cleansing vote.[613] I turn next to whether Plaintiff has stated a nonexculpated claim **[*120]** in view of *Revlon*, and then turn to whether cleansing has occurred under *Corwin*.

2. Plaintiff Has Stated A Nonexculpated Claim For Breach Against The Director Defendants.

The duties of care and loyalty "are the traditional hallmarks of a fiduciary who endeavors to act in the service of a corporation and its stockholders" and "[e]ach of these duties is of equal and independent significance."[614] The duty of care requires the directors of a company to act on an informed basis.[615] It also "requires a director to take an active and direct role in the context of a sale of a company from beginning to end."[616] "A breach of the duty of care exists where the fiduciary acted with gross negligence."[617]

"[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."[618] Corporate fiduciaries "are not permitted to use their position of trust and confidence to further their private interests."[619] Under Delaware law, for a director to act loyally to advance the best interests of the corporation, she "must seek to promote the value of the **[*121]** corporation for the benefit of its stockholders."[620] "Delaware case law is clear that the board of directors of a for-profit corporation must, within the limits of its legal discretion, treat stockholder welfare as the only end, considering other interests only to the extent that doing so is rationally related to stockholder welfare."[621]

There is "no dilution of the duty of loyalty when a director holds dual or multiple fiduciary obligations," and there is "no safe harbor for such divided loyalties in Delaware."[622] "If the interests of the beneficiaries to whom the dual fiduciary owes duties diverge, the fiduciary faces an inherent conflict of interest. But if the interests of the beneficiaries are aligned, then there is no conflict."[623]

Claims arising out of the cash-out Merger, "a final-stage transaction presumptively subject to enhanced scrutiny under *Revlon*,"[624] "do not admit of easy categorization as duties of care or loyalty."[625] Situations that warrant enhanced scrutiny "involv[e] potential conflicts of interest where the realities of the decisionmaking context can subtly undermine the decisions **[*122]** of even independent and disinterested directors."[626] "[T]he predicate question of what the board's true motivation was comes into play, and the court must take a nuanced and realistic look at the possibility that personal interests

[613] *See* KCG Hldgs., 2019 Del. Ch. LEXIS 233, 2019 WL 2564093, at *10.

[614] Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 367 (Del. 1993).

[615] *See* id. at 368.

[616] *Id.* (citing Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 66 (Del. 1989), and also citing Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985)).

[617] Mindbody, 2020 Del. Ch. LEXIS 307, 2020 WL 5870084, at *32 (citing Morrison v. Berry (Morrison I), 2019 Del. Ch. LEXIS 1412, 2019 WL 7369431, at *22 (Del. Ch. Dec. 31, 2019)).

[618] Cede & Co., 634 A.2d at 361 (citing Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984), and also citing Aronson, 473 A.2d at 812).

[619] Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503, 510 (Del. 1939).

[620] Frederick Hsu Living Tr. v. ODN Hldg. Corp., 2017 Del. Ch. LEXIS 67, 2017 WL 1437308, at *17 (Del. Ch. Apr. 14, 2017) (internal quotation marks omitted) (quoting eBay Domestic Hldgs., Inc. v. Newmark, 16 A.3d 1, 34 (Del. Ch. 2010)).

[621] *Id.* (alteration and internal quotation marks omitted) (quoting Leo E. Strine, Jr., *A Job is Not a Hobby: The Judicial Revival of Corporate Paternalism and its Problematic Implications*, 41 J. Corp. L. 71, 107 (2015)).

[622] Chen, 87 A.3d at 670 (internal quotation marks omitted) (quoting Weinberger, 457 A.2d at 710).

[623] *Id.* (footnote omitted) (citing Van de Walle v. Unimation, Inc., 1991 Del. Ch. LEXIS 27, 1991 WL 29303, at *11 (Del. Ch. Mar. 7, 1991)).

[624] Mindbody, 2020 Del. Ch. LEXIS 307, 2020 WL 5870084, at *13.

[625] Chen, 87 A.3d at 677 (quoting In re Santa Fe Pac. Corp. S'holder Litig., 669 A.2d 59, 67 (Del. 1995)).

[626] *Id.* (quoting Trados II, 73 A.3d at 43).

short of pure self-dealing have influenced the board."[627]

To address this pervasive concern in final-stage transactions, Delaware law expects directors to hold a single goal: "get the highest value reasonably attainable for the shareholders."[628] "At a minimum, *Revlon* requires that there be the most scrupulous adherence to ordinary principles of fairness in the sense that stockholder interests are enhanced, rather than diminished, in the conduct of an auction for the sale of corporate control."[629] "The sole responsibility of the directors in such a sale is for the shareholders' benefit," and "[t]he board may not allow any impermissible influence, inconsistent with the best interests of the shareholders, to alter the strict fulfillment of th[is obligation]."[630]

"A corporate board's failure to obtain the best value for its stockholders may be the result of illicit motivation (bad faith), personal interest divergent from shareholder interest (disloyalty) or a **[*123]** lack of due care."[631] In evaluating alleged breaches of the duties of care and loyalty through the lens of enhanced scrutiny, "the focus is on whether the directors' decision was, on balance, within a range of reasonableness."[632]

In order to maximize stockholder value, "[d]irectors are not required by Delaware law to conduct an auction according to some standard formula, only that they observe the significant requirement of fairness for the purpose of enhancing general shareholder interests."[633] Accordingly, Delaware law does not *per se* "preclude differing treatment of bidders when necessary to advance those interests," as "[v]ariables may occur which necessitate such treatment."[634] "A board of directors may favor a bidder if in good faith and advisedly it believes shareholder interests would be thereby advanced,"[635] and "[a] board may tilt the playing field if, but only if, it is in the shareholders' interest to do so."[636] But "the board's primary objective, and essential purpose, must remain the enhancement of the bidding process for the benefit of the stockholders."[637]

"[T]he paradigmatic claim under *Revlon* [] arises when a supine board under the sway of an overweening CEO bent **[*124]** on a certain direction tilts the sales process for reasons inimical to the stockholders' desire for the

---

627 *Id. at 678* (alterations and internal quotation marks omitted) (quoting *In re Dollar Thrifty S'holder Litig., 14 A.3d 573, 598 (Del. Ch. 2010)*). In these game-ending situations, "there is a basis for concern that directors without a pure self-dealing motive might be influenced by considerations other than the best interests of the corporation and other stockholders." *Dollar Thrifty, 14 A.3d at 599 n.181*.

628 *Macmillan, 559 A.2d at 1285*.

629 *Id.*; *see also id. at 1264* ("When conducting an auction for the sale of corporate control, this concept of fairness must be viewed solely from the standpoint of advancing general, rather than individual, shareholder interests.").

630 *Id. at 1285* (citing *Revlon, 506 A.2d at 182*).

631 *Rudd v. Brown, 2020 Del. Ch. LEXIS 288, 2020 WL 5494526, at *6 (Del. Ch. Sept. 11, 2020)* (quoting *Lukens, 757 A.2d at 731*).

632 *Baker Hughes, 2020 Del. Ch. LEXIS 321, 2020 WL 6281427, at *7* (internal quotation marks omitted) (quoting *Paramount, 637 A.2d at 45*).

633 *Macmillan, 559 A.2d at 1286*; *see also id. at 1287* ("We do not intend to limit the broad negotiating authority of the directors to achieve the best price available to the stockholders."); *KCG Hldgs., 2019 Del. Ch. LEXIS 233, 2019 WL 2564093, at *16* ("Under *Revlon*, directors are generally free to select the path to value maximization, so long as they choose a reasonable route to get there." (internal quotation marks omitted) (quoting *In re Answers Corp. S'holders Litig., 2011 Del. Ch. LEXIS 57, 2011 WL 1366780, at *3 (Del. Ch. Apr. 11, 2011)*)).

634 *Macmillan, 559 A.2d at 1286-87*.

635 *Chen, 87 A.3d at 674* (internal quotation marks omitted) (quoting *In re Fort Howard Corp. S'holders Litig., 1988 Del. Ch. LEXIS 110, 1988 WL 83147, at *14 (Del. Ch. Aug. 8, 1988)* (Allen, C.)).

636 *Id.* (internal quotation marks omitted) (quoting *In re J.P. Stevens & Co. S'holders Litig., 542 A.2d 770, 782 (Del. Ch. 1988)*).

637 *Macmillan, 559 A.2d at 1287* (noting that "there must be a rational basis for the action such that the interests of the stockholders are manifestly the board's paramount objective"); *see also Chen, 87 A.3d at 674* ("A board may not favor one bidder over another for selfish or inappropriate reasons. Any favoritism directors display toward particular bidders must be justified solely by reference to the objective of maximizing the price the stockholders receive for their shares." (alterations and citation omitted) (quoting *Golden Cycle, LLC v. Allan, 1998 Del. Ch. LEXIS 237, 1998 WL 892631, at *14 (Del. Ch. Dec. 10, 1998)*, and then quoting *In re Topps Co. S'holders Litig., 926 A.2d 58, 64 (Del. Ch. 2007)*)).

best price."[638] A plaintiff may state a claim for liability under *Revlon* by pleading a claim as to only one board member--"[t]he sins of just one fiduciary can support a viable *Revlon* claim."[639] Plaintiff's allegations are modeled after that paradigmatic theory: she asserts Riverstone, through or alongside Garland, overrode a supine Special Committee which, while disinterested and independent, breached its duty of loyalty to Company stockholders by acting in bad faith.

Under this rubric, Plaintiff's ability to state a claim against each of the Director Defendants is further restricted by the exculpation provision in the Company's charter pursuant to *8 Del. C § 102(b)(7)*.[640] Even under *Revlon* scrutiny, allegations of a violation of duty of care alone do not state a claim against the Director Defendants; Plaintiff must state a claim for breach of the duty of loyalty.[641] In order to survive a motion to dismiss under a breach of the duty of loyalty theory, Plaintiff must plead that the Director Defendants "were interested in the transaction, lacked independence, or acted in bad faith."[642] If a plaintiff alleges "well pleaded **[*125]** facts that track the paradigmatic *Revlon* theory," they will generally be sufficient to support a nonexculpated claim at the motion to dismiss phase.[643]

A finding of bad faith in the fiduciary context is rare.[644] "In the context of a sale of corporate control, bad faith is qualitatively different from an inadequate or flawed effort to obtain the highest value reasonably available for a corporation."[645] "[C]riticizing the price at which a board agrees to sell a company, without more, does not a bad a faith claim make."[646] Delaware law explicitly recognizes several forms of bad faith: (i) subjective bad faith, in conduct motivated by an intent to do harm; (ii) intentional dereliction of duty or conscious disregard of duty; and (iii) "allow[ing] interests other than obtaining the best value reasonably available for [the company's] stockholders to influence [director] decisions during the sale process, given that they made decisions falling outside of the range of reasonableness."[647] "Absent direct evidence of an improper intent, a plaintiff must point to a decision that lacked any rationally conceivable basis associated with maximizing stockholder value to survive a motion to dismiss."[648]

Plaintiff asserts the Director Defendants' bad faith takes the forms of conscious disregard of their obligation to seek the highest value reasonably available for Company shareholders, and conduct that "lacked any rationally conceivable basis associated with maximizing stockholder value."[649] In support, Plaintiff contends that the Director Defendants "knew the Merger did not

---

[638] *Mindbody, 2020 Del. Ch. LEXIS 307, 2020 WL 5870084, at *1* (alteration, footnote, and internal quotation marks omitted) (quoting *Toys "R" Us, 877 A.2d at 1002*).

[639] *2020 Del. Ch. LEXIS 307, [WL] at *14*.

[640] *See* Kirby Decl. Ex. 8 ("To the fullest extent permitted by the DGCL, a director of the Corporation shall not be personally liable to the Corporation or its stockholders for monetary damages for breach of fiduciary duty owed to the Corporation or its stockholders.").

[641] *See* *Cornerstone, 115 A.3d at 1179*; *Malpiede v. Townson, 780 A.2d 1075, 1094-95 (Del. 2001)*; *Rudd, 2020 Del. Ch. LEXIS 288, 2020 WL 5494526, at *7*; *KCG Hldgs., 2019 Del. Ch. LEXIS 233, 2019 WL 2564093, at *16*.

[642] *Baker Hughes, 2020 Del. Ch. LEXIS 321, 2020 WL 6281427, at *15* (quoting *Morrison I, 2019 Del. Ch. LEXIS 1412, 2019 WL 7369431, at *13*).

[643] *Mindbody, 2020 Del. Ch. LEXIS 307, 2020 WL 5870084, at *13*.

[644] *See* *In re Saba Software, Inc., 2017 Del. Ch. LEXIS 52, 2017 WL 1201108, at *20 (Del. Ch. Mar. 31, 2017)* (citing *In re Chelsea Therapeutics Int'l Ltd. Stockholders Litig., 2016 Del. Ch. LEXIS 79, 2016 WL 3044721, at *1 (Del. Ch. May 20, 2016)*).

[645] *In re Essendant, Inc. Stockholder Litig., 2019 Del. Ch. LEXIS 1404, 2019 WL 7290944, at *13 (Del. Ch. Dec. 30, 2019)* (internal quotations marks omitted) (quoting *Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 243 (Del. 2009)*).

[646] *2019 Del. Ch. LEXIS 1404, [WL] at *14* (collecting cases).

[647] *Chen, 87 A.3d at 677-78*; *see also* ***[*126]*** *Disney II, 906 A.2d at 63-66*.

[648] *Essendant, 2019 Del. Ch. LEXIS 1404, 2019 WL 7290944, at *13, *14* (alteration and internal quotation marks omitted) (quoting *Chen, 87 A.3d at 684*); *see also* *Chelsea Therapeutics, 2016 Del. Ch. LEXIS 79, 2016 WL 3044721, at *1* (stating that in cases where "there is no indication of conflicted interests or lack of independence on the part of the directors," a finding of bad faith should be reserved for situations where "the nature of [the directors'] action can in no way be understood as in the corporate interest: *res ipsa loquitur*").

[649] D.I. 82 at 59 (alteration omitted) (quoting *In re USG Corp. S'holder Litig., 2020 Del. Ch. LEXIS 281, 2020 WL 5126671, at *29 (Del. Ch. Aug. 31, 2020)*).

maximize stockholder value but approved it anyway,"[650] and "knowingly fail[ed] to manage conflicts at virtually every level of the Merger process" and "protect stockholders"[651] by "d[oing] nothing to exclude Garland or Riverstone from the sale process after learning of their misconduct" and "retain[ing] Goldman."[652] "In the transactional context, an extreme set of facts is required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties."[653] Plaintiff's allegations do not support an inference of conscious disregard, or that the transaction lacked any rationally conceivable basis.

The Special Committee took a great number of reasonable actions to fulfill their duties, as pled in the Complaint and disclosed in the Proxy. The Board **[*127]** immediately formed the disinterested and independent Special Committee when it decided to put the Company up for sale, and tasked it with managing the sales process. The Special Committee hired Evercore as an independent financial advisor and Paul Weiss as counsel, and met regularly with those advisors. The Special Committee's meeting minutes reflect that it discussed with its advisors how Riverstone might wield the Consent Right. The Special Committee was aware Goldman, Garland, and Browne had conflicts and those conflicts were later disclosed in part to Company stockholders. To manage fiduciary conflicts, the Special Committee twice implemented protocols requiring its authorization before Garland, Browne, or the Officer Defendants contacted bidders. Those protocols specifically prohibited management from discussing compensation relating to any potential transaction.

Further, for over one year, the Special Committee actively engaged in sale discussions with roughly a dozen bidders, and kept at least four bidders in the running until late October 2019. It weighed the risks and merits of transactions with each potential bidder; executed confidentiality agreements with serious bidders **[*128]** in an effort to further due diligence; encouraged those bidders to connect with Riverstone in view of the Consent Right to increase the likelihood of a deal; arranged meetings between Company representatives and each bidder; and exchanged draft merger agreements with more than one interested party. The Special Committee resisted calls for exclusivity, pursued go-shop provisions, and interfaced with numerous bidders during the go-shop in its agreement with Buyer.[654]

Specifically as to Brookfield, Batkin and the Special Committee worked to extract value and to facilitate Brookfield's cooperation with Riverstone on multiple occasions. When Brookfield threatened to walk away, Batkin and the Special Committee worked to keep Brookfield seated. It offered to cover Brookfield's going-forward expenses, accommodated requests in due diligence, and gave numerous extensions for document submissions. These actions with respect to Brookfield yielded a return: by November 2019, Brookfield was offering a 45% premium, was willing to satisfy Riverstone and Developer 2's demands, and decided to forego a Company-on-top merger.

Thus, the Special Committee took an "active and direct role in the sale process" **[*129]** from beginning to end,[655] was "reasonably informed about the alternatives available to the company," and acted "reasonably to learn about actual and potential conflicts faced by directors, management, and their advisors."[656] "At first glance, it is difficult to discern bad faith from this narrative."[657] It is impossible to conceive of conscious disregard or the absence of any rationally conceivable basis for the Director Defendants' action.

But with each reasonable and measured step forward, the Complaint alleges the Director Defendants took two steps back. At this procedural stage and in view of the Court's obligation to view end-game transactions with inherent skepticism,[658] "the predicate question of what the board's true motivation was comes into play, and *the court* must take a nuanced and realistic look at the

[650] *Id.*

[651] *Id.* at 62.

[652] *Id.* at 64 (emphasis omitted).

[653] *Lyondell, 970 A.2d at 243* (alterations and internal quotation marks omitted) (quoting *In re Lear Corp. S'holder Litig., 967 A.2d 640, 654 (Del. Ch. 2008)*).

[654] *See* Compl. ¶ 216; Proxy at 47-49, 54.

[655] *Citron, 569 A.2d at 66*.

[656] *KCG Hldgs., 2019 Del. Ch. LEXIS 233, 2019 WL 2564093, at *16* (quoting *In re Rural Metro Corp. Stockholders Litig., 88 A.3d 54, 89-90 (Del. Ch. 2014)*).

[657] *Saba Software, 2017 Del. Ch. LEXIS 52, 2017 WL 1201108, at *20*.

[658] *See* *Chen, 87 A.3d at 677-78*.

possibility that personal interests short of pure self-dealing have influenced the board."[659] While this does not give the Court free rein to rewrite the story or impose on fiduciaries *post hoc* obligations to have taken certain steps,[660] the Court must seek to "assure itself that the board acted reasonably, in the sense of taking a logical and reasoned approach for the purpose of advancing **[*130]** a proper objective and to thereby smoke out mere pretextual justifications for improperly motivated decisions."[661] This mandates that I assess the facts as pled and determine whether Plaintiff has stated a claim for bad faith on the part of the Director Defendants. Rather than conscious disregard, "[t]he loyalty issue in this case is whether the directors allowed interests other than obtaining the best value reasonably available for [the Company's] stockholders to influence their decisions during the sale process, given that they made decisions falling outside of the range of reasonableness."[662]

Plaintiff's allegations make it reasonably conceivable that the Director Defendants placed the interests of Riverstone, Developer 2, and the Officer Defendants above the interest of Company stockholders and their obligation to maximize stockholder value, and therefore acted in bad faith.[663]

a. The Complaint Pleads That The Director Defendants Allowed Interests Other Than Obtaining The Best Value For Company Stockholders To Influence Their Decisions During The Sales Process.

The Complaint alleges that the Director Defendants elevated the long-term welfare of **[*131]** Riverstone and Developer 2 over seeking the best value reasonably available for Company stockholders by (1) infecting the process with interested fiduciaries and conflicted advisors; (2) preferring Buyer throughout the process and at the moment of decision over Brookfield's premium bid; and (3) misusing the Consent Right to dissuade Brookfield. Plaintiff's concerns outweigh the Special Committee's few reasonable steps and demonstrate that, on balance, the Director Defendants' choices in conducting the sales process were unreasonable and in bad faith.

i. *The Special Committee's Work Was Infected By Conflicted Directors, Management, And Advisors*.

First, Plaintiff contends the Director Defendants allowed conflicted individuals and entities to participate in deliberations (including Browne, Garland, and Goldman) and failed to manage those conflicts. The facts alleged demonstrate that the decision to involve these conflicted parties in the sales process depressed Company stockholders' value for Riverstone and Developer 2's benefit.

The Board immediately identified Riverstone and Developer 2 as the source of potential and actual conflicts with respect to the sales process. Nonetheless, the **[*132]** Board gave Riverstone a seat at the table on day one and every day thereafter. Before the June 5, 2018, annual meeting, and presumably without the knowledge of the Board or stockholders, conflicted management—including Garland—retained Evercore and secured a presentation that "included preliminary potential valuations for various strategic options."[664] At the meeting, Garland first proposed that the Board consider a potential sale, despite repeated and numerous representations to Company investors (both before and after the meeting) that Pattern Vision 2020 was proceeding as planned and that the Company had ample liquidity and was not planning on raising common equity capital. Hunt (Developer 2's director and Riverstone's partner, but not a Company fiduciary) attended that meeting, knowing that Riverstone had already explored a potential take-private of the

---

[659] *Id. at 678* (alterations and internal quotation marks omitted) (emphasis added) (quoting *Dollar Thrifty, 14 A.3d at 598*).

[660] *See Baker Hughes, 2020 Del. Ch. LEXIS 321, 2020 WL 6281427, at *7*; *see also Lyondell, 970 A.2d at 243* ("The trial court decided that the *Revlon* sale process must follow one of three courses, and that the Lyondell directors did not discharge that known set of *Revlon* 'duties.' But, as noted, there are no legally prescribed steps that directors must follow to satisfy their *Revlon* duties. . . . More importantly, there is a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties." (alteration, internal quotation marks, and citation omitted)).

[661] *Baker Hughes, 2020 Del. Ch. LEXIS 321, 2020 WL 6281427, at *7* (quoting *Dollar Thrifty, 14 A.3d at 598*).

[662] *Chen, 87 A.3d at 677*.

[663] *See, e.g., KCG Hldgs., 2019 Del. Ch. LEXIS 233, 2019 WL 2564093, at *17*.

[664] Compl. ¶ 95 (emphasis omitted).

Company, with access to the Company's confidential information and with Goldman as an advisor.[665] The Board solicited Riverstone's views on a potential transaction while simultaneously identifying Riverstone as a prospective acquirer.[666] From these facts, it is reasonably conceivable that the June 5 suggestion that the Board "consider a **[*133]** potential sale of the business" was from the start driven by, or for the benefit of, Riverstone.[667]

Thereafter, the Board formed the Special Committee. The Board was aware of Garland and Browne's open and apparent ties to Riverstone.[668] Because the interests of Developer 2 and Riverstone diverged from those of the Company stockholders, Browne and Garland "face[d] an inherent conflict of interest."[669] In view of these conflicts, the Board did not appoint Browne or Garland to the Special Committee, and the Special Committee twice implemented conflict-safety protocols. Nonetheless, despite the risk that Browne would share information with Riverstone, the Special Committee allowed Browne to attend the majority of Special Committee meetings in his capacity as Riverstone's representative and to attend executive sessions where the Special Committee specifically excluded conflicted Company management.[670]

The Special Committee also allowed Garland substantial involvement in its process, delegating to him primary responsibility for engaging with the Company's potential suitors.[671] As the Director Defendants accurately point out, "[t]here is nothing inherently wrong with a Board delegating **[*134]** to a conflicted CEO the task of negotiating a transaction."[672] "But the conflict must be adequately disclosed to the Board, and the Board must properly oversee and manage the conflict."[673] Garland was afforded the opportunity to tip the scales in Riverstone's favor and did so.

Plaintiff points to Garland's unauthorized April 15 Meeting with Riverstone and Buyer. The context is important. At this point, the Special Committee was actively shopping the Company, taking into consideration Riverstone and Developer 2's interest in and potential satisfaction from the outcome, and working to find a Riverstone-friendly financial acquirer, beginning with PSP.[674] But Brookfield had emerged as a disinterested strategic bidder, proposing a transaction that might not benefit Riverstone and leave Developer 2 behind.[675] In late February, Garland and Elkort allegedly met Brookfield's interest with resistance, raising the Consent Right to cast doubt on the viability of a Brookfield transaction.[676] At a March 11, 2019 Special Committee meeting, Brookfield submitted a term sheet reflecting a Company-TerraForm transaction structured to circumvent the Consent Right.[677] The Special Committee did not meet again **[*135]** until May.[678]

---

665 *See id.* ¶¶ 93, 98.

666 *Id.* ¶ 97.

667 *Id.* ¶ 94.

668 *Id.* ¶ 101.

669 Chen, 87 A.3d at 670.

670 Compl. ¶¶ 101-04. The Proxy does not disclose Browne's attendance at any Special Committee meeting. *Id.* ¶ 104.

671 *Id.* ¶¶ 102-03, 105.

672 ***Haley, 235 A.3d at 721 n.69***.

673 *Id.*; *see also* In re OPENLANE, Inc. S'holders Litig., 2011 Del. Ch. LEXIS 156, 2011 WL 4599662, *5 (Del. Ch. Sept. 30, 2011) (finding that, as the Board was aware of the CEO's possible employment after consummation of the transaction "and was fully committed to the process," and that even though the CEO, who led the negotiations, was conflicted, "his efforts in negotiating the Merger Agreement and dealing with other potential acquirers d[id] not taint the process")); ***RBC, 129 A.3d at 850-57*** (affirming trial court's findings that the Board failed to oversee the Special Committee, failed to become informed about strategic alternatives and about potential conflicts faced by advisors, and approved the merger without adequate information); ***id. at 855*** (holding that, "[t]he record indicates that Rural's Board was unaware of the implications of the dual-track structure of the bidding process and that the design was driven by RBC's motivation to obtain financing fees in another transaction with Rural's competitor," and that, "[t]he Board, as a result, took no steps to address or mitigate RBC's conflicts"); *id.* ("While a board may be free to consent to certain conflicts, . . . directors need to be active and reasonably informed when overseeing the sale process, including identifying and responding to actual or potential conflicts of interest.").

674 *See* Compl. ¶¶ 109-11, 116-17; Proxy at 3.

675 *See* Compl. ¶¶ 111-15.

676 *See id.* ¶¶ 116-19.

677 *Id.* ¶ 121.

678 *Id.* ¶ 122.

During this period of quiet, after Brookfield sharpened its offer to avoid the Consent Right, Garland arranged and held the unauthorized April 15 Meeting with Riverstone and Buyer. That meeting presented Riverstone the opportunity to offer up a preferred and familiar face as a third-party bidder: Buyer, which previously invested over $700 million in Riverstone investment funds and whose representative Garland "knew."[679] While Riverstone had been in the room since the first Board meeting on June 5, 2018, and while the Special Committee had kept Riverstone and Developer 2 in mind since the early stages of the sales process, Garland's meeting after Brookfield's offer spurred Buyer to action.[680] It is reasonably conceivable (in view of loose information sharing in the past, including through Hunt and Browne) that Riverstone and Garland communicated the Company's confidential information to Buyer at the meeting.

If sunlight is the best disinfectant, the April 15 Meeting remained infectious. Weeks later, on May 2, Garland disclosed that Riverstone had suggested taking the Company private in conjunction with an unidentified third-party institutional investor, **[*136]** but had "dropped the suggestion following consideration of conflicts and certain contractual obligations of [Riverstone]."[681] This was misleading, as evidenced by the Batkin Memo and Proxy, which themselves fall short of full and adequate disclosure.[682] This series of inconsistent and incomplete disclosures gives rise to the reasonable inference that Garland was less than candid with the Special Committee—and later, Company stockholders—about his early dealings with Riverstone and Buyer.

Nonetheless, after the April 15 Meeting, the Special Committee allowed Garland to continue to front the sale process, even after learning that the risks associated with his conflicts had materialized when he violated the Special Committee's express conduct guidelines. The April 15 Meeting serves as one of the structural components of the sales process that renders it reasonably conceivable that Garland perceptibly tilted the sales process in favor of Riverstone, the Special Committee was lackluster in its response, and this classic *Revlon* combination ultimately gave Riverstone, via Buyer, the advantage.

In addition to conflicted management, the Special Committee's work was tainted by a conflicted **[*137]** advisor. The decision to hire Goldman illustrates the Special Committee's passivity in the face of Garland's requests. When the Special Committee first met on July 13, 2018, Garland (and the Officer Defendants) recommended that the Special Committee retain Goldman, despite Evercore having prepared management's presentation for the June 5, 2018 meeting. As alleged, conflicted management's push for Goldman is unsurprising, as Goldman had longstanding, deep, and financial ties to Riverstone and, more significantly, had recently advised Riverstone with respect to a potential take-private of the Company.[683]

Conceivably perceiving the risks associated with Goldman's conflict, the Special Committee decided to retain only Evercore and to revisit the possibility of retaining Goldman at a later time, but did not determine that Goldman's participation would run afoul of the stockholder's best interests.[684] The Special Committee left the door open, and Goldman would eventually join the fray and advocate for Riverstone and Buyer, who each enjoyed a "substantial business relationship" with Goldman.[685] Goldman entered the sales process (1) in "early April 2019," on the heels of Brookfield's third-party, **[*138]** independent bid and Paul Weiss' suggestion that a Company-TerraForm transaction could be structured to circumvent the Consent Right and exclude Riverstone; and (2) on the eve of Riverstone and Garland offering up a third-party bidder of their own, Buyer, with whom Goldman and Riverstone were affiliated. Unlike the decision to retain Evercore, the Special Committee's decision to retain Goldman is not recorded in meeting minutes.[686] Plaintiff and the Director Defendants agree that "each and every one of these alleged conflicts was disclosed to the Special Committee prior to the Special Committee's decision to retain Goldman Sachs."[687] At the end of the day,

---

[679] *Id.* ¶ 128.

[680] *See id.* ¶ 132; Proxy at 37.

[681] Compl. ¶ 127.

[682] *See supra* Section II.A.1.a.

[683] *See* Compl. ¶¶ 12, 98; *see* *Cinerama, 663 A.2d at 1169* (holding a "stake in" a "firm that deals with the corporation" is "self-dealing") (citing *8 Del. C. § 144(a)*).

[684] Compl. ¶ 108.

[685] *Id.*

[686] *See id.* ¶¶ 134-35.

[687] *See* D.I. 74 at 23-24.

Goldman did not issue an opinion.[688] Rather, in the final days of the sales process, "Goldman advocated for Riverstone, describing Riverstone's communications with the conflicted investment bank that expressed confidence in the proposed transaction among the Company, Buyer, and [Developer 2]."[689]

A secondary financial advisor may be "conflict-cleansing."[690] Here, as alleged, Goldman further contaminated the process, despite the Special Committee's awareness of that risk. There was no apparent need for the Special Committee **[*139]** to retain a second advisor; the Complaint and the Proxy indicate that Evercore was sufficiently advising on the financial aspects of the process.[691] And Goldman benefitted from the Merger, as Goldman's engagement letter entitled it to $2 million upon the announcement of the Merger; an additional $4 million upon consummation of the Merger; and a discretionary payment of up to $3 million upon or promptly following the consummation of the Merger.[692]

Thus, Buyer, Riverstone, and conflicted management—who maintained post-close positions with the company—had the ability to pay or withhold nearly a third of Goldman's total fee. Further, the Company granted Goldman a right of first offer to act as joint book-runner or agent in the case of any offering of securities and a right of first offer as a joint arranger and book-runner for any bank or bridge loan related to the Merger.[693] As alleged, this further incentivized Goldman to push the Special Committee toward Buyer's offer and away from Brookfield's, which was structured such that the Company would not be required to raise capital through debt or a security offering.[694]

ii. *The Director Defendants Prioritized Riverstone and Developer 2 Over [*140] Maximizing Value*.

In addition to mismanaging the foregoing conflicts, the Special Committee, and eventually the entire Board, approved Riverstone's preferred transaction with Buyer despite acknowledging that Brookfield offered the superior bid. Plaintiff has pled facts making it reasonably conceivable that the Director Defendants did not believe "in good faith and advisedly" that Buyer's bid would advance the stockholders' interest,[695] and that the Director Defendants had no "rational basis" for shunning Brookfield's premium that was "justified solely by reference to the objective of maximizing the price the stockholders receive for their shares."[696]

As alleged, Riverstone's desire for a Company take-private and Developer 2 internalization was the impetus for the sales process, the Special Committee's focus during deliberations, and the reason for its final selection of Buyer over Brookfield. The Special Committee held various meetings that addressed Developer 2 and its interests; ways to structure transactions to include Developer 2; and the importance of Riverstone's ability to exercise the Consent Right, even though it was readily circumvented. And the Special Committee explicitly told **[*141]** bidders that internalizing Developer 2 was the preferred course of conduct and pressed bidders to structure offers toward that end, despite knowing that it would require the Company's stockholders to compete for transaction consideration. Thus, while the Special Committee engaged with numerous bidders and pressed them for value, they repeatedly revealed their focus on satisfying Riverstone and meeting its desire to internalize Developer 2.

When the sales process began, with Riverstone in the room, the Special Committee first looked to Riverstone as an acquirer. The Special Committee next considered PSP, which had strong ties to Riverstone. When a transaction directly involving Riverstone or Riverstone-friendly PSP did not pan out, Riverstone's role evolved from preferred bidder to co-negotiator alongside the Company's fiduciaries, attending meetings with Garland, Brookfield and other bidders to discuss Developer 2. The Special Committee encouraged bidders to meet with Riverstone and agree to confidentiality, and Riverstone had those meetings.

---

688 *See* Proxy at A-24.

689 Compl. ¶ 197; *see also id.* ¶¶ 153-58.

690 ***RBC, 129 A.3d at 864***.

691 *See* Compl. ¶ 108.

692 *Id.* ¶ 271.

693 *Id.* ¶ 272.

694 *Id.*

695 *Chen, 87 A.3d at 674* (quoting *Fort Howard, 1988 Del. Ch. LEXIS 110, 1988 WL 83147, at *14*).

696 *Id.* (quoting *Topps, 926 A.2d at 64*).

While the Special Committee properly responded to Brookfield's initial October 2018 offer by pressing for a premium, it also communicated Riverstone's **[*142]** concerns about internalizing Developer 2. By May 31, 2019, Brookfield submitted a revised term sheet that reflected an all-stock acquisition of the Company by TerraForm at a 15% premium and also contemplated a concurrent acquisition of Developer 2, which would cash Riverstone out of the Company and Developer 2 for a cash price to be negotiated by the Company and Riverstone.[697] The Special Committee authorized Garland to "notify" Developer 2 and Riverstone about the Company's discussions with Brookfield.[698]

Brookfield's offer inspired Garland and Riverstone to introduce Buyer into the process. Even in the absence of an offer, the Special Committee devoted time and resources to Buyer.[699] Buyer did not submit a proposal to acquire the Company until June 28, 2019. It proposed an all-cash transaction at a 14% premium, less than Brookfield's offer.[700] Buyer's offer specifically assumed that it would reach a separate agreement with Riverstone with respect to Developer 2, and separate agreements with senior management, without the Special Committee's involvement.[701] As the sales process progressed, Buyer solidified its offer for Developer 2, stating it would purchase Developer 2 at a price equal to 1.8x **[*143]** of Riverstone's invested capital subject to a contingent earnout provision that could increase the total purchase price to up to 2.25x Riverstone's invested capital. The Special Committee would later deem this earnout "acceptable to Riverstone."[702]

Brookfield volleyed on July 1, reiterating its offer for the Company and pricing Developer 2 for cash at a 1.75x multiple of invested capital, still cashing Riverstone out of the combined company. Unlike Buyer, Brookfield intended to reach an agreement with the Company, not just Riverstone, regarding Developer 2's valuation. Despite the higher premium and acquisition of Developer 2, the Special Committee did not favor Brookfield, allegedly because Brookfield's proposal did not contemplate negotiating for Developer 2 free of the Special Committee.

On July 23, Brookfield submitted a new offer, noting the Special Committee's desire to "internalize [Developer 2] as part of this transaction."[703] Brookfield offered to do so for cash at a 15% premium to Company stockholders. But Brookfield also offered a 20% premium for a deal without Developer 2.[704]

The Special Committee worried over Riverstone and Developer 2, even though a deal with **[*144]** Brookfield offered the greatest value to Company stockholders.[705] At July 31 and August 1 meetings, the Special Committee discussed that Brookfield's and Buyer's offers internalizing Developer 2 provided similar value to Company stockholders; but in a key difference, Brookfield would cash out Riverstone, while Buyer would allow Riverstone to continue to own an equity interest.[706] The Special Committee also considered that Buyer's offer favored Riverstone over the Company's stockholders: its offer for Developer 2 with an earnout was higher than Brookfield's, which made it less likely Buyer would increase its offer for the Company.[707] Thus, the Special Committee explicitly acknowledged that the Company's public stockholders were competing with Developer 2's owners for merger consideration.[708]

With Riverstone and Developer 2's satisfaction driving the Special Committee's deliberations, Buyer emerged from those Special Committee meetings as the frontrunner.[709] Evercore observed that Buyer was already in "advanced stages of negotiation" with Riverstone, and that combining the Company and Developer 2 was "in line with management's vision."[710] The Special Committee recognized the need to **[*145]**

[697] Compl. ¶ 142.

[698] *Id.* ¶ 119.

[699] *See id.* ¶ 145.

[700] *Id.* ¶¶ 145-47.

[701] *Id.* ¶¶ 147-48.

[702] *Id.* ¶ 163.

[703] *Id.* ¶ 151.

[704] *Id.*

[705] *See id.* ¶ 158.

[706] *Id.* ¶ 154.

[707] *Id.* ¶ 163.

[708] *See id.*

[709] *See id.* ¶¶ 156-57.

[710] *Id.* ¶ 157.

"determine whether [Buyer] would increase its offer,"[711] but also insisted that "it would need to convey to Brookfield the importance of reaching an agreement with Riverstone about a deal that included [Developer 2] if it wanted to have a chance to acquire [the Company]."[712]

On August 16, Buyer submitted an updated offer for both the Company and Developer 2, valuing the Company less than Brookfield's 15% premium bundled with Developer 2, and certainly less than Brookfield's 20% standalone premium.

The Company's messaging to Brookfield from this point was inconsistent at best and sabotage at worst. At an August 20 meeting, Evercore and Goldman told Brookfield that the "Board of Directors of [the Company] is no longer supportive of any transaction which includes the internalization of the 71% [of Developer 2] that [the Company] does not currently own."[713] Goldman and Evercore also pressed the Consent Right, stating that "Riverstone will not provide such consent to a transaction in which TerraForm becomes the parent company of [the Company]."[714]

On August 28, 2019, the Special Committee discussed how Brookfield's offer was worth $34 per share, a 45% premium based on the then-current **[*146]** trading price, and the risk that Riverstone would sue to block a transaction that did not involve Developer 2 even though the Brookfield proposal was structured to avoid the Consent Right. The Special Committee determined it was best "to progress the transaction" with Buyer.[715]

By late August, Brookfield submitted an updated offer valuing the Company at $33.38 per share.[716] Brookfield restructured the proposed transaction as a Company acquisition of TerraForm to avoid the Consent Right; addressed the Board's supposed disinterest in internalizing Developer 2; and stated that it had been told early in the process, when internalizing Developer 2 was a priority, that the Company believed it was desirable for senior management to maintain their positions in the combined company, including their dual positions at Developer 2.[717] Meanwhile, Buyer's offer had remained afloat with little to no enhancement.

The Special Committee met on September 29, 2019. The meeting minutes show the Special Committee explicitly recognized its duty to "maximize value for shareholders"[718] and had even acknowledged to Brookfield "that [its] proposal [wa]s superior from a value perspective to the others that [the **[*147]** Company] ha[d] received and that [the Company] will receive in this sales process."[719]

But at that meeting, focused on Developer 2, Garland warned that a Company-TerraForm merger would alter the Company's relationship with Developer 2.[720] In addition, pushing to lock up a transaction with Buyer, Garland pressured the Board to issue preferred stock that was bound to vote in favor of a Board-recommended merger with Buyer. Garland brought this idea to the Special Committee as Brookfield continued to press forward in the face of Riverstone's many demands.[721] A separate and independent committee was responsible for handling the stock issuance, so there is no reasonably conceivable explanation as to why Garland would have brought the "importance" of consummating the Preferred Issuance to the Special Committee's attention.[722] And Garland had been touting the Company's padded wallet and exceptional performance; representing that the Company had no need for liquidity; and assuring investors that the Company could easily manage any maturing obligations without raising additional funds. But he told the Special Committee that the issuance was required to fund two new projects.

The next day, **[*148]** September 30, the Board's transaction committee approved the Preferred Issuance. Plaintiff alleges Defendants issued the preferred shares to tilt the stockholder vote on the Merger with Buyer in

[711] *Id.* ¶ 156.

[712] *Id.* ¶ 157.

[713] *Id.* ¶ 164.

[714] *Id.* (alteration omitted).

[715] *Id.* ¶ 172.

[716] *Id.* ¶ 167.

[717] *See id.* ¶¶ 166, 168, 173-75.

[718] *Id.* ¶ 188.

[719] *Id.* ¶ 192.

[720] *Id.* ¶ 186.

[721] *See id.* ¶¶ 183-90.

[722] *Id.* ¶ 187.

their favor.[723] In support, Plaintiff points out that "[t]he issuance of the preferred shares made no commercial sense" because "[the Company] had more than sufficient borrowing capacity under its credit agreements to purchase the projects in question, and the interest rate on such debt would have been lower than the interest rate it agreed to pay on the preferred shares."[724] Those shares would become pivotal in approving the Merger. It is reasonably conceivable that the preferred stock issuance, backed by Garland and passively observed by the Special Committee, was in furtherance of jamming though the Board-approved Merger, which was not the best deal for stockholders.

Brookfield soldiered on. In late October, Evercore presented an analysis that indicated that a TerraForm merger would result in a combined company with a stock valued well above Buyer's latest offer.[725] But Evercore also asserted that a TerraForm transaction would undermine the "purpose and commercial viability" of Developer 2. **[*149]** [726] Goldman expressed its confidence in the Company-Buyer-Developer 2 proposal.[727]

On November 1, Brookfield told the Special Committee it believed it could negotiate any necessary terms with Riverstone within thirty days. This was met with an unanticipated change of pace.[728] The Special Committee's advisors demanded that Brookfield submit definitive documents the next day, which Brookfield could not do without Riverstone's cooperation.[729] From the facts alleged, Riverstone had its sights set on a take-private with a friendly acquirer, and so it would not finalize a deal with Brookfield on that short deadline. Considering that the sales process had lasted over a year and a half, that there was no exigent need to sell, and that the Company had been amenable to extensions in the past, it is reasonably conceivable that this was the final effort to elevate Buyer as the best and last bidder standing. It worked: Brookfield withdrew its bid.[730] And on November 3, the Special Committee voted to recommend that the Board approve the all-cash Merger with Buyer at $26.75 per share, which was $1.05 less than the $27.80 closing trading price of the Company's stock the previous day.[731]

The Director Defendants **[*150]** have argued they favored Buyer's all-cash proposal based in part on the complexities of Brookfield's more burdensome stock-for-stock deal. But in the *Revlon* context, it is dispositive that Buyer's offer took Merger consideration away from the Company's public stockholders in protecting Developer 2 and Riverstone. The Special Committee was bound to obtain the best possible transaction for Company Stockholders.[732] Where other forces preclude a transaction at a higher price, "[t]he only leverage that a special committee may have . . . is the power to say no."[733] As this Court has recognized,

> The power to say no is a significant power. It is the duty of directors serving on such a committee to approve only a transaction that is in the best interests of the public shareholders, to say no to any transaction that is not fair to those shareholders and is not the best transaction available.[734]

Here, the Special Committee failed to use its voice. It is reasonably conceivable that the Special Committee favored Riverstone's long-term play over stockholders' final-moment value, and did so due to Riverstone's influence and a concern for Developer 2: "inappropriate" reasons that undermined the interests **[*151]** of the stockholders.[735] And even in the shadow of the Company's contractual obligation under the Consent Right, the Special Committee remained bound by fiduciary duty to maximize stockholder value when considering that obligation and any alternatives, such as Brookfield's offer structured around the Consent

---

723 *See id.* ¶¶ 236-38.

724 D.I. 82 at 26; Compl. ¶¶ 238-44.

725 Compl. ¶ 199. Plaintiff alleges that even those values for the combined company were depressed because Evercore did not use consistent or updated dividend yields across its analyses, and if corrected, Evercore's analysis would have shown the combined company would trade in the range of $32.69 to $36.15 per share.

726 *Id.* ¶ 201.

727 *Id.* ¶ 197.

728 *See id.* ¶ 205; Proxy at 52.

729 Compl. ¶ 205; Proxy at 52.

730 Compl. ¶ 205; Proxy at 53.

731 Compl. ¶¶ 206-07, 222.

732 *See* In re First Bos., Inc. S'holders Litig., 1990 Del. Ch. LEXIS 74, 1990 WL 78836, at *7 (Del. Ch. June 7, 1990).

733 *Id.*

734 *Id.*

735 Chen, 87 A.3d at 674.

Right.[736]

Accordingly, Plaintiff has stated a nonexculpated claim against the Director Defendants collectively.[737]

"Whether Plaintiff can develop proof to sustain these allegations remains to be seen, but for now, the Complaint alleges facts from which it is reasonably conceivable that the Board's conduct with regard to the sales process and approval of the Merger can in no way be understood as in the corporate interest."[738] The Individual Defendants' motion to dismiss Count I is denied.[739]

b. The Complaint Pleads That The Director Defendants Abdicated Their Duty Of Disclosure.

After resolving to sell the Company to Buyer in a combination with Developer 2, the Board issued a resolution giving the Officer Defendants the power to "prepare and execute" the Merger Proxy "containing such information deemed necessary, appropriate or advisable" by only the Officer Defendants, **[*152]** and then to file the Proxy with the SEC without the Board's review.[740] Plaintiff contends that the Director Defendants acted in bad faith by "abdicating their strict and unyielding duty of disclosure,"[741] and relatedly, by "knowingly fail[ing] to correct a proxy statement that they knew was materially incomplete and misleading."[742]

Directors' "fiduciary duties of care and loyalty apply when directors communicate with stockholders," and their "specific disclosure obligations are defined by the

[736] *See* Frederick Hsu, 2017 Del. Ch. LEXIS 67, 2017 WL 1437308, at *23-24.

[737] Indeed, "[t]he liability of the directors must be determined on an individual basis because the nature of their breach of duty (if any), and whether they are exculpated from liability for that breach, can vary for each director." *In re Dole Food Co., Stockholder Litig.*, 2015 Del. Ch. LEXIS 223, 2015 WL 5052214, at *39 (Del. Ch. Aug. 27, 2015); *see also* *In re Oracle Corp. Deriv. Litig., 2018 Del. Ch. LEXIS 92, 2018 WL 1381331, at *20 (Del. Ch. Mar. 19, 2018)*. Consequently, "[a] plaintiff must well-plead a loyalty breach against each individual director; so-called 'group pleading' will not suffice." *Reith v. Lichtenstein, 2019 Del. Ch. LEXIS 244, 2019 WL 2714065, at *18 (Del. Ch. June 28, 2019)* (internal quotation marks omitted) (quoting *In re Tangoe, Inc. Stockholders Litig., 2018 Del. Ch. LEXIS 534, 2018 WL 6074435, at *12 (Del. Ch. Nov. 20, 2018)*). That is, even if a plaintiff could "state a duty of loyalty claim against the interested fiduciaries," that "does not relieve the plaintiff of the responsibility to plead a non-exculpated claim against each [other] director who moves for dismissal." *Cornerstone, 115 A.3d at 1180*.

Here, Plaintiff has pled specific facts against Garland and Browne supporting the reasonable inference that they acted in bad faith such that they breached the duty of loyalty. While the allegations against Batkin, Goodman, Hall, Newson, and Sutphen collectively group them as the Special Committee, Plaintiff pleads an adequate basis "to infer that these defendants acted disloyally or in bad faith" by virtue of the Special Committee's involvement in the sales process. *Voigt, 2020 Del. Ch. LEXIS 55, 2020 WL 614999, at *25-26*; *see also* *In re WeWork Litig., 2020 Del. Ch. LEXIS 365, 2020 WL 7343021, at *11 (Del. Ch. Dec. 14, 2020)* ("Although group pleading is generally disfavored, the Complaint's use of the term 'SoftBank' to capture both SBG and Vision Fund was justified here given the close relationship between these entities plead in the Complaint."); *Chen, 87 A.3d at 676-77* ("Depending on the facts of the case, the standard of review, and the procedural stage of the litigation, a court may be able to determine that a plaintiff's claims only involve breaches of the duty of care such that the court can apply an exculpatory provision to enter judgment in favor of the defendant directors before making a post-trial finding of a breach of fiduciary duty and determining the nature of the breach. If a court cannot make the requisite determination as a matter of law on a pre-trial record, then it becomes necessary to hold a trial and evaluate each director s potential liability individually. The liability of the directors must be determined on an individual basis because the nature of their breach of duty (if any), and whether they are exculpated from liability for that breach, can vary for each director." (footnote omitted) (quoting *In re Emerging Commc'ns, Inc. S'holders Litig., 2004 Del. Ch. LEXIS 70, 2004 WL 1305745, at *38 (Del. Ch. June 4, 2002)*, and citing *Venhill Ltd. P'ship ex rel. Stallkamp v. Hillman, 2008 Del. Ch. LEXIS 67, 2008 WL 2270488, at *23 (Del. Ch. June 3, 2008)*)).

[738] *Saba Software, 2017 Del. Ch. LEXIS 52, 2017 WL 1201108, at *20* (internal quotation marks omitted) (quoting *Chelsea Therapeutics, 2016 Del. Ch. LEXIS 79, 2016 WL 3044721, at *1*).

[739] *See, e.g.* *KCG Hldgs., 2019 Del. Ch. LEXIS 233, 2019 WL 2564093, at *17*; *Saba Software, 2017 Del. Ch. LEXIS 52, 2017 WL 1201108, at *20*; *Chen, 87 A.3d at 677-78*.

[740] Compl. ¶ 231; *see id.* ¶¶ 232-33.

[741] D.I. 82 at 66 (alterations and internal quotation marks omitted) (quoting *Rosenblatt v. Getty Oil Co., 493 A.2d 929, 944 (Del. 1985)*).

[742] *Id.* at 68.

context in which the director communicates."[743] When directors request discretionary stockholder action, such as the approval of corporate transactions like mergers, "they must disclose fully and fairly all material facts within their control bearing on the request."[744] "This application of the fiduciary duties of care and loyalty is referred to as the 'fiduciary duty of disclosure.'"[745] The Delaware Supreme Court has described the parameters of this duty as "strict and unyielding."[746]

"A fundamental precept of Delaware corporation law is that it is the board of directors, and neither shareholders nor managers, that has ultimate responsibility for the management of the enterprise."[747] But "[t]he **[*153]** realities of modern corporate life are such that directors cannot be expected to manage the day-to-day activities of a company."[748] "Thus *Section 141(a) of DGCL* expressly permits a board of directors to delegate managerial duties to officers of the corporation, except to the extent that the corporation's certificate of incorporation or bylaws may limit or prohibit such a delegation."[749] While the board "may delegate such powers to the officers of the company as in the board's good faith, informed judgment are appropriate," "this power is not without limit."[750] "The board may not either formally or effectively abdicate its statutory power and its fiduciary duty to manage or direct the management of the business and affairs of this corporation."[751] "Thus it is well established that while a board may delegate powers subject to possible review, it may not abdicate them."[752] "The board must retain the ultimate freedom to direct the strategy and affairs of the Company for the delegation decision to be upheld."[753]

Abdication of directorial duty evidences disloyalty.[754] "Allegations that [the company's] directors abdicated all responsibility to consider appropriately an action of material **[*154]** importance to the corporation puts directly in question whether the board's decision-making processes were employed in a good faith effort to advance corporate interests."[755] "Whether or not a delegation of a particular responsibility constitutes an abdication of directorial duty is necessarily a fact specific question."[756] The Court must consider "why the delegation was made, and what task was actually

---

743 ***Dohmen v. Goodman, 234 A.3d 1161, 1168 (Del. 2020)***.

744 *Id.*; *see also* *Baker Hughes, 2020 Del. Ch. LEXIS 321, 2020 WL 6281427, at *12* ("Under Delaware law, when directors solicit stockholder action, they must disclose fully and fairly all material information within the board's control." (quoting *In re Solera Holdings, Inc. Stockholder Litig., 2017 Del. Ch. LEXIS 1, 2017 WL 57839, at *9 (Del. Ch. Jan. 5, 2017)*)).

745 *Id.*

746 *Rosenblatt, 493 A.2d at 944* (discussing whether the defendant fiduciaries had satisfied their "duty of complete candor" and "whether the proxy statement satisfied the strict and unyielding disclosure requirements of Delaware law").

747 *Grimes v. Donald, 1995 Del. Ch. LEXIS 3, 1995 WL 54441, at *8 (Del. Ch. Jan. 11, 1995)*, *aff'd*, *673 A.2d 1207 (Del. 1996)*.

748 *Rosenblatt, 493 A.2d at 943*; *accord* *Grimes, 1995 Del. Ch. LEXIS 3, 1995 WL 54441, at *8* ("Of course, given the large, complex organizations through which modern, multi-function business corporations often operate, the law recognizes that corporate boards, comprised as they traditionally have been of persons dedicating less than all of their attention to that role, cannot themselves manage the operations of the firm, but may satisfy their obligations by thoughtfully appointing officers, establishing or approving goals and plans and monitoring performance.").

749 *Grimes, 1995 Del. Ch. LEXIS 3, 1995 WL 54441, at *8*.

750 *1995 Del. Ch. LEXIS 3, [WL] at *9*.

751 *Id.*

752 *Id.*

753 *In re Bally's Grand Deriv. Litig., 1997 Del. Ch. LEXIS 77, 1997 WL 305803, at *4 (Del. Ch. June 4, 1997)* (internal quotation marks omitted) (quoting *Grimes v. Donald, 673 A.2d 1207, 1215 (Del. 1996)*, *overruled on other grounds by* *Brehm v. Eisner, 746 A.2d 244 (Del. 2000)*).

754 *Bomarko, Inc. v. Int'l Telecharge, Inc., 794 A.2d 1161, 1178 (Del. Ch. 1999)* (citing *Cede & Co., 634 A.2d at 363*), *aff'd*, *766 A.2d 437 (Del. 2000)*.

755 *In re Walt Disney Co. Deriv. Litig. (Disney I), 825 A.2d 275, 278 (Del. Ch. 2003)*; *see also* *Cysive, 836 A.2d at 550 n.26* ("Unless the plaintiffs can show that the independent board majority was duped by the interested block holder, abdicated its responsibilities so as to have acted in subjective bad faith, or acted so irrationally so as to have committed a violation of their duty of care, the business judgment standard of review would condemn their claims.").

756 *Bally's Grand, 1997 Del. Ch. LEXIS 77, 1997 WL 305803, at *4*.

delegated," as well as whether the board acted independently in delegating the task.[757]

Here, Plaintiff has alleged that the Director Defendants delegated to conflicted management total and complete authority to prepare and file the Proxy and that the Director Defendants did not review the Proxy before it was filed. The Director Defendants contend that "[o]f course" Plaintiff's allegations are "not true."[758] They argue that while Plaintiff is entitled to all reasonable inferences in her favor, she "is not entitled to ask the Court to presume a board of directors somehow waives its right to review a Proxy, acts in bad faith and breaches its fiduciary duty whenever it fails to reserve its right to review subsequent drafts of a proposed disclosure in a standard board resolution." **[*155]** [759]

But the Director Defendants have not asserted any reason to reject Plaintiff's allegations as untrue at this stage, particularly where those allegations are consistent with the delegating Board resolution. For example, there are no meeting minutes demonstrating that the Director Defendants oversaw the Proxy's preparation or that they reviewed the Proxy before the Officer Defendants filed it with the SEC.[760] So, as is nearly always the case, the Court must accept Plaintiff's allegations as true for the purpose of the Motions.[761] Plaintiff has alleged facts making it reasonably conceivable that the Director Defendants delegated full authority to prepare and disseminate the Proxy to the allegedly conflicted Officer Defendants, and did so in bad faith.[762] Bad faith is reflected in the choice of agent and the complete scope of delegation.

I first consider the Board's chosen agents in determining whether a delegation constitutes abdication.[763] The Board delegated drafting the Proxy to the Officer Defendants, known conflicted individuals who had been ostensibly walled off from the sale process but still assisted in tilting the playing field toward Buyer for the benefit of Riverstone and Developer **[*156]** 2. Delegating to Garland was particularly problematic, especially after he had been less than forthright with the Special Committee about his April 15 Meeting with Riverstone after Brookfield's first offer.

Second, the scope of the delegation goes too far. The Board's resolution granted the Officer Defendants full power and discretion to prepare the Proxy with information they thought it needed to contain, and then to file the Proxy with the SEC without the Board's review.[764] The Board authorized interested parties to unilaterally describe the process to the stockholders with finality, thereby infecting the stockholder vote as well.

And from the alleged misrepresentations in the Proxy, it appears that the Officer Defendants—specifically, Garland—capitalized on the opportunity to selectively disclose the Individual Defendants' self-interested involvement.[765] As alleged, the Proxy and Supplemental Proxy failed to disclose, among other things, that Riverstone leveraged its relationship with Developer 2 and the Company to block a more valuable deal with Brookfield and TerraForm; that Garland had unauthorized discussions with potential bidders in violation of the Special Committee's instructions, **[*157]** including an unauthorized in-person April 15 Meeting with Buyer and Riverstone in April 2019; that Goldman faced conflicts of interest, including that Goldman owns a substantial stake in Riverstone, had advised Riverstone on a take-private of the Company, and had earned fees totaling over $100 million from Riverstone and Buyer in recent years; that Browne, a representative of Riverstone, attended a majority of the Special Committee's meetings and Executive Sessions; and that the Company's largest stockholder, PSP, held a 22% interest in Developer 2.

---

[757] *[Rosenblatt, 493 A.2d at 943](https://)*; *see also* *[id. at 944](https://)*.

[758] D.I. 74 at 39.

[759] D.I. 85 at 28.

[760] *See* D.I. 74 at 39-40; D.I. 85 at 28.

[761] *See* *KCG Hldgs., 2019 Del. Ch. LEXIS 233, 2019 WL 2564093, at *17* ("Defendants attack these allegations as factually inaccurate, but the Court must accept them as true for the purpose of this motion." (footnote omitted)).

[762] *See* Compl. ¶¶ 231-32; Weinberger Decl. Ex. 8.

[763] *Cf.* *Rosenblatt, 493 A.2d at 942-43* (upholding the board's delegation of authority as a valid exercise of business judgment where there was "no proof that D & M lacked independence or was in any way beholden to either party," and "[t]he record fully support[ed] a conclusion that D & M had the requisite reputation and experience to assist Getty and Skelly").

[764] *See* Compl. ¶¶ 231-33.

[765] The Officer Defendants' involvement in drafting and disseminating the Proxy, as well as the Proxy's deficiencies, are discussed in Section II.B.2 *infra*.

Finally, Plaintiff has adequately alleged that the Director Defendants failed to correct a Proxy they knew to be false and misleading. The Complaint's allegations indicate that the Director Defendants knew the truth (except for the whole truth about Garland's April 15 Meeting) so if the Director Defendants had reviewed the Proxy, even if only after it was issued, they would have known it was false or misleading. Because the Company issued further disclosures before the stockholder vote in the Supplemental Proxy, the Director Defendants conceivably had the opportunity to correct any alleged misstatements but failed to do so.[766]

As alleged, **[*158]** the Director Defendants' decisions to delegate the Proxy to the Conflicted Officer Defendants and forego reviewing it before filing, as well as their failure to correct the Proxy's alleged false and misleading statements, are actionable as bad faith.[767]

3. The Merger Was Not Cleansed Under *Corwin*.

Having determined that Plaintiff has stated a claim against the Director Defendants for breach of the duty of loyalty, I turn to the Director Defendants' argument that any such breach was cleansed by a stockholder vote and that therefore dismissal is appropriate under *Corwin*.[768] *Corwin* gives rise to the irrebuttable presumption of the business judgment rule when a transaction "is approved by a fully informed, uncoerced vote of the disinterested stockholders."[769] To obtain the protection of that presumption, the Director Defendants must "demonstrate that the [cash-out] merger has been approved by a fully informed, uncoerced majority of the disinterested stockholders."[770] Otherwise, for the reasons discussed *supra, Revlon* enhanced scrutiny or entire fairness will apply and Plaintiff's claims against the Director Defendants will survive the Motions.

As of the close of business on the **[*159]** Merger's record date, the Company had 98,218,625 shares of common stock and 10,400,000 shares of preferred stock outstanding.[771] The common and preferred shares voted together on the Merger as a single class, with each common and preferred share receiving one vote for a total of 108,618,625 potential votes.[772] CBRE's 10,400,000 preferred shares represented roughly 10.4% of the outstanding shares. PSP, which also held a substantial stake in Developer 2, held 9,341,025 shares.[773] And management, who received post-close equity and jobs, held 1,210,049 shares.[774] Overall, 56,856,604 of these shares or 52%, including CBRE, PSP, and management, voted in favor of the Merger.[775]

---

[766] *See* Kirby Decl. Ex. 2.

[767] *See, e.g.,* Rich ex rel. Fuqi Int'l, Inc. v. Yu Kwai Chong, 66 A.3d 963, 979 (Del. Ch. 2013) (holding that complaint stated a claim that board had abdicated its responsibilities by failing to conduct meaningful investigation and allowing management to make decisions without oversight); *Disney I, 825 A.2d at 278* (holding that complaint stated a claim for breach of duty of loyalty and action not in good faith where it alleged that board failed to act on executive's compensation and abdicated decision-making responsibility to the company's CEO); *Nagy v. Bistricer, 770 A.2d 43, 61-62, 64 (Del. Ch. 2000)* (holding that a board abdicated its statutory duty under Section 251(b) when it delegated the determination of the merger consideration to an investment bank selected by the acquirer); *Grimes, 1995 Del. Ch. LEXIS 3, 1995 WL 54441, at *11* (finding that complaint stated a claim that board had improperly delegated its authority under Section 141(a) to the CEO, where the board agreed not to engage in "unreasonable interference, in the good faith judgment of the Executive, by the Board . . . in the Executive's carrying out of his duties and responsibilities"); *Jackson v. Turnbull, 1994 Del. Ch. LEXIS 25, 1994 WL 174668, at *4-5 (Del. Ch. Feb. 8, 1994)* (holding board impermissibly abdicated statutory obligation to set merger consideration by delegating task to its investment bankers), *aff'd*, ***653 A.2d 306 (Del. 1994)*** (TABLE); *Sealy Mattress Co. of N.J., Inc. v. Sealy, Inc., 532 A.2d 1324, 1338 (Del. Ch. 1987)* (holding that board "could not abdicate its obligation to make an informed decision on the fairness of the merger by simply deferring to the judgment of the controlling stockholder").

[768] ***125 A.3d at 308*** (holding that an "uncoerced, informed stockholder vote is outcome-determinative, even if *Revlon* applied to the merger").

[769] ***Id. at 309***.

[770] *KCG Hldgs., 2019 Del. Ch. LEXIS 233, 2019 WL 2564093, at *10* (internal quotation marks omitted) (quoting ***Corwin, 125 A.3d at 306***).

[771] Compl. ¶ 247.

[772] *Id.*

[773] *Id.* ¶ 249.

[774] *Id.*

[775] *Id.* ¶ 248. The Proxy informed stockholders if "you abstain from voting or fail to cast your vote, in person or by proxy, it will have the same effect as a vote 'AGAINST' the proposal to adopt the Merger Agreement and approve the Merger." Proxy

Plaintiff contends that *Corwin* does not apply because the vote was uninformed and because a significant block of votes was not disinterested.[776] Plaintiff argues PSP was not disinterested because "it held a stake in the buyer,"[777] meaning Riverstone's Developer 2. Plaintiff argues CBRE was neither disinterested nor uncoerced, as it was contractually obligated to vote its preferred shares in accordance with the Board's recommendation regardless of its own economic interest, and that further, its "preferred shares rolled over **[*160]** into the combined company with an increased dividend rate."[778] The parties submitted supplemental briefing on whether CBRE's preferred shares should count toward the uncoerced, disinterested, and fully-informed vote. Removing shares held by PSP, CBRE, and conflicted management from the vote total, 35,905,530—or only 41%—of the remaining 87,667,551 disinterested shares were voted in favor of the Merger.[779] Removing only CBRE's preferred shares leaves 46,456,604 or 47.3% of the overall outstanding 98,218,625 shares in favor of the Merger.[780]

In light of CBRE's contractual obligation to vote in favor of the merger, which CBRE agreed to without being informed of the merger's terms, the Director Defendants cannot invoke *Corwin*'s protections. CBRE was neither fully informed nor disinterested, and its votes were compelled by contractual duty. Because removing CBRE's preferred stock strips the Director Defendants of *Corwin*'s protections, I need not reach PSP and management's votes.

CBRE's vote in favor of the Merger was not informed. Under Delaware law, determining whether a vote was fully informed at the pleading stage requires the Court to consider whether the "complaint, when fairly read, **[*161]** supports a rational inference that material facts were not disclosed or that the disclosed information was otherwise materially misleading."[781] For shareholders to be "fully informed," they must possess "all material information" as to a particular transaction.[782]

CBRE acquired its stock on October 10 when it executed the Purchase Agreement.[783] CBRE agreed that in the event of "*any proposed* merger," it would "vote its Preferred Shares in a manner consistent with the recommendation of the Board."[784] CBRE agreed to this term 13 days before bidders submitted definitive documentation and 18 days before bidders submitted best and final offers; 24 days before the Special Committee and Board voted to approve the Merger; 117 days before the Company issued the Proxy; and 152 days before the stockholder vote. As of the date of the Purchase Agreement, the Special Committee was fielding offers from at least four bidders, including Brookfield and Buyer, and it was rejecting exclusivity requests. No transaction was definitive, and any terms were tentative at best. CBRE effectively cast its vote in favor of the Merger before the Special Committee and Board had the opportunity to finalize its terms, consider its **[*162]** merits, approve it as furthering the best interests of the Company and its stockholders, or disclose its terms for stockholder consideration. When CBRE agreed to vote in favor of the Merger, it did not know that the transaction would close, the price at which it might close and whether that price would be paid in cash or stock, or who the counterparty might be. Contrary to the Director Defendants' assertion,[785]

at 5 (emphasis omitted).

[776] *See* D.I. 82 at 84-85.

[777] *Id.* at 84.

[778] *Id.*

[779] Compl. ¶ 250.

[780] *Id.* ¶ 252.

[781] *Mindbody, 2020 Del. Ch. LEXIS 307, 2020 WL 5870084, at *26*.

[782] *van der Fluit v. Yates, 2017 Del. Ch. LEXIS 829, 2017 WL 5953514, at *7 (Del. Ch. Nov. 30, 2017)* (quoting *Solomon v. Armstrong, 747 A.2d 1098, 1127-28 (Del. Ch. 1999)*).

[783] *See* Compl. ¶¶ 181-206, 235; D.I. 92, Ex. A.

[784] D.I. 92, Ex. A. § 6.09(g) (emphasis added); Compl. ¶ 237. CBRE also expressly waived any right to recover damages from the Company beyond the purchase price of the preferred stock, absent fraud. D.I. 92, Ex. A § 8.04. The preferred stock issuance and voting provision were disclosed in the Proxy. *See, e.g.*, Proxy at 15 ("[T]he holders of Company Preferred Stock and Pattern have agreed that the holders of Company Preferred Stock shall vote their 10,400,000 shares of Company Preferred Stock in a manner consistent with the recommendations of the Board . . . ."); *id.* at 129 ("Pursuant to the Company Preferred Stock Purchase Agreement, we issued and sold 10,400,000 shares of Company Preferred Stock on October 25, 2019 to entities affiliated with CBRE . . . .").

[785] *See* D.I. 96 at 2 ("Plaintiff asks the Court to simply assume that CBRE must have disregarded the Proxy and the terms of

CBRE's lack of information was not cured *ex post facto* by the allegedly deficient Proxy, issued after CBRE agreed to vote in favor of the Merger. CBRE's uninformed assent to the Merger precludes its votes from contributing to any cleansing under *Corwin*.

Second, CBRE was interested with respect to the Merger. A stockholder is interested if it may derive pecuniary interest from one particular result or is otherwise unable to be fair-minded, unbiased, and impartial.[786] "That is, only the votes of those stockholders with no economic incentive to approve a [challenged] transaction count."[787] CBRE's contractual obligation to vote in favor of the Merger carried with it financial consequences for breach and financial incentives for performance. CBRE bargained for the right to **[*163]** rollover its preferred stock at a premium into the post-closing company and keep its shares after a merger.[788] And after a change in control, the annual dividend rate on CBRE's preferred stock would increase by as much as seventy-five basis points, and the holders would receive an accelerated payment on certain otherwise contingent dividends.[789] CBRE's Merger benefits were not shared with the Company's public common stockholders, who were to be cashed out.[790] Accordingly, CBRE was interested by virtue of the Purchase Agreement, as it stood to receive benefits from the Merger that were not shared with the cashed-out majority.[791] CBRE was also economically

---

the Merger itself in casting its votes because it had agreed to vote in favor of whatever transaction the [Company] board recommended. . . . CBRE, as a holder of preferred stock, had access to the same information set forth in the Proxy as every other stockholder. Plaintiff does not allege otherwise, and she offers no reason to assume that CBRE ignored the Proxy." (footnote omitted)).

[786] *See* Scott v. Arden Farms Co., 26 Del. Ch. 283, 28 A.2d 81, 85 (Del. Ch. 1942) ("The word 'disinterested' as so used, plainly means something more than not having a pecuniary interest in the controversy; it connotes fair-mindedness, including freedom from actual or probable bias, prejudice or partiality with relation to the questions to be determined.").

[787] Harbor Fin. P'rs v. Huizenga, 751 A.2d 879, 900 (Del. Ch. 1999) (emphasis omitted); *cf.* ***Corwin*, 125 A.3d at 313-14** ("There are sound reasons for this policy. When the real parties in interest—the disinterested equity owners—can easily protect themselves at the ballot box by simply voting no, the utility of a litigation-intrusive standard of review promises more costs to stockholders in the form of litigation rents and inhibitions on risk-taking than it promises in terms of benefits to them. The reason for that is tied to the core rationale of the business judgment rule, which is that judges are poorly positioned to evaluate the wisdom of business decisions and there is little utility to having them second-guess the determination of impartial decision-makers with more information (in the case of directors) or an actual economic stake in the outcome (in the case of informed, disinterested stockholders). In circumstances, therefore, where the stockholders have had the voluntary choice to accept or reject a transaction, the business judgment rule standard of review is the presumptively correct one and best facilitates wealth creation through the corporate form." (footnote omitted)); *see* In re Pure Res., Inc., S'holders Litig., 808 A.2d 421, 426 (Del. Ch. 2002) (stating that "it is clear that the Put Agreements can create materially different incentives for the holders than if they were simply holders of Pure common stock," and therefore discounting holders of those shares in majority of minority calculation); In re CNX Gas Corp. S'holders Litig., 4 A.3d 397, 416 (Del. Ch. 2010) (explaining that "[e]conomic incentives matter, particularly for the effectiveness of a legitimizing mechanism like a . . . stockholder vote"); Morton's Rest. Gp., 74 A.3d at 663 n.34 ("[O]nly disinterested stockholder approval is a strong assurance of fairness."); In re Zale Corp. Stockholders Litig., 2015 Del. Ch. LEXIS 249, 2015 WL 5853693, at *9 (Del. Ch. Oct. 29, 2015) (ruling plaintiff had not adequately alleged a stockholder was interested where the stockholder's alternate economic interest, unique to that stockholder, was not material); Brandon Mordue, *The* Revlon *Divergence: Evolution of Judicial Review of Merger Litigation*, 12 Va. L. Bus. R. 531, 567 (2018) (explaining, in light of *Corwin*'s economic purposes, "*Corwin* thus suggests that an 'interested' stockholder would be one voting in favor of a transaction for reasons other than the economic merits of the transaction itself").

[788] Compl. ¶ 249.

[789] D.I. 94, Ex. A § 2(a)-(c).

[790] *See* PNB, 2006 Del. Ch. LEXIS 158, 2006 WL 2403999, at *8, *14, *15 (holding that for the purposes of ratification, the only votes that counted were those of the shareholders who would be cashed out; a *majority* of those shareholders had to vote in favor of the transaction for the interested transaction to be ratified; and that the shareholders who stood to keep their shares in the merger were considered interested); *cf.* Stewart v. BF Bolthouse Holdco, LLC, 2013 Del. Ch. LEXIS 215, 2013 WL 5210220, at *10 (Del. Ch. Aug. 30, 2013) (stating that "allegations that the directors stood on both sides of the transaction or derived a benefit that was not shared *pro rata* among the other shareholders" may implicate duty of loyalty as an "interested transaction").

[791] *Cf.* Larkin v. Shah, 2016 Del. Ch. LEXIS 134, 2016 WL 4485447, at *20 (Del. Ch. Aug. 25, 2016) (noting that "[n]ot all stockholder approvals of a transaction have a cleansing effect," and observing that "[a]mong that 'yes'-block were stockholders owning 27.4% of Auspex's shares who

incentivized to perform under the Purchase Agreement and avoid the consequences of breach. CBRE's votes cannot contribute to cleansing under *Corwin*.

Finally, and fundamentally, Defendants have failed to demonstrate that CBRE's vote was voluntary. The business judgment rule standard of review applies only if disinterested and informed stockholders have had the voluntary choice to accept or reject a transaction.[792] "[T]he term 'ratification' **[*164]** applies only to a voluntary stockholder vote."[793] The Court declines to second-guess the board when the stockholders, as a second set of decisionmakers, have approved the economic merits of a transaction for themselves.[794] To be a meaningful ratifying vote, the stockholder must be voting on the transaction of her own accord and on the transaction's merits. A stockholder voting in favor of a specific transaction because it had previously contracted to vote in favor of *any* transaction in exchange for consideration is not offering the second review that supports application of the business judgment rule.[795] Indeed, this Court has excluded from a *Corwin* calculus votes by stockholders who contractually agreed to vote their shares in favor of a transaction.[796]

CBRE's vote was not a ratification of the Merger. Rather, it was a dutiful performance under the Purchase Agreement. CBRE lacked the ability to vote no at the ballot box in light of its contractual obligation to vote for the Merger. CBRE could either perform its contractual obligation to vote in favor of the Merger, or breach the Purchase Agreement and face the consequences. **[*165]** Including CBRE in the cleansing vote count would run afoul of *Corwin*'s logical underpinnings.

In an effort to count CBRE's votes as cleansing votes, the Director Defendants point out that the Special Committee put Buyer and Brookfield on level footing before CBRE. According to the September 29 meeting minutes, the purchaser of the preferred shares would have a premium redemption right in the event the Company's acquirer did not meet certain requirements, but both Brookfield and Buyer were carved out from that redemption right.[797] But this does not change the fact that CBRE was required to vote in favor of the Merger regardless of the identity of the acquirer.

The Director Defendants also contend Plaintiff cannot "explain how it was coercive for CBRE to agree to vote in a manner consistent with the board's recommendation, where the Board itself was bound to vote the way of a fully independent Special Committee, and a majority of the Board and all of the Special Committee members are concededly independent."[798] This misses the point of ratification and why the vote must be voluntary: the stockholders must consider and approve the transaction with their own voice, wholly independently from the **[*166]** board. CBRE agreed to vote in favor of the Merger—or any merger—without evaluating the transaction's merits or the Board's

contractually agreed to tender under the Tender and Support Agreement," and "[e]xcluding them, stockholders owning roughly 70% of the outstanding shares not contractually bound to tender agreed to the merger").

[792] ***Corwin*, 125 A.3d at 306, 310, 312-13**; *Frank v. Wilson & Co., 27 Del. Ch. 292, 305, 32 A.2d 277 (Del. 1943)* ("Ratification . . . implies a voluntary and positive act . . . .").

[793] *KKR, 101 A.3d at 1003*. The vote itself may be statutorily required; the point is that the stockholder's "yes" is voluntary. *See* ***Corwin*, 125 A.3d at 312-14**; *In re Volcano Corp. Stockholder Litig., 143 A.3d 727, 740-45 (Del. Ch. 2016)*.

[794] *See* *Lavin v. West Corp., 2017 Del. Ch. LEXIS 866, 2017 WL 6728702, at *8 (Del. Ch. Dec. 29, 2017)* (citing ***Corwin*, 125 A.3d at 313**); J. Travis Laster, *The Effect of Stockholder Approval on Enhanced Scrutiny*, *40 Wm. Mitchell L. Rev. 1443, 1457 (2014)* (commenting that "a compromised board can substitute the stockholders as the necessary qualified decision maker and, thereby, restore the protections of the business judgment rule" and that it is appropriate that "a court should take into account and defer to an uncoerced endorsement from fully informed, disinterested stockholders").

[795] *See* *In re Inv'rs Bancorp, Inc. Stockholder Litig., 177 A.3d 1208, 1220-21 (Del. 2017)* (noting "mere approval by stockholders of a request by directors for the authority to take action within broad parameters does not insulate all future action by the directors within those parameters from attack," and explaining that only where "stockholders approve a specific corporate action, [will] the doctrine of ratification, in most situations, preclude[] claims for breach of fiduciary duty attacking that action" (quoting *Sample v. Morgan, 914 A.2d 647, 663-64 (Del. Ch. 2007)*)); *Gantler v. Stephens, 965 A.2d 695, 713 (Del. 2009)* ("[T]he only director action or conduct that can be ratified is that which the shareholders are specifically asked to approve.").

[796] *See* *Larkin, 2016 Del. Ch. LEXIS 134, 2016 WL 4485447, at *20* (excluding shareholders who had contractual obligation to tender shares and vote yes if necessary).

[797] Kirby Decl. Ex. 20 at PEGI-00001291.

[798] D.I. 92 at 5.

fiduciary performance. CBRE agreed to substitute or forego its own independent judgment and support the Board's recommendation for any merger within the identified timeframe.[799] Plaintiff's argument, connecting CBRE's vote through a daisy chain of substituted judgment to the very Special Committee whose conduct the vote is to ratify, demonstrates the fundamental reason why CBRE's vote cannot be a cleansing vote. A stockholder who must vote the same way as the board is echoing, not ratifying, the board's conduct, even if the board were comprised of entirely careful and loyal directors.

Without CBRE's vote, the Director Defendants do not have the majority necessary for *Corwin* to cleanse the Merger. The Individual Defendants' Motion is denied as to Count I, and Plaintiff's nonexculpated claims against the Director Defendants shall proceed.

B. Plaintiff Has Stated A Claim For Breach Of Fiduciary Duty Against Certain Officer Defendants.

Because *Section 102(b)(7)* does not exculpate a corporate officer's breach of fiduciary duty, Plaintiff's claims against the Officer Defendants face a **[*167]** different standard.[800] Plaintiffs need only plead facts supporting a reasonable inference that the Officer Defendants breached their fiduciary duty of care in their official capacities.[801] Plaintiff may recover damages from the Officer Defendants in their roles as officers for breach of either the duty of loyalty or the duty of care.[802]

"Corporate officers owe fiduciary duties that are identical to those owed by corporate directors."[803] As stated, "the 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."[804] Corporate officers "are not permitted to use their position of trust and confidence to further their private interests."[805]

"To plead a claim for breach of the duty of loyalty that will overcome a motion to dismiss, a plaintiff must plead sufficient facts to support a rational inference that the corporate fiduciary acted out of material self-interest that diverged from the interests of the shareholders."[806] To

[799] *See* *Invrs. Bancorp, 177 A.3d at 1222*.

[800] *See, e.g.,* *Baker Hughes, 2020 Del. Ch. LEXIS 321, 2020 WL 6281427, at *15-16*; *Essendant, 2019 Del. Ch. LEXIS 1404, 2019 WL 7290944, at *15*.

[801] *See, e.g.,* *Baker Hughes, 2020 Del. Ch. LEXIS 321, 2020 WL 6281427, at *15*. As this Court noted recently, "[i]t is an open issue of Delaware law as to whether *Revlon* applies to an officer's actions." *Mindbody, 2020 Del. Ch. LEXIS 307, 2020 WL 5870084, at *32 n.287*. For purposes of this decision, I assume a breach of an officer's duties of care and loyalty should be reviewed under the traditional standards of bad faith and gross negligence, respectively, because the directors—not the officers—are responsible for the types of decisions that warrant *Revlon* enhanced scrutiny review. *See id.* (applying gross negligence even though *Revlon* applied to the underlying transaction because "*Revlon* neither creates a new type of fiduciary duty in the sale-of-control context nor alters the nature of the fiduciary duties that generally apply" (quoting *Malpiede, 780 A.2d at 1083*)); *Morrison I, 2019 Del. Ch. LEXIS 1412, 2019 WL 7369431, at *22* (applying gross negligence standard to officer conduct, even though *Revlon* applied to the underlying company sale process).

[802] *See, e.g.,* *Baker Hughes, 2020 Del. Ch. LEXIS 321, 2020 WL 6281427, at *15*.

[803] *Frederick Hsu, 2017 Del. Ch. LEXIS 67, 2017 WL 1437308, at *39* (citation, footnote, and internal quotation marks omitted) (quoting *Gantler, 965 A.2d at 708*, and then quoting *Hampshire Gp. Ltd. v. Kuttner, 2010 Del. Ch. LEXIS 144, 2010 WL 2739995, at *12 (Del. Ch. July 12, 2010)*).

[804] *Cede & Co., 634 A.2d at 361*; *see also* *Gantler, 965 A.2d at 709* ("[T]he fiduciary duties of officers are the same as those of directors."); *Guth, 5 A.2d at 510* ("While technically not trustees, [corporate officers and directors] stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest. The occasions for the determination of honesty, good faith and loyal conduct are many and varied, and no hard and fast rule can be formulated. The standard of loyalty is measured by no fixed scale.").

[805] *Guth, 5 A.2d at 510*.

[806] *Saba Software, 2017 Del. Ch. LEXIS 52, 2017 WL 1201108, at *21*.

make such a showing, the plaintiff may plead **[*168]** that the officer was interested or lacked independence with respect to the challenged transaction.[807] To plead interestedness, a plaintiff can plead the fiduciary received "a personal financial benefit from a transaction that is not equally shared by the stockholders," or "was a dual fiduciary and owed a competing duty of loyalty to an entity that itself stood on the other side of the transaction or received a unique benefit not shared with the stockholders."[808] To plead a lack of independence, a plaintiff can plead the fiduciary is "sufficiently loyal to, beholden to, or otherwise influenced by an interested party" to undermine the fiduciary's ability to judge the matter on its merits.[809]

Further, "[l]ike directors, officers breach the duty of loyalty if they act in bad faith for a purpose other than advancing the best interests of the corporation."[810] A claim for breach of the duty of loyalty against officers will proceed where the complaint alleges that they manipulated the sales process to sabotage the alternatives they did not personally favor and acted with favoritism toward a particular bidder.[811]

An officer's compliance with the duty of care is evaluated for gross negligence. **[*169]** [812] "Gross negligence involves more than simple carelessness. To plead gross negligence, a plaintiff must allege conduct that constitutes reckless indifference or actions that are without the bounds of reason."[813] "While the inquiry of whether the claims amount to gross negligence is necessarily fact-specific, the burden to plead gross negligence is a difficult one."[814]

Plaintiff's Complaint places many wrongs at the many feet of the Officer Defendants or "conflicted management," and Garland appears in nearly every scene of Plaintiff's narrative. But the Complaint pleads few facts addressing the other Officer Defendants' individual involvement in the sales process. As a result, Plaintiff has failed to plead breaches by each Officer Defendant. Plaintiff has alleged facts from which it is reasonably conceivable that Garland, Elkort, and Lyon—but not Armistead and Pedersen—breached their duty of loyalty by titling the sales process toward Buyer in pursuit of their own interests and Riverstone and Developer 2's interests. Plaintiff has stated a claim against Garland for breaching his duties as an officer in preparing the allegedly false and misleading Proxy—but not Armistead, Elkort, Lyon, **[*170]** or Pedersen. The Individual Defendants' Motion on Count II is granted and denied in part.

1. It Is Reasonably Conceivable That Only Garland, Elkort, And Lyon Tilted The Sales Process In Buyer's Favor; It Is Not Reasonably Conceivable That Armistead And Pedersen Did The Same.

Plaintiff claims the Officer Defendants breached both their duty of loyalty and duty of care by "tilt[ing] the sale process" in Riverstone's and Buyer's "favor due to [their] conflicts of interest."[815] The Complaint supports a reasonable inference that Garland, Elkort, Lyon, and Pederson favored Riverstone and Developer 2's

---

[807] *See, e.g.*, Cede & Co., 634 A.2d at 362 ("Classic examples of director self-interest in a business transaction involve either a director appearing on both sides of a transaction or a director receiving a personal benefit from a transaction not received by the shareholders generally. We have generally defined a director as being independent only when the director's decision is based entirely on the corporate merits of the transaction and is not influenced by personal or extraneous considerations. By contrast, a director who receives a substantial benefit from supporting a transaction cannot be objectively viewed as disinterested or independent. This principle necessarily constrains our review of the Court of Chancery's duty of loyalty formulation." (citations omitted)).

[808] Frederick Hsu, 2017 Del. Ch. LEXIS 67, 2017 WL 1437308, at *26 (quoting Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993)).

[809] *Id.*

[810] 2017 Del. Ch. LEXIS 67, [WL] at *39 (alteration and internal quotation marks omitted) (quoting Kuttner, 2010 Del. Ch. LEXIS 144, 2010 WL 2739995, at *12).

[811] *See* Chen, 87 A.3d at 686-87 (quoting and discussing Gantler, 965 A.2d at 709).

[812] Baker Hughes, 2020 Del. Ch. LEXIS 321, 2020 WL 6281427, at *15.

[813] *Id.* (internal quotation marks omitted) (quoting Morrison I, 2019 Del. Ch. LEXIS 1412, 2019 WL 7369431, at *22).

[814] *Id.* (quoting Zucker v. Hassell, 2016 Del. Ch. LEXIS 180, 2016 WL 7011351, at *7 (Del. Ch. Nov. 30, 2016), *aff'd*, ***165 A.3d 288 (Del. 2017)***).

[815] D.I. 82 at 35 (quoting Mindbody, 2020 Del. Ch. LEXIS 307, 2020 WL 5870084, at *1).

interests over the Company's public stockholders because they were not independent of Riverstone and Developer 2.[816]

As an initial matter, Plaintiff has alleged that each Officer Defendant was conflicted with respect to Riverstone.[817] Each held substantial roles with Riverstone's subsidiaries and the favored entity in the sales process, Developer 2 as preceded by Developer 1. Garland, the Company's CEO since its founding in October 2012, also served as the President and a director of both Developer 1 and Developer 2.[818] Armistead, the Company's Executive Vice President of Business Development since August **[*171]** 2013, served as Developer 1's Executive Director since June 2009 and as Developer 2's President since April 2019.[819] Elkort, the Company's Executive Vice President and Chief Legal Officer since May 2018, also served as Developer 1's Director of Legal Services and Co-Head of Finance since June 2009 and as a Developer 2 officer.[820] Lyon, the Company's President since April 2019, also previously served as Developer 1's Head of Structured Finance.[821] And Pedersen, the Company's CFO since April 2019, also served as Developer 2's CFO since May 2018 and Developer 1's Co-Head of Finance since June 2009.[822] Thus, the Officer Defendants were dual fiduciaries at the time of the Merger.[823] Because Riverstone's and Developer 2's interests diverged from those of the Company's stockholders, those Officer Defendants faced an inherent conflict of interest.[824]

Plaintiff has also alleged that those Officer Defendants were interested in the Merger and incentivized to favor Buyer and the associated internalization of Developer 2 to secure for themselves equity and continued employment.[825] Post-closing, Garland continues to run the combined entity, and Armistead, Elkort, Lyon, and Pedersen continue **[*172]** to serve as its executives.[826] During the sales process, the Company communicated to bidders that it was desirable for the Officer Defendants "to maintain their positions in the combined company,"[827] and the Officer Defendants were, after a blackout period, permitted to negotiate these roles without the Special Committee's involvement.[828] Each was therefore conceivably beholden to Riverstone and Developer 2 for their continued employment, calling into question their independence. Armistead, Garland, Elkort, Lyon, and Pederson also had the opportunity to retain equity in the post-closing company, while the Company's public stockholders were cashed out. As disclosed in the Proxy, each received substantial equity in the post-closing company.[829]

While Plaintiff has alleged that each of the Officer Defendants faced conflicts of interest with respect to the Merger, the key question is whether Plaintiff has plead facts making it reasonably conceivable that each Officer Defendant acted during the sales process due to those conflicts. Plaintiff has not. The Complaint pleads facts supporting a reasonable inference that only Garland, Elkort, and Lyon acted disloyally to favor Riverstone **[*173]** and Developer 2's interests, consistent with their incentives. The Complaint lacks similarly sufficient allegations against Armistead and Pedersen.

Readers who have made it this far are familiar with Garland's questionable contributions to the sales process. As discussed at length above, Garland is

---

[816] *See* [*Frederick Hsu, 2017 Del. Ch. LEXIS 67, 2017 WL 1437308, at *39*](#).

[817] Compl. ¶¶ 32-36.

[818] *Id.* ¶ 24. Before the Merger, Garland also held a substantial equity interest in Developer 2. Therefore, his interests also diverged from those of the Company's public stockholders to the extent an internalization of Developer 2 required the companies' stockholders to compete for consideration.

[819] *Id.* ¶ 32.

[820] *Id.* ¶ 33. Before the Merger, Elkort also held a substantial equity interest in Developer 2. Therefore, his interests also diverged from those of the Company's public stockholders to the extent an internalization of Developer 2 required the companies' stockholders to compete for consideration.

[821] *Id.* ¶ 34.

[822] *Id.* ¶ 35.

[823] *See, e.g.,* [*Chen, 87 A.3d at 670*](#).

[824] *Id.*

[825] *See, e.g.,* [*Frederick Hsu, 2017 Del. Ch. LEXIS 67, 2017 WL 1437308, at *26*](#).

[826] Compl. ¶¶ 24, 32-36.

[827] *Id.* ¶ 174.

[828] *See id.* ¶¶ 147, 174, 163.

[829] *Id.* ¶¶ 24, 32-35.

alleged to have initiated and actively participated in the sales process as both a director and officer with the primary objective of securing a merger with a friendly bidder that would internalize Developer 2 at a premium price. In pursuit of this objective, he and the Director Defendants acknowledged, yet ignored, concerns that the Company's public stockholders would be shorted merger consideration.

In addition, Plaintiff has alleged that Elkort and Lyon also contributed to tilting the sales process toward Buyer. After Riverstone spurred the idea of take-private, at a time when the Company did not need to raise equity capital, management—including Garland, Elkort, and Lyon—kicked off the sales process with Riverstone in the room and able to gather Company confidential information.[830] Plaintiff alleges Garland and Lyon encouraged the Special Committee to retain Goldman, despite its known conflicts **[*174]** including advising Riverstone on a potential buyout of the Company.[831] Garland and Elkort pressed the Special Committee to favor a transaction that was Riverstone-approved.[832] Elkort "emphasized" to the Special Committee that "the need for Riverstone's support for any potential transaction should not be underestimated because Riverstone's rights to consent that would likely be implicated by the proposed transaction appeared to be very broad."[833] But, as Brookfield realized, the Consent Right was readily structurally circumvented.

Based on these facts, it is reasonably conceivable that Garland, Elkort and Lyon breached their fiduciary duties as officers by consciously pressing for a transaction with Buyer consistent with their personal and financial incentives, as well as Riverstone and Developer 2 interests.[834] As alleged, their actions give rise to a breach of the duty of loyalty, as they cannot escape their inherent conflicts. But even if it were a close call, at a minimum, the facts pled give rise to the reasonable inference that Elkort and Lyon were at least recklessly indifferent or grossly negligent with respect to the steps Garland and the Board took to tilt the sale process **[*175]** in Buyer's favor.[835] Plaintiff has stated a

[830] Taking Plaintiff's group pleading as true, Armistead and Pedersen also participated in the sales process kickoff. However, unlike Elkort and Lyon, the Complaint does not allege that they took action to further their own interests or Riverstone's interests once the sales process was underway.

[831] Compl. ¶¶ 106-08; *see also id.* ¶ 139.

[832] *Id.* ¶ 117.

[833] *Id.* (alterations omitted).

[834] *See* Frederick Hsu, 2017 Del. Ch. LEXIS 67, 2017 WL 1437308, at *39; Chen, 87 A.3d at 687. The Officer Defendants contend that the 220 materials undermine Plaintiff's allegations against them. *See* D.I. 85 at 23. Plaintiff refutes the Officer Defendants' interpretation of those materials. *See* D.I. 82 at 37-40, 41. The 220 documents used to draft the Complaint are incorporated by reference or integral to it, and therefore I may review documents cited in the Complaint "to ensure that the plaintiff has not misrepresented [their] contents and that any inference the plaintiff seeks to have drawn is a reasonable one." Amalgamated Bank v. Yahoo! Inc., 132 A.3d 752, 797 (Del. Ch. 2016), *abrogated on other grounds by* ***Tiger v. Boast Apparel, Inc., 214 A.3d 933 (Del. 2019)***. "Section 220 documents, hand selected by the company, cannot be offered to rewrite an otherwise well-pled complaint," but can be offered to ensure the plaintiff is not taking documents out of context. In re Clovis Oncology, Inc. Deriv. Litig., 2019 Del. Ch. LEXIS 1293, 2019 WL 4850188, at *14 n.216 (Del. Ch. Oct. 1, 2019). The Court cannot weigh competing factual interpretations of incorporated documents on a motion to dismiss. Owens on Behalf of Esperion Therapeutics, Inc. v. Mayleben, 2020 Del. Ch. LEXIS 59, 2020 WL 748023, at *9 (Del. Ch. Feb. 13, 2020), *aff'd sub nom.* ***Owens v. Mayleben, 241 A.3d 218 (Del. 2020)***. It appears to me that Plaintiff has not misrepresented the 220 materials and has drawn reasonable inferences therefrom. *See* Winshall v. Viacom Int'l, Inc., 76 A.3d 808, 818 (Del. 2013); *see also* In re CBS Corp. Stockholder Class Action & Derivative Litig., 2021 Del. Ch. LEXIS 12, 2021 WL 268779, at *18 (Del. Ch. Jan. 27, 2021) ("The incorporation-by-reference doctrine does not enable a court to weigh evidence on a motion to dismiss. It permits a court to review the actual documents to ensure that the plaintiff has not misrepresented their contents and that any inference the plaintiff seeks to have drawn is a reasonable one. Where a defendant improperly and extensively uses Section 220 Documents in support of a Chancery Rule 12(b)(6) motion to support factual inferences that run counter to those supported in the complaint, the court may either exclude the extraneous matter from its consideration or convert the Chancery Rule 12(b)(6) motion into a motion for summary judgment so that the plaintiff may take discovery before the court determines if pre-trial dispositive relief is appropriate." (footnotes and internal quotation marks omitted) (quoting Voigt, 2020 Del. Ch. LEXIS 55, 2020 WL 614999, at *9)).

[835] *See* Mindbody, 2020 Del. Ch. LEXIS 307, 2020 WL 5870084, at *33 ("White was also involved in providing timing and informational advantages to Vista throughout the sale process. Plaintiffs allege that White, with Stollmeyer [director], populated Vista's substantial data room. . . . In view of these facts, it is reasonably conceivable that White was at least recklessly indifferent to the steps Stollmeyer took to tilt the

claim against Garland, Elkort, and Lyon.

Plaintiff has failed to state a claim for breach against Armistead and Pedersen. Unlike Elkort and Lyon, the Complaint fails to allege anything specific about Armistead and Pedersen's involvement in the sales process.[836] The Complaint alleges that Armistead and Pedersen had long histories with Riverstone and were conflicted.[837] But the only allegations tethering Armistead and Pedersen to the process concern the Officer Defendants collectively.[838] With no allegations whatsoever tying Armistead to the process, it is not reasonably conceivable that Armistead breached his duty of loyalty or care by titling the process toward Buyer in pursuit of his, Riverstone, or Developer 2's interests.[839] Plaintiff has not stated a claim against Armistead.

As for Pedersen, the Complaint alleges that Pedersen shared the Company's favorable financial growth on 2019 earnings calls.[840] Pedersen's statements are the backdrop against which Plaintiff outlines Garland's stock issuances, contending the issuances **[*176]** were not financially necessary and only done to secure CBRE's favorable votes. But Pedersen's statements are consistent with his position as CFO, and Plaintiff has not alleged that he utilized those statements to advance his own interests or Riverstone and Developer 2's interests. Nor has Plaintiff alleged those statements were false; rather, Plaintiff relies on the truth of those statements to outline the preferred stock issuance in stark relief. Plaintiff has not pled a breach of fiduciary duty by Pedersen.

2. It Is Reasonably Conceivable That Garland Is Responsible For The False And Misleading Proxy.

Plaintiff also claims the Officer Defendants breached their duty of loyalty or, at a minimum, their duty of care by causing the Company to issue the materially incomplete and misleading Proxy to stockholders. "It is elementary that under Delaware law the duty of candor imposes an unremitting duty on fiduciaries, including directors and officers, to not use superior information or knowledge to mislead others in the performance of their own fiduciary obligations."[841] And those fiduciaries certainly cannot "use their position of trust and confidence" to withhold from stockholders material information **[*177]** "to further their private interests."[842] "Officers may breach their fiduciary duties to the extent they are involved in preparing a proxy statement that contains materially misleading disclosures or omissions."[843] This requires that the Court conduct an

sale process in Vista's favor."); *cf.* KCG Hldgs., 2019 Del. Ch. LEXIS 233, 2019 WL 2564093, at *18 ("The allegations support a pleadings-stage inference that the Director Defendants breached their duty of care by failing to employ a reasonable process that managed Jefferies' influence. Whether the Director Defendants' actions in this regard rose to the level of bad faith or merely state a claim for breach of the duty of care is a close call. The Court need not make this call in light of the sufficiency of Plaintiff's other allegations." (footnote omitted)).

[836] *Compare* Compl. ¶¶ 33, 34, 106, 117, 130, 139, 210, 213-14, *with id.* ¶¶ 32, 35, 45, 85-88, 210, 213-14.

[837] *See id.* ¶¶ 32, 35.

[838] *See, e.g.,* Essendant, 2019 Del. Ch. LEXIS 1404, 2019 WL 7290944, at *7 n.91 ("[G]roup pleading is not sufficient to state a claim of breach of duty against an individual fiduciary."); *see* D.I. 82 at 36 (citing Compl. ¶¶ 107-08, 116-17, 124, 126-27, 140, 187, 234).

[839] *Compare* Baker Hughes, 2020 Del. Ch. LEXIS 321, 2020 WL 6281427, at *15-16, *with* Frederick Hsu, 2017 Del. Ch. LEXIS 67, 2017 WL 1437308, at *39-40 (recognizing the lack of allegations against certain officer defendants, but inferring their involvement in management-level initiatives that were constructed to favor differentiated equity, and stating that "the claims against Kupietzky and Morrow strike me as weaker than the other claims in the case, but relative weakness is not grounds for dismissal" and "[g]iven the plaintiff-friendly standard that governs a Rule 12(b)(6) motion, these claims survive"). In *Frederick Hsu*, the Court found that, despite its scant allegations, the complaint stated a claim against those officers in view of their role in crafting management-level strategy and initiatives to shape the company to favor undifferentiated equity. Here, the Court is asked to assess a Board-level sales process that looped in conflicted management. There is no allegation that Armistead touched that process, nor are there allegations from which it would be reasonable to infer his involvement simply by virtue of his role as a Company offer and dual fiduciary.

[840] Compl. ¶¶ 85-88.

[841] ***Haley, 235 A.3d at 718*** (alteration, internal quotation marks, and footnote omitted) (quoting MacMillan, 559 A.2d at 1283).

[842] *Id.* (alteration, internal quotation marks, and footnote omitted) (quoting Guth, 5 A.2d at 510); *accord* Macmillan, 559 A.2d at 1283.

[843] Roche, 2020 Del. Ch. LEXIS 352, 2020 WL 7023896, at

officer-by-officer analysis.[844]

As explained, Plaintiff has pled the Board delegated preparation of the Proxy to the conflicted Officer Defendants. Plaintiff contends the Officer Defendants are collectively responsible for the allegedly false and misleading Proxy. Plaintiff's disclosure claim therefore involves a two-step analysis. The first step considers which Officer Defendants were involved in preparing the Proxy. The second addresses whether the Proxy is materially misleading.[845]

a. The Complaint Pleads Only That Garland Was Involved In Preparing And Disseminating The Proxy.

I turn first to the issue of whether the Officer Defendants were involved in preparing the Proxy and whether group pleading is sufficient to state a claim against all Officer Defendants. This Court recently addressed allegations that the companies' officers were responsible for disclosure deficiencies in *City of Warren General Employees' Retirement **[*178]** System v. Roche* [846] and *In re Baker Hughes Inc. Merger Litigation*.[847] In both cases, the Court held that a plaintiff fails to plead a claim against an officer based on disclosure deficiencies where "the Complaint is devoid of any allegations that [the officer] had any role in drafting or disseminating the Proxy."[848] The Court concluded the plaintiffs failed to state a claim against certain officer defendants where (1) the complaint's allegations did not specifically allege that certain officers were involved in preparing the proxy, and (2) it was not reasonably inferable from the Complaint or the Proxy that they were involved because those officers did not sign the Proxy.[849]

Here, the Complaint sufficiently alleges that Garland was involved in preparing and disseminating the Proxy. Garland was the Company's CEO throughout the sales process and "an integral figure" during merger negotiations.[850] The Board resolutions approving the issuance of the Proxy authorized the Company's officers to prepare and issue the Proxy and, most significantly, Garland signed the Proxy.[851] It is reasonable to infer that Garland was involved in preparing the disclosures in the Proxy in his capacity as an officer of the **[*179]** Company.[852] Count II survives as to Garland.

The same cannot be said for Armistead, Elkort, Lyon, and Pedersen. Although the Board resolution delegated disclosure authority to the Officer Defendants generally, the Complaint contains no specific allegations that Armistead, Elkort, Lyon, or Pedersen were involved, and there is no indication from the Proxy itself that they were, as only Garland signed off on the disclosures. Plaintiff's case against Armistead, Elkort, Lyon, and Pederson "boils down to the unsubstantiated assertion"

*18 (citing Hansen, 2018 Del. Ch. LEXIS 197, 2018 WL 3025525, at *11 (holding that a complaint stated a claim against an officer for violation of the fiduciary duty of disclosure and noting that directors and officers of a corporation generally owe the same fiduciary duties)); *see also* Baker Hughes, 2020 Del. Ch. LEXIS 321, 2020 WL 6281427, at *15-16; Morrison I, 2019 Del. Ch. LEXIS 1412, 2019 WL 7369431, at *25, *27.

[844] *See* Roche, 2020 Del. Ch. LEXIS 352, 2020 WL 7023896, at *18; Baker Hughes, 2020 Del. Ch. LEXIS 321, 2020 WL 6281427, at *15-16.

[845] *See* Roche, 2020 Del. Ch. LEXIS 352, 2020 WL 7023896, at *18-19 (noting, in the event the Proxy is misleading and Defendants' disclosure is insufficient, the resulting transaction may still be cleansed if ratified by a shareholder vote under *Corwin*).

[846] 2020 Del. Ch. LEXIS 352, 2020 WL 7023896, at *18-19 (Del. Ch. Nov. 30, 2020).

[847] 2020 Del. Ch. LEXIS 321, 2020 WL 6281427, at *15-16 (Del. Ch. Oct. 27, 2020).

[848] Roche, 2020 Del. Ch. LEXIS 352, 2020 WL 7023896, at *19 (quoting Baker Hughes, 2020 Del. Ch. LEXIS 321, 2020 WL 6281427, at *16).

[849] *Id.*; Baker Hughes, 2020 Del. Ch. LEXIS 321, 2020 WL 6281427, at *16.

[850] Roche, 2020 Del. Ch. LEXIS 352, 2020 WL 7023896, at *19.

[851] *Id.*; *see* Baker Hughes, 2020 Del. Ch. LEXIS 321, 2020 WL 6281427, at *15-16 (holding that a CEO could be liable for breach of the duty of care for a deficient proxy where the CEO was involved in the negotiation of the merger and signed the proxy); Hansen, 2018 Del. Ch. LEXIS 197, 2018 WL 3025525, at *11 ("Vance affixed his signature to the Proxy in his capacity as President and CEO and presented the information to the stockholders for their consideration. This means he may be liable for material misstatements in the Proxy in his capacity as an officer [and] as a director.").

[852] *See* Roche, 2020 Del. Ch. LEXIS 352, 2020 WL 7023896, at *19; Baker Hughes, 2020 Del. Ch. LEXIS 321, 2020 WL 6281427, at *16.

that they would have reviewed and authorized dissemination of the Proxy simply because they were Company officers.[853] This is "insufficient" to plead that Armistead, Elkort, Lyon, and Pederson "acted with *scienter* or were grossly negligent in connection with the failure" to prepare and file a materially complete and accurate Proxy.[854] Count II of the Complaint fails to state a claim for relief against them.[855]

b. Plaintiff Has Alleged That Garland Prepared And Disseminated A False And Misleading Proxy.

I turn next to whether the Proxy was materially misleading. Plaintiff contends that Garland breached his duty of disclosure, and consequently his duties **[*180]** of care and loyalty, in preparing and disseminating a false and misleading Proxy. In a request for stockholder action, directors are under a duty to disclose fully and fairly all material facts within their control bearing on the request.[856] The duty of disclosure is not an independent duty, but derives from the duties of care and loyalty.[857] To state a claim for breach of the duty of loyalty, the Complaint must include well-pled allegations supporting a reasonable inference that Garland acted in bad faith or to further his own self-interest in disseminating the allegedly misleading Proxy.[858] To state a claim for breach of the duty of care, the Complaint must allege Garland was grossly negligent in preparing and filing the Proxy.[859] "Because fiduciaries must take risks and make difficult decisions about what is material to disclose, they are exposed to liability for breach of fiduciary duty only if their breach of the duty of care is extreme."[860]

Corporate fiduciaries can breach their duty of disclosure "by making a materially false statement, by omitting a material fact, or by making a partial disclosure that is materially misleading."[861] "An omitted fact is material if there is a substantial **[*181]** likelihood that a reasonable shareholder would consider it important in deciding how to vote," in that it "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[862] "[T]his materiality test does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote."[863] Rather, a proxy must contain "information that a reasonable stockholder would generally want to know in making [his or her voting] decision."[864] "The issue of materiality of an alleged misstatement or omission in a prospectus is a mixed question of law and fact, but predominantly a question of fact. Nevertheless, conclusory allegations need not be treated as true, nor should inferences be drawn unless they truly are reasonable."[865]

Plaintiff identifies ten categories of materially false and statements in the Proxy.[866] Plaintiff has adequately alleged that the Proxy was false or misleading with

---

853 *Baker Hughes, 2020 Del. Ch. LEXIS 321, 2020 WL 6281427, at *16*.

854 *Id.*

855 *See id.*

856 *E.g.*, *Stroud v. Milliken Enters., Inc., 552 A.2d 476, 480 (Del. 1989)*.

857 *E.g.*, *Pfeffer v. Redstone, 965 A.2d 676, 684 (Del. 2009)*.

858 *Cf. Roche, 2020 Del. Ch. LEXIS 352, 2020 WL 7023896, at *19-20* ("For the reasons addressed above, the only potential claim against Roche for issuing a materially misleading Proxy sounds in the fiduciary duty of care because there is no well-pleaded allegation in the Complaint supporting a reasonable inference that she acted in bad faith or to further her own self-interest.").

859 *See id.*

860 *Morrison I, 2019 Del. Ch. LEXIS 1412, 2019 WL 7369431, at *25* (alteration omitted) (quoting *Metro Commc'n Corp. BVI v. Advanced Mobilecomm Techs. Inc., 854 A.2d 121, 157 (Del. Ch. 2004)*).

861 *Pfeffer, 965 A.2d at 684* (quoting *O'Reilly v. Transworld Healthcare, Inc., 745 A.2d 902, 916 (Del. Ch. 1999)*).

862 *Rosenblatt, 493 A.2d at 944* (quoting *TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449, 96 S. Ct. 2126, 48 L. Ed. 2d 757 (1976)*).

863 *Morrison v. Berry (Morrison II), 191 A.3d 268, 283 (Del. 2018)* (internal quotation marks omitted) (quoting *Rosenblatt, 493 A.2d at 944*).

864 *Id. at 287*.

865 *Pfeffer, 965 A.2d at 685* (internal quotation marks omitted) (quoting ***Branson v. Exide Elecs. Corp., 645 A.2d 568 (Del. 1994)*** (TABLE), and also quoting *Feldman v. Cutaia, 951 A.2d 727, 731 (Del. 2008)*).

866 *See* D.I. 82 at 43-58.

respect to many of them, based on fair characterizations of the disclosures and materials produced pursuant to *Section 220*.[867] Because the claim against Garland survives if any one of Plaintiff's identified deficiencies **[*182]** is sufficiently pled, I address only a handful of the Proxy's allegedly misleading disclosures.[868]

First, Plaintiff has adequately alleged that the Proxy did not disclose all material information about Goldman's compensation and conflicts. "Because of the central role played by investment banks in the evaluation, exploration, selection, and implementation of strategic alternatives, this Court has required full disclosure of investment banker compensation and potential conflicts."[869] Here, the Proxy disclosed neither Goldman's compensation nor its conflicts with respect to Riverstone.[870] The Individual Defendants do not argue otherwise.[871] They instead claim that no disclosure obligation existed because Goldman's conflicts were well known in the market and disclosed to the Special Committee before they retained Goldman. These arguments miss the mark, as the *Company's stockholders* were entitled to be told all material information when considering the Merger, without having to extract it from publicly available information.[872] And disclosing conflicts to a disloyal special committee compounds, rather than excuses, the failure to disclose those conflicts to the electorate.

Second, **[*183]** Plaintiff contends that the Proxy failed to disclose all material information about the Consent Right, including that the Special Committee and its advisors confirmed that it did not prevent the Company from acquiring another company through a reverse triangular merger.[873] The Proxy described the Consent Right and Brookfield's reluctance to enter into a transaction without Riverstone's approval. But

> [o]nce defendants travel down the road of partial disclosure of the history leading up to the Merger[,] they have an obligation to provide the stockholders with an accurate, full, and fair characterization of those historic events. Partial disclosure, in which some material facts are not disclosed or are presented in an ambiguous, incomplete, or misleading manner, is not sufficient to meet a fiduciary's disclosure obligations.[874]

In my view, Plaintiff has alleged that other material information about the Consent Right's overarching importance in the sales process was omitted from the Proxy. For example, any reasonable stockholder reading the Proxy would not have understood that a transaction could have been structured to avoid triggering the Consent Right—and that such a transaction was offered **[*184]** and was more lucrative for stockholders. The Proxy also fails to disclose that Riverstone and management badgered the Special Committee and bidders about the Consent Right's scope to emphasize Riverstone and Developer 2's interests. From the sales process alleged and the Company's deep and historic ties to Riverstone, it is reasonably conceivable the stockholders would have considered all information about the Consent Right—including how it was wielded in the sales process and by whom, potential bidders' responses to its invocation, and the potential to circumvent it with creative structuring—to be important in deciding how to vote on the Merger.

The Individual Defendants argue that "the terms of the consent right were public, and any investor that had decided to invest in [Company] stock was well aware of these terms," as the Consent Right "had already been disclosed to [Company] investors, for years, in [the

---

[867] The Individual Defendants argue "[t]here was nothing materially misleading about the Proxy," D.I. 85 at 22, and that "[a]ll of Plaintiff's allegations are based on mischaracterizations of the 220 Materials." D.I. 74 at 41; *see also* D.I. 85 at 24. But, again, the Individual Defendants cannot rely on those materials "to rewrite an otherwise well-pled complaint" and overcome the reasonable inferences that can be drawn therefrom. *Clovis, 2019 Del. Ch. LEXIS 1293, 2019 WL 4850188, at *14 n.216*.

[868] Whether each of the ten categories was in facts inadequately disclosed and material will be determined through discovery.

[869] *In re Del Monte Foods Co. S'holders Litig., 25 A.3d 813, 832 (Del. Ch. 2011)* (collecting cases).

[870] *See* Compl. ¶¶ 267-72.

[871] *See* D.I. 74 at 23-24.

[872] *See Zalmanoff v. Hardy, 2018 Del. Ch. LEXIS 529, 2018 WL 5994762, at *5 (Del. Ch. Nov. 13, 2018)*, *aff'd*, ***211 A.3d 137 (Del. 2019)***.

[873] Compl. ¶ 254.

[874] *KCG Hldgs., 2019 Del. Ch. LEXIS 233, 2019 WL 2564093, at *11* (alterations, citations, and internal quotation marks omitted) (quoting *Morrison II, 191 A.3d at 283*, and then quoting ***Appel v. Berkman, 180 A.3d 1055, 1064 (Del. 2018)***).

Company]'s public filings."[875] In support, the Individual Defendants point to three SEC Form 10-Ks.[876] But "our law does not impose a duty on stockholders to rummage through a company's prior public filings to obtain information that might be material to a request for stockholder action." **[*185]** [877] And even if those public filings disclose the existence of the Consent Right, the Consent Right's importance as implemented in the sales process would not have been in those filings.[878] Here, the Proxy purported to describe the sales process, but omitted any mention of how the Consent Right loomed over it.

Third, Plaintiff alleges that the Proxy was deficient in that it failed to disclose that Brookfield proposed to pay stockholders over $6 per share more than Buyer, and that the Special Committee believed that Brookfield's proposal was "superior" to all others received, including from Buyer.[879] "Delaware law does not require disclosure of a play-by-play of negotiations leading to a transaction or of potential offers that a board has determined were not worth pursuing."[880] And a disclosure claim will not be supported where it "boil[s] down to an argument that plaintiff disagreed with a Special Committee's decision not to pursue another acquisition proposal and that other stockholders should have been informed about the offer in case they, too, disagreed with the Special Committee."[881] However, the availability of a superior bid may be material and therefore **[*186]** may be required to be disclosed to stockholders.[882]

Here, the Proxy omitted material information about Brookfield's superior offer. The Individual Defendants argue that Proxy disclosed that in July 2019 Brookfield offered a 20% premium for a transaction that did not include Developer 2 and a 15% premium for a transaction that did include Developer 2, and that this was sufficient to disclose the value of Brookfield's offers.[883] This argument misses the mark. Even assuming that information regarding Brookfield's bid was immaterial, the Delaware Supreme Court has "recognized that a partial and incomplete disclosure of arguably immaterial information regarding the history of negotiations leading to a merger might result in a materially misleading disclosure if not supplemented with information that would allow the stockholders to

[875] D.I. 74 at 20-21 (emphasis omitted).

[876] *Id.* at 20 (citing Kirby Decl. Exs. 3-5).

[877] *Zalmanoff, 2018 Del. Ch. LEXIS 529, 2018 WL 5994762, at *5* (citing *In re Trans World Airlines, Inc. S'holders Litig., 1988 Del. Ch. LEXIS 139, 1988 WL 111271, at *10 (Del. Ch. Oct. 21, 1988)* (Allen, C.) ("Nor can I agree that if a fact is material, that a failure to disclose it is necessarily cured by reason that it could be uncovered by an energetic shareholder by reading an SEC filing. Closer to an acceptable response is the assertion that the number could be derived from appraisal information contained in the proxy statement."), *abrogated on other grounds by Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110 (Del. 1994)*).

[878] *See id.*; *Trans World Airlines, 1988 Del. Ch. LEXIS 139, 1988 WL 111271, at *10*.

[879] *E.g.*, Compl. ¶ 192; *see id.* ¶¶ 261-65.

[880] *Comstock, 2016 Del. Ch. LEXIS 133, 2016 WL 4464156, at *15*; *see also David P. Simonetti Rollover IRA v. Margolis, 2008 Del. Ch. LEXIS 78, 2008 WL 5048692, at *12 (Del. Ch. June 27, 2008)* ("In the usual case, where a board has not received a firm offer or has declined to continue negotiations with a potential acquirer because it has not received an offer worth pursuing, disclosure is not required.").

[881] *In re OM Grp., Inc. Stockholders Litig., 2016 Del. Ch. LEXIS 155, 2016 WL 5929951, at *14 (Del. Ch. Oct. 12, 2016)* (internal quotation marks omitted) (quoting *Comstock, 2016 Del. Ch. LEXIS 133, 2016 WL 4464156, at *15*).

[882] *See Xura, 2018 Del. Ch. LEXIS 563, 2018 WL 6498677, at *12* ("From the public disclosures provided to Xura stockholders, it is reasonably conceivable that stockholders lacked the following material information when they voted to approve the Transaction: . . . (5) *Francisco Partners initially expressed interest in offering a superior bid* but somehow learned that Siris was Xura's counterparty and then moved its financial support to the buy-side of the Transaction . . . ." (emphasis added)); *cf. Dent v. Ramtron Int'l Corp., 2014 Del. Ch. LEXIS 110, 2014 WL 2931180, at *15 (Del. Ch. June 30, 2014)* ("The types of companies that may or may not have made an offer for Ramtron during the sales process has no bearing on the issue of whether or not to seek appraisal. *Furthermore, there are no allegations that any company made an offer for Ramtron that was of equal or greater value to the Cypress offer*. Dent has failed to allege adequately how including the details of rejected offers that offered less value for the Company than the Cypress bid would be material to a Ramtron stockholder in determining whether or not to seek appraisal. Accordingly, I conclude that this aspect of Dent's disclosure claim also fails to state a claim upon which relief can be granted." (emphasis added)).

[883] *See* D.I. 74, App. A at 2.

draw the complete picture."[884] The Proxy's disclosure does not state the monetary value of the July offer, and most importantly, it does **[*187]** not disclose or suggest that Brookfield offered even more value in August, September, and October 2019.[885] Without more, the reasonable stockholder would be left to believe that Brookfield's bid remained stagnant, when, in fact, it increased in value and became noticeably superior to other bids.

The Proxy also fails to disclose that the Special Committee itself believed, as confirmed by Evercore's valuation analysis, that Brookfield's offer was more valuable than Buyer's.[886] The Individual Defendants reject this position and the Complaint's allegations, arguing that the Special Committee merely believed that Brookfield's proposal "could" be superior and that in any event Brookfield never submitted a "definitive, all-cash offer and proposed merger agreement."[887] The documents incorporated and integral to the Complaint show that the Special Committee and its advisors clearly told Brookfield that its offer was superior; and the October 31, 2019 Board presentation shows that the Special Committee's advisors told the Board that Brookfield's offer was worth vastly more to stockholders than Buyer's offer.[888] This information should have been disclosed to Company stockholders.[889]

Further, **[*188]** the fact that Brookfield did not submit a definitive offer does not excuse disclosure of Brookfield's final terms in view of the Complaint's allegations and the Proxy's overall disclosures about the sales process. Brookfield eagerly pursued the Company, even if that meant ceding to Riverstone's demands, until the Special Committee imposed an unreasonable deadline. As alleged, it is reasonable to infer that Brookfield considered its late October 2019 offer as implying some commitment to a deal within thirty days, contingent on Riverstone's satisfaction in negotiations; Brookfield walked away and took its premium bid with it because the Special Committee ran out the clock.[890] It is reasonable to infer that the absence of the terms of Brookfield's final superior bid and the Board's recognition of that superiority rendered the Proxy materially misleading.

Accordingly, Plaintiff has pled that the Proxy was materially misleading and that Garland, who prepared the Proxy, was aware of its inaccuracies, and has therefore stated a claim for breach against him. Count II, to the extent it is based on the false and misleading Proxy, survives as to Garland.

C. Plaintiff Has Stated Third Party Liability [*189] Claims.

As explained above, Plaintiff may establish that the Officer Defendants and Entity Defendants constitute a control group owing fiduciary duties. In the alternative, Plaintiff has also asserted the Entity Defendants are liable as nonfiduciary outsiders to the Company, through theories of aiding and abetting (Count III), conspiracy together with the Officer Defendants and Browne (Count V), and tortious interference (Count IV). If Plaintiff succeeds in demonstrating a control group, the aiding and abetting and conspiracy claims against the Controller Defendants will be dismissed.[891]

---

[884] *OM Grp., 2016 Del. Ch. LEXIS 155, 2016 WL 5929951, at *12* (citing *Arnold v. Soc'y for Sav. Bancorp, Inc., 650 A.2d 1270, 1281 (Del. 1994)*).

[885] *See* Compl. ¶¶ 164-67, 173-79, 192-200.

[886] *See id.* ¶¶ 192-200.

[887] D.I. 74 at 22.

[888] *See* Compl. ¶¶ 192-200.

[889] *Cf. In re Cogent, Inc. S'holder Litig., 7 A.3d 487, 511-12 (Del. Ch. 2010)* (suggesting that a board should disclose its basis for rejecting a competitive bid and pursuing an allegedly inferior offer).

[890] *Cf. Xura, 2018 Del. Ch. LEXIS 563, 2018 WL 6498677, at *12 n.122* ("I acknowledge Defendants' argument that Plaintiff merely speculates regarding whether Francisco Partners ultimately would have made a bid for Xura and whether that bid would have been superior to the Siris bid. Plaintiff's response—that we will never know where the Francisco Partners' overture might have gone—is, likewise, well taken. Indeed, as a wise 'do-dah man' once observed, 'Sometimes your cards ain't worth a dime if you don't lay 'em down.' . . . In any event, what is conceivably material about Francisco Partners is not its initial expression of interest but the fact that it expressed interest, later declined to participate in the Go-Shop and then mysteriously joined forces with Siris on the buy-side of the Transaction.").

[891] *See Wallace ex rel. Cencom Cable Income P'rs II, L.P. v. Wood, 752 A.2d 1175, 1184 (Del. Ch. 1999)* ("[Aiding and abetting], which on its face assumes the officers, parents and affiliates to be 'non-fiduciaries,' seems inconsistent with plaintiff[']s primary argument that each defendant owes fiduciary duties to the [Company stockholders]. Nonetheless, I will not dismiss plaintiff[']s[] aiding and abetting claim as I may

1. Plaintiff's Claims for Aiding and Abetting and Civil Conspiracy Are Held In Abeyance Pending A Determination As To Whether The Controller Defendants Owe Fiduciary Duties.

For now, it is enough to say that the allegations about the Entity Defendants' involvement, set forth in my discussion of their potential role as controllers, are sufficient to plead knowing participation[892] and substantial assistance[893] for purposes of aiding and abetting.[894] While the Entity Defendants had the right to work in their own interests by leveraging the Consent Right,[895] that right ends at the point the party "attempts **[*190]** to create or exploit conflicts of interest in the board."[896] Plaintiff has alleged facts from which it is reasonable to infer that the Entity Defendants wielded the Consent Right and bargained with bidders in knowing tandem with the Company's dual fiduciaries tilting the Special Committee's sales process toward Riverstone's preferred bidder.

With this conclusion on aiding and abetting, it is not surprising that Plaintiff's factual allegations about the Entity Defendants also support a claim for civil conspiracy, as the claims often rise and fall together.[897]

---

later decide, after discovery or at trial, that plaintiff[] cannot prove the pleaded requisite control necessary to establish the existence of a fiduciary relationship between each defendant and the [Company]."); OptimisCorp v. Waite, 2015 Del. Ch. LEXIS 222, 2015 WL 5147038, at *57 (Del. Ch. Aug. 26, 2015) ("In those instances where a fiduciary takes actions that would amount to aiding and abetting by a non-fiduciary, that conduct amounts to a direct breach of fiduciary duties."), *aff'd*, ***137 A.3d 970 (Del. 2016)***; Albert v. Alex. Brown Mgmt. Servs., Inc., 2005 Del. Ch. LEXIS 133, 2005 WL 2130607, at *11 (Del. Ch. Aug. 26, 2005) ("[C]ivil conspiracy is vicarious liability. It holds a third party, not a fiduciary, responsible for a violation of fiduciary duty. Therefore, it does not apply to the defendants which owe the [stock]holders a direct fiduciary duty."); *accord* OptimisCorp, 2015 Del. Ch. LEXIS 222, 2015 WL 5147038, at *57 ("[I]t is highly doubtful that a conspiracy of fiduciaries is a legally cognizable cause of action.").

[892] *See* ***RBC, 129 A.3d at 861-62*** ("Knowing participation in a board's fiduciary breach requires that the third party act with the knowledge that the conduct advocated or assisted constitutes such a breach." (alterations and internal quotation marks omitted) (quoting Malpiede, 780 A.2d at 1097)); Agspring Holdco, LLC v. NGP X US Hldgs., L.P., 2020 Del. Ch. LEXIS 252, 2020 WL 4355555, at *20 (Del. Ch. July 30, 2020) ("[A]ll that is required to show that a defendant knew something are sufficient well-pleaded facts from which it can reasonably be inferred that this something was knowable and that the defendant was in a position to know it." (quoting Great Hill Equity P'rs IV, LP v. SIG Growth Equity Fund I, LLLP, 2014 Del. Ch. LEXIS 243, 2014 WL 6703980, at *20 (Del. Ch. Nov. 26, 2014)).

[893] *See* In re Oracle Corp. Deriv. Litig., 2020 Del. Ch. LEXIS 218, 2020 WL 3410745, at *11 (Del. Ch. June 22, 2020) (noting "the secondary actor must have provided assistance or participation in aid of the primary actor's allegedly unlawful acts" and that assistance must be substantial (alterations and internal quotation marks omitted) (quoting Restatement (Second) of Torts § 876 cmt. d (1979))).

[894] This is necessarily a fact-intensive inquiry, making claims for aiding and abetting "ill-suited for disposition on the pleadings." Clark v. Davenport, 2019 Del. Ch. LEXIS 264, 2019 WL 3230928, at *15 (Del. Ch. July 18, 2019) (internal quotation marks omitted) (quoting In re Good Tech. Corp. Stockholder Litig., 2017 Del. Ch. LEXIS 109, 2017 WL 2537347, at *2 (Del. Ch. May 12, 2017) (ORDER)); *accord* Oracle, 2020 Del. Ch. LEXIS 218, 2020 WL 3410745, at *11.

[895] *See* Morrison v. Berry (Morrison III), 2020 Del. Ch. LEXIS 200, 2020 WL 2843514, at *11 (Del. Ch. June 1, 2020); Morgan v. Cash, 2010 Del. Ch. LEXIS 148, 2010 WL 2803746, at *7-8 (Del. Ch. July 16, 2010).

[896] Morrison III, 2020 Del. Ch. LEXIS 200, 2020 WL 2843514, at *11 (quoting *RBC, 129 A.3d at 862*). The cases the Entity Defendants invoke to defend arms-length bargaining for their own benefit are distinguishable. Unlike the alleged aider and abettor in Jacobs v. Meghji, 2020 Del. Ch. LEXIS 310, 2020 WL 5951410, at *8 (Del. Ch. Oct. 8, 2020), the Entity Defendants had knowledge about the Company's process; the Special Committee's creation and role; Brookfield's proposal; and the dual fiduciary Individual Defendants' compliance with their fiduciary duties. This case is also unlike Morrison III, in which the Court dismissed an aiding and abetting claim against a private equity acquirer, even though it allegedly "act[ed] together with the [target's chairman]," who "used silence, falsehoods, and misinformation" to mislead the board. 2020 Del. Ch. LEXIS 200, 2020 WL 2843514, at *11 (internal quotation marks omitted). The Court concluded it could not "reasonably infer that [the acquirer] knowingly advocated or assisted [the chairman's] deceptive communications," and therefore dismissed the claim because the acquirer "had the right to work in its own interests to maximize its value." *Id.* But unlike the acquirer in *Morrison III*, which was an arm's-length bargaining party with no alleged connection to any officer, director, or advisor, the Entity Defendants were tied to and held power over Company fiduciaries and were alongside or behind the fiduciaries every step of the way.

[897] *See* Agspring, 2020 Del. Ch. LEXIS 252, 2020 WL 4355555, at *21; *see also* Allied Cap. Corp. v. GC-Sun Hldgs., L.P., 910 A.2d 1020, 1039-40 (Del. Ch. 2006). Because

Plaintiff's allegations support a reasonable inference that the Entity Defendants worked closely with Browne and the remaining Officer Defendants throughout the sale process for the purpose of closing an all-cash deal with Buyer that took the Company private, internalized Developer 2, and left Riverstone and its dual fiduciaries with equity stakes in the new structure.

2. Plaintiff Has Pled Tortious Interference.

Count IV asserts the Entity Defendants tortiously interfered with the stockholders' prospective economic advantage in the superior Brookfield offer.[898] The parties have not **[*191]** briefed the doctrinal viability of a tortious interference claim if the Entity Defendants are held to be fiduciaries. For now, assuming the claim would go forward, allegations underpinning their *de facto* control support the elements of tortious interference. The Entity Defendants' three arguments to the contrary are unavailing. First, as explained, their right to compete and wield the Consent Right did not excuse their alleged improper actions. Second, Brookfield was a business opportunity as it was "prepared to enter into a business relationship but was dissuaded from doing so."[899]

Finally, proximate cause presents the difficult question of whether Riverstone's actions throughout the process caused Brookfield to walk away where it would not have but for Riverstone's conduct.[900] The Entity Defendants assert it is the Company that proximately caused Brookfield to walk away, by declining exclusivity or by requiring Brookfield to submit its best and final offer within twenty-four hours, complete with an agreement with Riverstone about Developer 2.[901] "Except in rare cases, the issue of proximate cause is uniquely a fact issue."[902] Viewing Plaintiff's pleadings in the light most favorable **[*192]** to her, it is reasonably conceivable that the Entity Defendants' challenged actions drove Brookfield away.

Thus, in a world in which the Entity Defendants are not fiduciaries, Plaintiff has pled aiding and abetting, conspiracy, and tortious interference. These claims may still be dismissed if Plaintiff establishes the Entity Defendants are fiduciaries.

III. CONCLUSION

The Motions are granted and denied in part. The Individual Defendants' Motion is **DENIED** as to Counts I and II. The Entity Defendants' Motion is **DENIED** as to Count IV. Counts III, V, VI are held in abeyance. With the exception of Count VI, all claims are **DISMISSED** as to Armistead and Pedersen. The parties shall submit an implementing order within twenty days of this decision.

End of Document

Plaintiff has not pled facts indicating that Armistead or Pedersen breached their duties or committed an unlawful act in furtherance of the conspiracy, Plaintiff has not stated a claim for civil conspiracy against them.

[898] *See* Compl. ¶¶ 308-13. To state such a claim, a plaintiff must plead "(a) the reasonable probability of a business opportunity, (b) the intentional interference by the defendant with that opportunity, (c) proximate causation, and (d) damages." ***Organovo Hldgs., Inc. v. Dimitrov, 162 A.3d 102, 122 (Del. Ch. 2017)*** (quoting *De Bonaventura v. Nationwide Mut. Ins. Co., 419 A.2d 942, 947 (Del. Ch. 1980)*); *accord* *Kuroda v. SPJS Hldgs., L.L.C., 971 A.2d 872, 886-87 (Del. Ch. 2009)*.

[899] *See* *Soterion Corp. v. Soteria Mezzanine Corp., 2012 Del. Ch. LEXIS 257, 2012 WL 5378251, at *13 (Del. Ch. Oct. 31, 2012)* (quoting *Agilent Techs., Inc. v. Kirkland, 2009 Del. Ch. LEXIS 11, 2009 WL 119865, at *7 (Del. Ch. Jan. 20, 2009)*) (noting the specific parties offering the business opportunity "performed extensive due diligence," executed multiple term sheets "outlin[ing] the major terms of the contemplated transaction[]," and had not "identified any business reasons for not proceeding with the transaction[]").

[900] *See* *2012 Del. Ch. LEXIS 257, [WL] at *17* ("Delaware recognizes the traditional "but for" definition of proximate causation. . . . Our understanding of proximate cause evolved from circumstances in which a tortfeasor caused something to happen that harmed the victim. The harm might have had more than one possible cause. A supervening cause might be considered the 'real cause' if it took over control from yet another cause that might otherwise eventually have resulted in the same (or similar) harm.").

[901] *See* D.I. 72 at 50-52.

[902] *Good Tech., 2017 Del. Ch. LEXIS 109, 2017 WL 2537347, at *2* (alteration omitted) (quoting *DiOssi v. Maroney, 548 A.2d 1361, 1368 (Del. 1988)*); *accord* *Everest Props. II, L.L.C. v. Am. Tax Credit Props. II, L.P., 2000 Del. Super. LEXIS 13, 2000 WL 145757, at *6-7 (Del. Super. Jan 7, 2000)* (noting proximate cause need not be pled with precision, but rather need only put defendants on notice of the claims against them).

In re Walt Disney Co. Derivative Litig.

Court of Chancery of Delaware, New Castle

September 8, 2004, Submitted ; September 10, 2004, Decided

CONSOLIDATED C.A. No. 15452

Reporter

2004 Del. Ch. LEXIS 132 *

IN RE THE WALT DISNEY COMPANY DERIVATIVE LITIGATION

Notice: **[*1]** THIS OPINION HAS NOT BEEN RELEASED FOR PUBLICATION. UNTIL RELEASED, IT IS SUBJECT TO REVISION OR WITHDRAWAL.

Subsequent History: Objection sustained by, in part, Objection overruled by, in part *In re Walt Disney Co. Derivative Litig, 2005 Del. Ch. LEXIS 28 (Del. Ch., Feb. 4, 2005)*

Prior History: *In re Walt Disney Co. Derivative Litig, 2004 Del. Ch. LEXIS 129 (Del. Ch., Aug. 31, 2004)*

Disposition: Summary judgment for waste denied. Summary judgment for Ovitz is granted in part as to claims arising from his entering into the OEA.

Counsel: Attorneys for Plaintiffs: Joseph A. Rosenthal, of ROSENTHAL, MONHAIT, GROSS & GODDESS, P.A., Wilmington, Delaware; Seth D. Rigrodsky, of MILBERG WEISS BERSHAD & SCHULMAN LLP, Wilmington, Delaware; OF COUNSEL: Steven G. Schulman, Joshua H. Vinik, Jennifer K. Hirsh and Lisa L. Cogan, of MILBERG WEISS BERSHAD & SCHULMAN LLP, New York, New York.

Attorneys for Defendant Michael S. Ovitz: David C. McBride and Christian Douglas Wright, of YOUNG CONAWAY STARGATT & TAYLOR, LLP, Wilmington, Delaware; OF COUNSEL: Mark H. Epstein and Jason L. Haas, of MUNGER, TOLLES & OLSON LLP, Los Angeles, California.

Attorneys for The Walt Disney Company: Andre G. Bouchard and Joel Friedlander, of BOUCHARD, MARGULES & FRIEDLANDER, P.A., Wilmington, Delaware.

Attorneys for Sanford M. Litvack: Robert K. Payson, Stephen C. Norman and Kevin R. Shannon, of POTTER ANDERSON & CORROON LLP, Wilmington, Delaware.

Attorneys for Defendants Stephen F. Bollenbach, Reveta F. Bowers, Ignacio E. Lozano, Jr., George J. Mitchell, Thomas S. Murphy, Richard A. Nunis, Leo J. O'Donovan, S.J., Sidney **[*2]** Poitier, Irwin Russell, Robert A.M. Stern, E. Cardon Walker, Raymond L. Watson and Gary L. Wilson: R. Franklin Balotti and Anne C. Foster, of RICHARDS, LAYTON & FINGER, Wilmington, Delaware.

Attorneys for Defendants Roy Disney and Stanley P. Gold: A. Gilchrist Sparks, III and S. Mark Hurd of MORRIS, NICHOLS, ARSHT & TUNNEL, Wilmington, Delaware; OF COUNSEL: Stephen D. Alexander and Peggy Sasso, of FRIED, FRANK, HARRIS, SHRIVER & JACOBSON LLP, Los Angeles, California.

Attorneys for Defendant Michael Eisner: Lawrence C. Ashby, of ASHBY & GEDDES, Wilmington, Delaware; OF COUNSEL: Gary P. Naftalis, of KRAMER LEVIN NAFTALIS & FRANKEL LLP, New York, New York.

Opinion

MEMORANDUM OPINION

CHANDLER, Chancellor

I. INTRODUCTION

This derivative action already has developed a lengthy and well-documented history. In anticipation of the trial scheduled to begin shortly, defendant Michael S. Ovitz has moved for summary judgment on the ground that the undisputed evidence obtained by plaintiffs is legally insufficient to establish that he violated whatever fiduciary duties he may have owed to the Walt Disney Company and its shareholders. Although Ovitz's motion itself purportedly **[*3]** addresses all three claims pled against Ovitz in the Second Amended Consolidated

Derivative Complaint ("Complaint"), the briefs filed in support of his motion only address the fiduciary duty issues and do not address the claim that Ovitz wrongfully caused Disney to engage in waste.

For reasons briefly described later, I conclude that Ovitz is entitled to summary judgment with respect to the First Claim of the Complaint, which alleges that he violated his fiduciary duties in negotiating, arranging, and finalizing the terms of his employment contract because, at the time all material negotiations occurred and alterations were made, Ovitz was not yet a fiduciary of Disney. With respect to the claim of waste and Ovitz's termination and receipt of Non-Fault Termination ("NFT") benefits when his employment with Disney ended, there are genuine issues of material fact to be resolved at trial, and summary judgment in favor of Ovitz as to those issues is inappropriate. Accordingly, the motion for summary judgment is granted in part and denied in part.

II. STATEMENT OF FACTS

At the outset of this section, the Court should make one thing very clear: The issues raised by Ovitz's motion **[*4]** for summary judgment relate to his alleged malfeasance or nonfeasance, not that of the other defendants. [1] The undisputed facts of greatest relevance for granting, in part, Ovitz's motion for summary judgment are drawn from the voluminous documents produced in this case, especially defendant Michael D. Eisner's [2] **[*5]** August 14, 1995 letter ("OLA") [3] to Ovitz outlining the key points of his employment agreement, and the various drafts and final version of Ovitz's employment agreement ("OEA").

Following the untimely death of Frank Wells, former President of Disney, and the acrimonious exit of Jeffrey Katzenberg, Disney was searching for a new President as part of a long-term succession plan. [4] Effective October 1, 1995, Ovitz filled that position. [5] As of that date, he did not have a finalized and duly executed employment agreement.

The first draft of the OEA was made by the office of Disney's General Counsel, and was sent to Ovitz's attorneys on September 23, 1995. [6] This draft already included several material changes from the OLA. [7] The September 23 draft contained the following language regarding termination for cause: "Termination . . . **[*6]** for good cause' as used in this Agreement shall be limited to gross negligence or malfeasance by Executive in the performance of his duties under this Agreement. . . ." [8]

[*7] Sometime between September 23, 1995 and the meeting of the Compensation Committee of Disney's Board of Directors on September 26, 1995, additional changes to the OEA were made. [9] When the terms of

---

[1] With respect to entering into the OEA, to the extent that plaintiffs, as evidenced by the Preliminary Statement made in their brief in opposition to this motion, contend that Ovitz's motion should be denied because he aided and abetted the other directors in a breach of their fiduciary duties, that argument is made improperly, as a claim for aiding and abetting a breach of fiduciary duty has not been pled, and it is far too late to permit plaintiffs to replead again in order to include such a claim.

[2] Eisner was the Chairman of the Walt Disney Company from 1984-2004, and currently is Disney's Chief Executive Officer ("CEO"), a position he has held since 1984. Eisner Tr. at 9, 28-42; Press Release, The Walt Disney Company, Statement From the Board of Directors of The Walt Disney Company (Mar. 3, 2004) (available from *http://disney.go.com/corporate/*).

[3] Dep. Ex. 33.

[4] *See* Dep. Ex. 266.

[5] *See* Dep. Ex. 3. The parties argue at length about Ovitz's departure from Creative Artists Agency ("CAA"), but that discussion is largely irrelevant and the Court only addresses those facts as necessary.

[6] *See* Dep. Ex. 112.

[7] The most important changes were: 1) the removal of the guarantee that the three million stock options would be worth at least $ 50 million, 2) a reduction of the options' exercise price to market price on the day of grant, 3) the addition of a $ 10 million termination payment if the contract was not renewed following extension to Ovitz of a "Qualifying Offer", and 4) the extension of the exercisability date of the three million options to their normal expiration date in the event of a NFT. *Compare* Dep. Ex. 33 *with* Dep. Ex. 112. Ovitz had almost no control over the extension of the exercisability date because it required shareholder approval, which was received at a special shareholder meeting on January 4, 1996. *See* Disney's Form 8-K, filed with the SEC on Jan. 5, 1996.

[8] Dep. Ex. 112 at WD00020.

[9] The most important change was the substitution of $ 7.5 million for $ 5 million as the base used to calculate bonuses in the event of a NFT. *Compare* Dep. Ex. 112 *with* Dep. Ex. 39. Dep. Ex. 39 is identical to Dep. Ex. 370.

the OEA were presented to the Compensation Committee on that date, it was preliminarily approved, subject to the final agreement being negotiated by Eisner and then memorialized and approved by the Compensation Committee via unanimous written consent. [10]

Several more drafts of the OEA were exchanged after Ovitz began as President on October 1, 1995. [11] The final agreement was signed on or about December 16, 1995, with an effective date of October 1, 1995. [12] There is only one glaring difference between the pre-October 1 drafts and the **[*8]** final OEA -- the date upon which Ovitz's options were to be priced. The September 23 draft would have priced the options on October 2, 1995 (when they were to have been granted), while the final OEA priced them on October 16, 1995 (the date on which the options were actually approved by the Compensation Committee). [13] The final OEA contained the following language regarding termination for cause: "Termination . . . for good cause' as used in this Agreement shall be limited to gross negligence or malfeasance by Executive in the performance of his duties under this Agreement . . .," [14]

Both sides agree that once he was hired, Ovitz's tenure at Disney was not successful. [15] By the close of business on December 27, 1996, Ovitz was no longer employed with Disney. [16] Ovitz did not resign, **[*9]** nor was he fired. Instead, Ovitz received what the OEA referred to as a "Non-Fault Termination." The NFT provisions of the OEA were triggered by the events of December 27, 1996, and Ovitz received almost $ 40 million in cash and the immediate vesting of his three million stock options at that time. [17]

There is significant disagreement as to why Ovitz's term at Disney was not a success. Ovitz makes four arguments in this regard: 1) Disney executives resisted Ovitz's ideas; 2) Ovitz never possessed the authority appropriate for his position; 3) Ovitz was not given sufficient time for his efforts to bear fruit; and, 4) Ovitz never achieved the "partnership" with Eisner that allegedly induced Ovitz to come to Disney. [18] Plaintiffs, on the other hand, argue that **[*10]** it was Ovitz who alienated the other Disney executives, that he showed a lack of focus and inattentiveness to his duties, that he spent Disney funds in violation of company protocol, and that Ovitz was both a liar and untrustworthy. [19]

Ovitz understood that his time at Disney would not last, and he pursued other opportunities for employment. In early October 1996, Ovitz wrote to Eisner requesting permission to negotiate an employment relationship with Sony. [20] Eisner agreed the next day by writing a note to Ovitz and also a note to be sent to Sony's Chairman, granting that permission and expressing a desire that Sony assume Disney's financial obligations under the OEA. [21] By November 1, 1996, the talks with Sony had ended, and Ovitz wrote to Eisner again, this time to "re-commit [himself] to [Eisner] and to Disney." [22] Ten days later, Eisner wrote a much longer note describing Ovitz's **[*11]** flaws and stating that Ovitz needed to make preparations to leave Disney. Although Eisner intended to send Ovitz this letter, he never did so. [23]

Once it was clear to all that Ovitz would be leaving Disney's employ, the question became how that end would be accomplished. Nevertheless, not everyone in Disney management was on the same page, as Ovitz was unanimously renominated to a three-year term as a director at a board meeting held on November 25, 1996. [24] On December 3, 1996, Eisner met with Ovitz to

[10] Dep. Ex. 39 at WD01170, WD01188.

[11] *See* Dep. Ex. 114 (Oct. 3, 1995); 117 (Oct. 10, 1995); 121 (Oct. 16, 1995); 122 (Oct. 22, 1995); 124 (Oct. 24, 1995).

[12] Dep. Ex. 7.

[13] *See* Dep. Exs. 41 and 43.

[14] Dep. Ex. 7 at WD00212.

[15] "Ovitz's relationship with Disney was not successful." Opening Br. In Support of Def. Michael Ovitz's Mtn. for Summ. J. at 13. Plaintiffs' brief is rife with derogatory remarks about Ovitz's management.

[16] Dep. Ex. 14.

[17] *Id.*

[18] *See* Eisner Tr. at 312-13.

[19] Pls.' Br. in Opp. to Michael S. Ovitz's Mtn. for Summ. J. at 30-37.

[20] Dep.Ex. 18.

[21] Dep. Ex. 19.

[22] Dep. Ex. 19 at WD00404.

[23] Dep. Ex. 24. This note was sent in draft form to Bass, Russell and perhaps Litvack, and after conversation with them, Eisner decided not to send the note because "it was too mean." Eisner Tr. at 605-06.

[24] Dep. Ex. 340 at WD06415. Eisner, Ovitz, Russell, Litvack, and others attended that board meeting. *Id.* at WD06409.

discuss issues regarding his impending termination, and then Eisner sent Russell a short letter detailing his conversation with Ovitz. [25] Russell thereafter began negotiating the specific language of the letter whereby **[*12]** Ovitz would receive his NFT. [26] **[*13]** On December 12, 1996, Litvack sent Ovitz a letter confirming their agreement that Ovitz would be terminated and receive a NFT. [27] About two weeks later, the above-referenced letter of December 27, 1996, was signed by both Ovitz and Litvack, ending Ovitz's employment immediately. [28] Disney's board did not meet to approve the termination of Ovitz or the payment of his NFT benefits. [29]

III. STANDARD OF REVIEW

Court of Chancery Rule 56 is the basis for motions for summary judgment. Summary judgment is appropriate "if the pleadings, depositions, answers to interrogatories and admissions on file, together with the affidavits, if any, show that there is no genuine issue of material fact and that the moving party is entitled to judgment as a matter of law." [30] In ruling on the motion, the Court must view the facts in the light most favorable to the non-moving party, and make all reasonable inferences in favor of the non-moving party. [31]

IV. ANALYSIS

A. **[*14]** *Ovitz Was Not a Fiduciary Until October 1, 1995*

To date, the fiduciary duties of officers have been assumed to be identical to those of directors. [32] With respect to directors, those duties include the duty of care and the duty of loyalty. There has also been much discussion regarding a duty of good faith, which may or may not be subsumed under the duty of loyalty. [33] **[*15]** Ovitz became an officer of Disney on October 1, 1995 when he became President of the corporation, [34] and he became a director on January 22, 1996. [35] Therefore, upon becoming an officer on October 1, 1995, Ovitz owed fiduciary duties to Disney and its shareholders.

As this Court previously held, before becoming a fiduciary, "Ovitz did have the right to seek the best employment agreement possible for himself." [36] In fact, that prior ruling implies that it may be the law of the case that Ovitz was not a fiduciary until October 1, 1995. [37] Even if this is not the law of the case, it is the correct result and the Court reaches that conclusion anew.

Plaintiffs claim that once the OLA was executed and Ovitz's hiring was publicly announced in mid-August 1995, his official installation as President and status as a fiduciary was a foregone conclusion. This may be so, but it does not explain why Ovitz would **[*16]** be bound by those fiduciary duties even though he had not yet taken office. Plaintiffs cite two cases for the proposition

---

[25] Eisner Tr. at 628-29; Dep. Ex. 326. According to Eisner's letter to Russell, Ovitz had requested that Russell, not Litvack, handle the negotiations on behalf of Disney. Eisner implicitly concurred, and Russell did conduct those negotiations as requested. Dep. Ex. 326 at DD002540.

[26] Dep. Exs. 326, 379-83. Russell, along with Litvack, had opined that Disney did not have grounds upon which to terminate Ovitz for cause. *See* Russell Tr. at 722-23; Litvack Tr. at 550-51. There is some indication that an opinion from outside counsel was sought, but apparently no final opinion was ever rendered and delivered to Disney. *See* Russell Tr. at 856-57.

[27] Dep. Ex. 13.

[28] Dep. Ex. 14.

[29] *See* Russell Tr. at 853 (compensation committee did not meet). In addition, there are no minutes indicating that the full board ever considered Ovitz's termination.

[30] 30 CT. CH. R. 56(c).

[31] *Judah v. Del. Trust Co., 378 A.2d 624, 632 (Del. 1977)*.

[32] "With respect to the obligation of officers to their own corporation and its stockholders, there is nothing in any Delaware case which suggests that the fiduciary duty owed is different in the slightest from that owed by directors." DAVID A. DREXLER, ET AL., *DELAWARE CORPORATION LAW AND PRACTICE § 14.02* (Rel. No. 16, 2003).

[33] *See In re Gaylord Container Corp. S'holders Litig., 753 A.2d 462, 475-76 n.41 (Del. Ch. 2000)*; Lyman P. Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, *30 WM. MITCHELL L. REV. 1149 (2004)*; Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456 (2004)

[34] Dep. Ex.29 at WD01196.

[35] Dep. Ex. 47 at WD01210-11.

[36] *In re Walt Disney Co. Derivative Litig., 825 A.2d 275, 290 (Del. Ch. 2003)* (*"Disney"*).

[37] "Nevertheless, once Ovitz became a fiduciary of Disney on October 1, 1995. . . ." *Id.*

that Ovitz owed Disney fiduciary duties before he assumed the position of President on October 1, 1995, though neither case supports their argument. [38]

[*17] Because there is no reason to impose a fiduciary duty upon Ovitz before he obtained fiduciary authority, Ovitz was not a fiduciary before October 1, 1995, and therefore, Ovitz was free to negotiate the OLA and OEA to his greatest advantage until October 1, 1995. If this means that Ovitz took advantage of any personal relationship he might have had with Eisner or Russell during the course of those negotiations, Ovitz would be entitled to do so unless his actions amounted to aiding and abetting a breach of their (Eisner's and Russell's) fiduciary duties, a claim that plaintiffs have not asserted.

Similarly, it is not Ovitz's responsibility to ensure that Eisner had actual authority to extend the offer of employment to Ovitz or to negotiate on behalf of Disney. Ovitz knew that Eisner was Chairman and CEO of Disney, which would be sufficient to give Eisner apparent authority to take those actions. [39] It would be nonsensical to require Ovitz to ignore this fundamental principle of agency law, and as part of his inchoate fiduciary duties, and without any authority vis-a-vis Disney, to verify that Eisner could negotiate on behalf of Disney and that the Disney Board of Directors were complying **[*18]** with their fiduciary responsibilities in connection with Ovitz's hiring.

Finding that Ovitz owed fiduciary duties at some time before October 1, 1995 would lead to significant uncertainty regarding when one becomes a fiduciary. [40] A bright-line rule whereby officers and directors become fiduciaries only when they are officially installed, and receive the formal investiture of authority that accompanies such office or directorship, is a more reasonable and desirable rule. [41] Therefore, because Ovitz did not have any authority at Disney before October 1, 1995, he was not a fiduciary of Disney before that time. It thus follows that any actions taken by him, or negotiations on his behalf with respect to the OEA, before **[*19]** October 1, 1995, cannot subject him to liability for breach of a fiduciary duty that he did not yet have.

[*20] *B. Once a Fiduciary, Ovitz Did Not Breach His Fiduciary Duties By Executing the Previously-Negotiated OEA*

Because Ovitz was not in a fiduciary relationship until October 1, 1995, he owed no duty until that time. If material changes were made to the OEA after that date, however, Ovitz would be required to act as a fiduciary in making those changes. In deciding the previous motions to dismiss, the Court noted that case law supports the proposition that "an officer may negotiate his or her own

[38] First, plaintiffs cite *Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503, 510 (Del. 1939)* for the proposition that "a corporate officer assumes fiduciary duties to the corporation and the shareholders, [and] that those duties flow not from the corporate title itself but from the assumption of an equivalent role or function in relation to the company." Pls.' Br. in Opp. to Michael S. Ovitz's Mm. for Summ. J. at 52 n.30. The Court has been unable to find this particular rule of law in the *Guth* opinion, but even if it were true, it would support Ovitz's argument instead. Although he was to be made President of Disney, Ovitz's duties did not flow from that title or the publicity stemming from his hiring, but from the assumption of his role and function in relation to the company, or in other words, his duties and authority as President, which he did not obtain until October 1, 1995. Secondly, plaintiffs' reference to Justice Jacobs' opinion in *Faraone v. Kenyon, 2004 Del. Ch. LEXIS 26, at *26 (Del. Ch.)*, is taken out of context and misleading because Justice Jacobs clearly was discussing relationships that fall outside the well-recognized set of fiduciary relationships, and the fiduciary relationship that an officer or director owes to the corporation and its shareholders has long been recognized in Delaware jurisprudence.

[39] Under Delaware law, an agent, such as a CEO, can bind the principal if the third person with whom that agent is dealing reasonably concludes that the agent is acting on behalf of the principal. *Int'l Boiler Works Co. v. Gen. Waterworks Corp., 372 A.2d 176, 177 (Del. 1977)*.

[40] For example, if a director does not become a fiduciary on the day he or she is installed as a director, when would that person's fiduciary duties begin? When the final results of the directorial election are certified? When the prospective director is placed on a management slate certain to win approval? Similar problems exist in attempting to determine when an officer becomes a fiduciary if not when that person is formally installed and assumes their responsibilities and duties as an officer of the corporation.

[41] Plaintiffs argue that Ovitz wielded some authority before October 1, 1995, perhaps in connection with the extensive remodeling of the Disney executive suite where Ovitz's office was eventually constructed. Even if Ovitz was consulted as to what he desired in an office, others in senior management with authority to approve those expenditures gave consent before work began. *See* Appendix of Exs. To Pls.' Br. in Opp. to Michael S. Ovitz's Mm. for Summ. J. at tabs D and E. Those documents have the Bates numbers of WD06758-72 and WD06756-57, respectively.

employment agreement as long as the process involves negotiations performed in an adversarial and arms-length manner." [42] The Court also concluded, based upon the record at the time and the precise procedural posture of a motion to dismiss, that "the final version of the [OEA] differed significantly from the draft version summarized to the board and to the compensation committee on September 26, 1995." [43]

Then, drawing all reasonable **[*21]** inferences in favor of the plaintiffs, the Court decided that if the allegations relating to the negotiation and execution of the OEA were proven true, that no adversarial or arms-length process occurred and that Ovitz may have breached his fiduciary duties. [44] Today the Court faces the issue anew in light of the facts uncovered through the discovery process and through the lens of a summary judgment motion brought by Ovitz. The facts that plaintiffs have produced simply do not support the Court's previous conclusion.

The correspondence between Disney and Ovitz and their respective counsel in regards to the OEA clearly shows what changes were made and when. No material changes to the compensation structure, severance or NFT benefits, or the definition of "good cause" changed between September 23, 1995 and December 12, 1995. [45] That material changes were made between the OLA on August 14 and the final OEA is irrelevant, so long as the changes were made before Ovitz became a fiduciary on October 1, 1995. **[*22]**

Plaintiffs argue vigorously that Ovitz's options were "in the money" on December 12, 1995 when the OEA was signed, and this evidences a *prima facie* case of self-dealing, quoting from the Court's previous decision, which was not made upon a full evidentiary record. [46] Although Ovitz's options were **[*23]** "in the money" on December 12, 1995, this was according to the previously agreed-upon terms of the OEA and the terms of Disney's stock option plan which required that the options be priced on the day they were approved by the Compensation Committee, in this case, October 16, 1995. [47]

[*24] Plaintiffs attempt to impugn Ovitz's actions by arguing that he was absent from the October 16, 1995 meeting of the Compensation Committee even though, according to Disney's bylaws, as President, he was an *ex officio* member of that committee. [48] Plaintiffs thus try to place Ovitz into a no-win situation: either he attends the meeting, possibly in breach of his duty of loyalty, or he does not attend the meeting, possibly in breach of his duty of care. Given the broad language with which the courts of Delaware have described the duty of loyalty, [49] Ovitz made the decision that a faithful

---

[42] *Disney, 825 A.2d at 290* (emphasis removed).

[43] *Id.*

[44] *Id.*

[45] Plaintiffs argue that contract language was added that would grant him the $ 10 million termination payment between the OLA and October 10 draft of the OEA. Pls.' Br. in Opp. to Michael S. Ovitz's Mtn. for Summ. J. at 56. The provision for the $ 10 million severance payment was included in the September 23 draft, and the specific language referred to in plaintiffs' brief can be considered mere surplusage -- it does not materially change the operation of the $ 10 million payment because if Ovitz were to receive an NFT the circumstances of Ovitz's imminent departure from Disney would also imply that he would not receive a "Qualifying Offer," the non-receipt of which would entitle Ovitz to the $ 10 million.

[46] Pls.' Br. in Opp. to Michael S. Ovitz's Mtn. for Summ. J. at 54-55; *Disney, 825 A.2d at 282*.

[47] *See* Dep. Ex. 7; Dep. Ex. 112. Disney's Amended and Restated 1990 Stock Incentive Plan, pursuant to which Ovitz's three million options were issued, required that the exercise price be "determined by the [Compensation] Committee at the time any option is awarded and shall not be less than 100% of the fair market value of the common stock of Disney on the date on which the option is granted." Dep. Ex. 41 at WD00133. Furthermore, the Compensation Committee minutes from October 16, 1995 make it clear that Ovitz's options were granted on that date, subject to the formalities of final execution of the OEA and execution and return of a formal stock option agreement. *Id.* at WD00121-22. Provisions similar to those in the final OEA that would possibly allow repricing based upon future amendments to the plan pursuant to the acquisition of Cap Cities/ABC existed in the September 23 draft. *Compare* Dep. Ex. 7 at WD00205 *with* Dep. Ex. 112 at WD00013-14. In addition, plaintiffs' conjecture that if Disney's stock price had dropped between October and December that Ovitz would have demanded a repricing of his options has no basis in the established record, and such "what ifs" based on events outside of Ovitz's control that did not occur cannot establish a breach of his fiduciary duties.

[48] *See* Pls.' Br. in Opp. to Michael S. Ovitz's Mtn. for Summ. J. at 25.

[49] For example, as this Court previously stated, the "duty of loyalty . . . imposes an affirmative obligation to protect and

fiduciary would make by abstaining from attendance at a meeting where a substantial part of his own compensation was to be discussed and decided upon.

[*25] Plaintiffs continue to argue that even if the OEA did not materially change after October 1, 1995, Ovitz, by signing the OEA and accepting its benefits, breached his fiduciary duties to Disney and its shareholders. [50] In support for this proposition, they again cite to *Guth*, the seminal case with respect to usurping a corporate opportunity. [51]

It would make little, if any, sense for the Court to adopt plaintiffs' position, which would, in essence, articulate the following rule: If a person who will **[*26]** become an officer successfully negotiates a compensation package and formally executes that contract before taking office, that person is entitled to negotiate the best deal possible; but, if all the negotiations take place before taking office and the parties begin performance as if the contract was duly executed, because the contract is not formally executed until after the officer assumes his or her position and the fiduciary duties that accompany it, that officer must demonstrate the entire fairness of that contract or be held to have breached his or her fiduciary duties. There is no reasonable rationale upon which to base such a rule, which would also conflict with elementary principles of contract law. [52]

[*27] Plaintiffs also suggest that after Ovitz became a fiduciary and obtained authority at Disney, he breached his fiduciary duties by failing to conduct an investigation into his hiring to ensure that the proper process was used by Disney and to ensure that the other officers and directors had complied with their fiduciary duties. Although the contours of the so-called "duty to monitor" [53] are unclear, they certainly do not extend to the situation present here, where Ovitz negotiated terms of his employment, as a reasonable person would expect, with the CEO and at least one member of the Compensation Committee. In addition, the Compensation Committee apparently approved the terms of his hiring in a formal resolution, and the full Board of Directors formally appointed him as President of the company.

[*28] Because Ovitz was not a fiduciary until October 1, 1995, and because no material changes to the OEA occurred after that date, the Court concludes as a matter of law that Ovitz could not have breached a fiduciary duty he owed by performing under the OEA and by duly executing that document which conformed with the course of performance of the parties. [54] Because Ovitz did not breach his fiduciary duties, irrespective of whether other Disney directors and officers may have done so, Ovitz need not show the entire fairness of the OEA, and he is entitled to summary judgment with respect to the claim that he breached his fiduciary duties by entering into the OEA.

[*29] *C. Genuine Issues of Material Fact Exist Regarding the Claim of Waste*

The parties did not squarely address the claims regarding waste in the briefing or argument on this motion. Because it is unclear whether Disney received

---

advance the interests of the corporation and mandates that [a director] absolutely refrain from any conduct that would harm the corporation. This duty has been consistently defined as *broad and encompassing*,' demanding of a director *the most scrupulous observance*.' To that end, a director may not allow his self-interest to jeopardize his *unyielding obligations* to the corporation and its shareholders." *BelCom, Inc. v. Robb, 1998 Del. Ch. LEXIS 58, 1998 WL 229527 at *3 (Del. Ch. 1998)* (internal citations omitted and emphasis added).

[50] Pls.' Br. in Opp. to Michael S. Ovitz's Mtn. for Summ. J. at 58.

[51] *5 A.2d at 510*. The language that plaintiffs refer to explains that when an officer or director of a corporation usurps a corporate opportunity, a constructive trust should be established for the benefit of the corporation. This result, clearly, is predicated by a finding that the officer or director breached his fiduciary duty. No such corporate opportunity or breach of fiduciary duty has been shown to exist here.

[52] Even though the OEA had not yet been executed, both Eisner and Ovitz had signed the OLA, both parties began performing in accordance with the basic economic terms laid out therein and approved by the Compensation Committee on September 26, 1995 (with the exception of the stock option value guarantee). This would likely be sufficient to prove or, at the very least, to make a colorable argument that some form of contract existed between Ovitz and Disney sufficient to bind both parties by no later than October 1, 1995.

[53] *See* *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 833 A.2d 961, 970-72 (Del. Ch. 2003)*, *aff'd*, *845 A.2d 1040 (Del. 2004)*; *In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996)*.

[54] Ovitz's personal, unadvised, and lay conclusions about whether he was legally bound by a handshake or a signature are irrelevant to this conclusion. Whether or not he thought he was bound, he almost certainly was bound based on the OLA, his oral representations, and his performance, and his counsel surely would have advised him thusly had the question been presented.

"any substantial consideration" and whether there was a "good faith judgment" by the board "that in the circumstances the transaction [was] worthwhile," the claims for waste must remain. [55] Having failed to present undisputed facts that would entitle him to judgment as a matter of law on this claim, Ovitz's motion for summary judgment as to the waste claims is denied.

D. Genuine Issues of Material Fact Exist Regarding Whether Ovitz Breached His Fiduciary Duties In Receiving A Non-Fault Termination

It is beyond question that Ovitz was a fiduciary of Disney during the discussions and negotiations regarding his termination in the latter part of 1996. Until December 27, 1996, Ovitz was both **[*30]** an officer of Disney and a director of Disney. As such, Ovitz owed to Disney the fiduciary duties of care and loyally. The question, therefore, is what was the extent and nature of Ovitz's duties during the termination period, and did he comply with them?

Ovitz has argued that so long as he possessed a subjective belief that Disney did not have good cause to terminate him, that he was justified in receiving the NFT, and thus did not breach his fiduciary duties. Delaware law, however, has always taken an objective approach to determining fiduciary duties. [56] Plaintiffs cite a previous decision in this case for the proposition that Ovitz, as a fiduciary, "had an obligation to ensure the process of his . . . termination was both impartial and fair." [57]

The situation in which Ovitz found himself was certainly undesirable. His severance from Disney **[*31]** was being orchestrated, and it would arguably spell the end of his career in Hollywood. Though Ovitz has attempted to characterize his termination as a unique situation in which "limited" fiduciary duties should apply, well-established principles of corporate law exist by which the Court may measure Ovitz's and the other Disney fiduciaries' actions.

Section 144 of the Delaware General Corporation Law governs the validity of certain interested transactions. [58] Section 144 provides that interested transactions are not void or voidable solely because they are between the corporation and a director or officer thereof if one of three requirements is met: 1) after full disclosure, a majority of disinterested directors of the board or an authorized committee thereof ratifies the transaction; [59] 2) after full disclosure, a majority of the shareholders, in good faith, approve the transaction; or 3) the transaction is fair as to the corporation. [60] Of course, if the transaction constitutes waste, illegality, fraud, or an *ultra vires* act, not even ratification by disinterested directors or anything less than a unanimous shareholder vote will protect the transaction, or those participating **[*32]** in it. [61]

Ovitz's negotiated separation from the company was an interested transaction within the meaning of section 144 because he, as a director and officer, engaged in a transaction with the **[*33]** corporation for which he was a fiduciary and received a benefit greater than that of Disney's stockholders, [62] and this benefit was material to Ovitz. [63] It was more than merely receiving what he was entitled to under his contract. Ovitz has argued that receiving his NFT was merely a pre-arranged contractual obligation, akin to receiving his salary. It is true that *if* Ovitz received a NFT, that he had a contractual right to receive the payout he did receive. But Ovitz did not have a contractual right to receive a NFT, which distinguishes this situation from the mere

---

[55] Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000) (emphasis removed).

[56] *See* Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 188 A.2d 125, 130 (Del. 1963).

[57] Disney, 825 A.2d at 291.

[58] For a discussion of the application of section 144(a)(2), see the earlier opinion in this case: In re Walt Disney Co. Derivative Litig., 731 A.2d 342, 366-69 (Del. Ch. 1998), *aff'd in part, rev'd in part sub nom.* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

[59] In fact, case law seems to indicate that not only must disinterested directors ratify the transaction, but that a disinterested party must negotiate on behalf of the company. *See* Cooke v. Oolie, 1997 Del. Ch. LEXIS 92, 1997 WL 367034 at *9 (Del. Ch.).

[60] 8 Del. C. § 144(a).

[61] *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del.), *modified*, 636 A.2d 956 (Del. 1994); Schreiber v. Bryan, 396 A.2d 512, 518 (Del. Ch. 1978).

[62] *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

[63] *See* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1161, 1167 (Del. 1995).

receipt of salary. Instead, Ovitz's receipt of a NFT was conditioned upon a one-time determination (to be made by Disney) that was not guaranteed by his contract, and Ovitz appears to have actively engaged in negotiations and decisionmaking that affected Disney's determination to grant the NFT.

[*34] Ovitz negotiated his exit from Disney with Eisner, Russell, and others. He made a conscious decision not to resign and to seek the benefits that his contract made available to him only under certain prescribed circumstances. Ovitz allegedly colluded with those on the other side of the bargaining table (and it is still unclear as to who those people were at various times) in bringing about the circumstances that would entitle him to his NFT benefits. In so doing, he allegedly manipulated corporate processes and thereby violated his fiduciary duties to Disney.

Furthermore, it is unclear from the record whether a majority of any group of disinterested directors ever authorized the payment of Ovitz's severance payments. [64] No meetings were held, and no written consents were executed. Similarly, there was no shareholder vote on the issue. Absent a demonstration that the transaction was fair to Disney, that transaction may be voidable at the discretion of the company. [65] Such an event would of course leave Ovitz in the position of insisting upon his various contractual rights under the OEA, as they originally existed. Here plaintiffs contend that Ovitz's abuse of corporate processes **[*35]** amounted to a breach of duty, for which they seek money damages for the company. As there are genuine issues of material fact regarding Ovitz's receipt of the NFT, and the use of his position to obtain the NFT, summary judgment for Ovitz as to this claim is inappropriate.

V. CONCLUSION

In sum, because Ovitz was not a fiduciary before October 1, 1995, prior to which the OEA was negotiated, he need not show the entire fairness of that contract. Summary **[*36]** judgment for Ovitz is granted in part as to claims arising from his entering into the OEA.

As mentioned above, the motion for summary judgment as to the claims of waste is denied.

Finally, because the record is unclear as to whether Ovitz abused his fiduciary position so as to cause Disney to grant the NFT, his motion for summary judgment as to that claim must be denied.

IT IS SO ORDERED.

End of Document

[64] Though the OEA had been approved by the Compensation Committee before Ovitz's hiring, the magnitude of the NFT, even for a company of Disney's size, would indicate to a reasonable, rational director that some action would be necessary. *See* Brehm, 746 A.2d at 259 ("Certainly in this case the economic exposure of the corporation to the payout scenarios of the Ovitz contract was material, particularly given its large size. . . .").

[65] I recognize that no party seeks to void the company's determination to grant Ovitz the NFT.

Kahn v. M&F Worldwide Corp.

Supreme Court of Delaware

December 18, 2013, Submitted; March 14, 2014, Decided

No. 334, 2013

Reporter

88 A.3d 635 *; 2014 Del. LEXIS 115 **; 2014 WL 996270

ALAN KAHN, SAMUEL PILL, IRWIN PILL, RACHEL PILL and CHARLOTTE MARTIN, Plaintiffs Below, Appellants, v. M&F WORLDWIDE CORP., RONALD O. PERELMAN, BARRY F. SCHWARTZ, WILLIAM C. BEVINS, BRUCE SLOVIN, CHARLES T. DAWSON, STEPHEN G. TAUB, JOHN M. KEANE, THEO W. FOLZ, PHILIP E. BEEKMAN, MARTHA L. BYORUM, VIET D. DINH, PAUL M. MEISTER, CARL B. WEBB and MacANDREWS & FORBES HOLDINGS, INC., Defendants Below, Appellees.

Subsequent History: Case Closed April 1, 2014.

Prior History: **[**1]** Court Below — Court of Chancery of the State of Delaware. C.A. No. 6566.

In re MFW S'holders Litig., 67 A.3d 496, 2013 Del. Ch. LEXIS 135 (Del. Ch., 2013)

Counsel: Carmella P. Keener, Esquire, Rosenthal, Monhait & Goddess, P.A., Wilmington, Delaware, Peter B. Andrews, Esquire, Nadeem Faruqi, Esquire, Beth A. Keller, Esquire, Faruqi & Faruqi, LLP, Wilmington, Delaware, Carl L. Stine, Esquire (argued) and Matthew Insley-Pruitt, Esquire, Wolf Popper LLP, New York, New York, and James S. Notis, Esquire and Kira German, Esquire, Gardy & Notis, LLP, New York, New York, for appellants.

William M. Lafferty, Esquire, and D. McKinley Measley, Esquire, Morris, Nichols, Arsht & Tunnell LLP, Wilmington, Delaware, and Tariq Mundiya, Esquire (argued), Todd G. Cosenza, Esquire and Christopher J. Miritello, Esquire, Willkie Farr & Gallagher LLP, New York, New York, for appellees, Paul M. Meister, Martha L. Byorum, Viet D. Dinh and Carl B. Webb.

Thomas J. Allingham, II, Esquire (argued), Christopher M. Foulds, Esquire, Joseph O. Larkin, Esquire, and Jessica L. Raatz, Esquire, Skadden, Arps, Slate, Meagher & Flom LLP, Wilmington, Delaware, for appellees MacAndrews & Forbes Holdings, Inc., Ronald O. Perelman, Barry F. Schwarz, and William C. Bevins.

Stephen P. Lamb, Esquire and Meghan M. Dougherty, **[**2]** Esquire, Paul, Weiss, Rifkind, Wharton & Garrison LLP, Wilmington, Delaware, for appellees M&F Worldwide Corp., Bruce Slovin, Charles T. Dawson, Stephen G. Taub, John M. Keane, Theo W. Folz, and Philip E. Beekman.

Judges: Before HOLLAND, BERGER, JACOBS and RIDGELY, Justices and JURDEN, Judge,[1] constituting the Court en Banc.

Opinion by: HOLLAND

Opinion

[*638] **HOLLAND**, Justice:

This is an appeal from a final judgment entered by the Court of Chancery in a proceeding that arises from a 2011 acquisition by MacAndrews & Forbes Holdings, Inc. ("M&F" or "MacAndrews & Forbes")—a 43% stockholder in M&F Worldwide Corp. ("MFW")—of the remaining common stock of MFW (the "Merger"). From the outset, M&F's proposal to take MFW private was made contingent upon two stockholder-protective procedural conditions. First, M&F required the Merger to be negotiated and approved by a special committee of independent MFW directors (the "Special Committee"). Second, M&F required that the Merger be approved by a majority of stockholders unaffiliated with M&F. **[**3]** The Merger closed in December 2011, after it was approved by a vote of 65.4% of MFW's minority stockholders.

---

[1] Sitting by designation pursuant to Del. Const. art. IV, § 12 and Supr. Ct. R. 2 and 4.

The Appellants initially sought to enjoin the transaction. They withdrew their request for injunctive relief after taking expedited discovery, including several depositions. The Appellants then sought post-closing relief against M&F, Ronald O. Perelman, and MFW's directors (including the members of the Special Committee) for breach of fiduciary duty. Again, the Appellants were provided with extensive discovery. The Defendants then moved for **[*639]** summary judgment, which the Court of Chancery granted.

Court of Chancery Decision

The Court of Chancery found that the case presented a "novel question of law," specifically, "what standard of review should apply to a going private merger conditioned upfront by the controlling stockholder on approval by both a properly empowered, independent committee and an informed, uncoerced majority-of-the-minority vote." The Court of Chancery held that business judgment review, rather than entire fairness, should be applied to a very limited category of controller mergers. That category consisted of mergers where the controller voluntarily relinquishes **[**4]** its control — such that the negotiation and approval process replicate those that characterize a third-party merger.

The Court of Chancery held that, rather than entire fairness, the business judgment standard of review should apply "if, *but only if*: (i) the controller conditions the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee acts with care; (v) the minority vote is informed; and (vi) there is no coercion of the minority."[2]

The Court of Chancery found that those prerequisites were satisfied and that the Appellants had failed to raise any genuine issue of material fact indicating the contrary. The court then reviewed the Merger under the business judgment standard and granted summary judgment for the Defendants.

Appellants' Arguments

The Appellants raise two main arguments on this appeal. First, they contend that the Court of Chancery erred in concluding that no material disputed facts existed regarding the conditions precedent **[**5]** to business judgment review. The Appellants submit that the record contains evidence showing that the Special Committee was not disinterested and independent, was not fully empowered, and was not effective. The Appellants also contend, as a legal matter, that the majority-of-the-minority provision did not afford MFW stockholders protection sufficient to displace entire fairness review.

Second, the Appellants submit that the Court of Chancery erred, as a matter of law, in holding that the business judgment standard applies to controller freeze-out mergers where the controller's proposal is conditioned on both Special Committee approval and a favorable majority-of-the-minority vote. Even if both procedural protections are adopted, the Appellants argue, entire fairness should be retained as the applicable standard of review.

Defendants' Arguments

The Defendants argue that the judicial standard of review should be the business judgment rule, because the Merger was conditioned *ab initio* on two procedural protections that together operated to replicate an arm's-length merger: the employment of an active, unconflicted negotiating agent free to turn down the transaction; and a requirement that **[**6]** any transaction negotiated by that agent be approved by a majority of the disinterested stockholders. The Defendants argue that using and *establishing* pretrial that both protective conditions were extant renders a going private transaction analogous to that of a third-party arm's-length merger under **[*640]** Section 251 of the Delaware General Corporation Law. That is, the Defendants submit that a Special Committee approval in a going private transaction is a proxy for board approval in a third-party transaction, and that the approval of the unaffiliated, noncontrolling stockholders replicates the approval of all the (potentially) adversely affected stockholders.

FACTS

MFW and M&F

MFW is a holding company incorporated in Delaware. Before the Merger that is the subject of this dispute,

[2] Emphasis by the Court of Chancery.

MFW was 43.4% owned by MacAndrews & Forbes, which in turn is entirely owned by Ronald O. Perelman. MFW had four business segments. Three were owned through a holding company, Harland Clarke Holding Corporation ("HCHC"). They were the Harland Clarke Corporation ("Harland"), which printed bank checks; Harland Clarke Financial Solutions, which provided technology products and services to financial services companies; **[**7]** and Scantron Corporation, which manufactured scanning equipment used for educational and other purposes. The fourth segment, which was not part of HCHC, was Mafco Worldwide Corporation, a manufacturer of licorice flavorings.

The MFW board had thirteen members. They were: Ronald Perelman, Barry Schwartz, William Bevins, Bruce Slovin, Charles Dawson, Stephen Taub, John Keane, Theo Folz, Philip Beekman, Martha Byorum, Viet Dinh, Paul Meister, and Carl Webb. Perelman, Schwartz, and Bevins were officers of both MFW and MacAndrews & Forbes. Perelman was the Chairman of MFW and the Chairman and CEO of MacAndrews & Forbes; Schwartz was the President and CEO of MFW and the Vice Chairman and Chief Administrative Officer of MacAndrews & Forbes; and Bevins was a Vice President at MacAndrews & Forbes.

The Taking MFW Private Proposal

In May 2011, Perelman began to explore the possibility of taking MFW private. At that time, MFW's stock price traded in the $20 to $24 per share range. MacAndrews & Forbes engaged a bank, Moelis & Company, to advise it. After preparing valuations based on projections that had been supplied to lenders by MFW in April and May 2011, Moelis valued MFW at between $10 and $32 **[**8]** a share.

On June 10, 2011, MFW's shares closed on the New York Stock Exchange at $16.96. The next business day, June 13, 2011, Schwartz sent a letter proposal ("Proposal") to the MFW board to buy the remaining MFW shares for $24 in cash. The Proposal stated, in relevant part:

> The proposed transaction would be subject to the approval of the Board of Directors of the Company [*i.e.*, MFW] and the negotiation and execution of mutually acceptable definitive transaction documents. It is our expectation that the Board of Directors will appoint a special committee of independent directors to consider our proposal and make a recommendation to the Board of Directors. *We will not move forward with the transaction unless it is approved by such a special committee. In addition, the transaction will be subject to a non-waivable condition requiring the approval of a majority of the shares of the Company not owned by M & F or its affiliates*. . . .[3]
>
> . . . In considering this proposal, you should know that in our capacity as a stockholder of the Company we are interested **[*641]** only in acquiring the shares of the Company not already owned by us and that in such capacity we have no interest in selling any of the **[**9]** shares owned by us in the Company nor would we expect, in our capacity as a stockholder, to vote in favor of any alternative sale, merger or similar transaction involving the Company. If the special committee does not recommend or the public stockholders of the Company do not approve the proposed transaction, such determination would not adversely affect our future relationship with the Company and we would intend to remain as a long-term stockholder.
>
> . . . .
>
> In connection with this proposal, we have engaged Moelis & Company as our financial advisor and Skadden, Arps, Slate, Meagher & Flom LLP as our legal advisor, and we encourage the special committee to retain its own legal and financial advisors to assist it in its review.

MacAndrews & Forbes filed this letter with the U.S. Securities and Exchange Commission ("SEC") and issued a press release disclosing substantially the same information.

The Special Committee Is Formed

The MFW board met the following day to consider the Proposal. At the meeting, Schwartz presented the offer on behalf of MacAndrews & Forbes. Subsequently, Schwartz and Bevins, as the two directors present who were also directors of MacAndrews & Forbes, **[**10]** recused themselves from the meeting, as did Dawson, the CEO of HCHC, who had previously expressed support for the proposed offer.

The independent directors then invited counsel from Willkie Farr & Gallagher — a law firm that had recently represented a Special Committee of MFW's independent directors in a potential acquisition of a

[3] Emphasis added.

subsidiary of MacAndrews & Forbes — to join the meeting. The independent directors decided to form the Special Committee, and resolved further that:

> [T]he Special Committee is empowered to: (i) make such investigation of the Proposal as the Special Committee deems appropriate; (ii) evaluate the terms of the Proposal; (iii) negotiate with Holdings [*i.e.*, MacAndrews & Forbes] and its representatives any element of the Proposal; (iv) negotiate the terms of any definitive agreement with respect to the Proposal (it being understood that the execution thereof shall be subject to the approval of the Board); (v) report to the Board its recommendations and conclusions with respect to the Proposal, including a determination and *recommendation as to whether the Proposal is fair and in the best interests of the stockholders of the Company other than Holdings* and its affiliates **[**11]** and should be approved by the Board; and (vi) determine to elect not to pursue the Proposal. . . .[4]
>
> . . . .
>
> . . . [T]he Board shall not approve the Proposal without a prior favorable recommendation of the Special Committee. . . .
>
> . . . [T]he Special Committee [is] empowered to retain and employ legal counsel, a financial advisor, and such other agents as the Special Committee shall deem necessary or desirable in connection with these matters. . . .

The Special Committee consisted of Byorum, Dinh, Meister (the chair), Slovin, and Webb. The following day, Slovin recused himself because, although the MFW **[*642]** board had determined that he qualified as an independent director under the rules of the New York Stock Exchange, he had "some current relationships that could raise questions about his independence for purposes of serving on the Special Committee."

ANALYSIS

What Should Be The Review Standard?

Where a transaction involving self-dealing by a controlling stockholder is challenged, the applicable standard of judicial review is "entire fairness," with the defendants having the burden of persuasion.[5] In other words, the defendants bear the ultimate burden of proving that the transaction **[**12]** with the controlling stockholder was entirely fair to the minority stockholders. In *Kahn v. Lynch Communication Systems, Inc.*,[6] however, this Court held that in "entire fairness" cases, the defendants may shift the burden of persuasion to the plaintiff if either (1) they show that the transaction was approved by a well-functioning committee of independent directors; **or** (2) they show that the transaction was approved by an informed vote of a majority of the minority stockholders.[7]

This appeal presents a question of first impression: what should be the standard of review for a merger between a controlling stockholder and its subsidiary, where the merger is conditioned *ab initio* upon the approval of **both** an **[**13]** independent, adequately-empowered Special Committee that fulfills its duty of care, and the uncoerced, informed vote of a majority of the minority stockholders. The question has never been put directly to this Court.

Almost two decades ago, in *Kahn v. Lynch*, we held that the approval by *either* a Special Committee *or* the majority of the noncontrolling stockholders of a merger with a buying controlling stockholder would shift the burden of proof under the entire fairness standard from the defendant to the plaintiff.[8] *Lynch* did not involve a merger conditioned by the controlling stockholder on both procedural protections. The Appellants submit, nonetheless, that statements in *Lynch* and its progeny could be (and were) read to suggest that even if both procedural protections were used, the standard of review would remain entire fairness. However, in *Lynch* and the other cases that Appellants cited, *Southern Peru* and *Kahn v. Tremont*, the controller did not give up its voting power by agreeing to a non-waivable majority-of-the-minority condition.[9] That is the vital distinction

---

[4] Emphasis added.

[5] Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997); Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983); *see also* Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985).

[6] Kahn v. Lynch Comc'n Sys., Inc., 638 A.2d 1110 (Del. 1994).

[7] *See* id. at 1117 (citation omitted).

[8] Kahn v. Lynch Commc'n Sys. (Lynch I), 638 A.2d 1110, 1117 (Del. 1994).

[9] *Id.*; ***Ams. Mining Corp. v. Theriault, 51 A.3d 1213, 1234***

between those cases and this one. The question is what the legal consequence of that distinction should be in these **[**14]** circumstances.

The Court of Chancery held that the consequence should be that the business judgment standard of review will govern going private mergers with a controlling stockholder that are conditioned *ab initio* upon (1) the approval of an independent and fully-empowered Special Committee that fulfills its duty of care and (2) the uncoerced, informed vote of the majority of the minority stockholders.

[*643] The Court of Chancery rested its holding upon the premise that the common law equitable rule that best protects minority investors is one that encourages controlling stockholders to accord the minority both procedural protections. A transactional structure subject to both conditions differs fundamentally from a merger having only one of those protections, in that:

> By giving controlling stockholders the opportunity to have a going private transaction reviewed under the business judgment rule, a strong incentive is created to give minority stockholders much broader access to the transactional structure **[**15]** that is most likely to effectively protect their interests. . . . That structure, it is important to note, is critically different than a structure that uses only *one* of the procedural protections. The "or" structure does not replicate the protections of a third-party merger under the DGCL approval process, because it only requires that one, and not both, of the statutory requirements of director and stockholder approval be accomplished by impartial decisionmakers. The "both" structure, by contrast, replicates the arm's-length merger steps of the DGCL by "requir[ing] two independent approvals, which it is fair to say serve independent integrity-enforcing functions."[10]

Before the Court of Chancery, the Appellants acknowledged that "this transactional structure is the optimal one for minority shareholders." Before us, however, they argue that neither procedural protection is adequate to protect minority stockholders, because "possible ineptitude and timidity of directors" may undermine the special committee protection, and because majority-of-the-minority **[**16]** votes may be unduly influenced by arbitrageurs that have an institutional bias to approve virtually any transaction that offers a market premium, however insubstantial it may be. Therefore, the Appellants claim, these protections, even when combined, are not sufficient to justify "abandon[ing]" the entire fairness standard of review.

With regard to the Special Committee procedural protection, the Appellants' assertions regarding the MFW directors' inability to discharge their duties are not supported either by the record or by well-established principles of Delaware law. As the Court of Chancery correctly observed:

> Although it is possible that there are independent directors who have little regard for their duties or for being perceived by their company's stockholders (and the larger network of institutional investors) as being effective at protecting public stockholders, the court thinks they are likely to be exceptional, and certainly our Supreme Court's jurisprudence does not embrace such a skeptical view.

Regarding the majority-of-the-minority vote procedural protection, as the Court of Chancery noted, "plaintiffs themselves do not argue that minority stockholders will vote against **[**17]** a going private transaction because of fear of retribution." Instead, as the Court of Chancery summarized, the Appellants' argued as follows:

> [Plaintiffs] just believe that most investors like a premium and will tend to vote for a deal that delivers one and that many long-term investors will sell out when they can obtain most of the premium without waiting for the ultimate vote. But that argument is not one that suggests that the voting decision is not voluntary, it is simply an editorial about **[*644]** the motives of investors and does not contradict the premise that a majority-of-the-minority condition gives minority investors a free and voluntary opportunity to decide what is fair for themselves.

Business Judgment Review Standard Adopted

We hold that business judgment is the standard of review that should govern mergers between a controlling stockholder and its corporate subsidiary, where the merger is conditioned *ab initio* upon both the approval of an independent, adequately-empowered Special Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders. We so conclude for several reasons.

(Del. 2012); [Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997)](#).

[10] *In re MFW Shareholders Litigation, 67 A.3d 496, 528 (Del. Ch. 2013)* (citing *In re Cox Commc'ns, Inc. S'holders Litig, 879 A.2d 604, 618 (Del. Ch. 2005))*.

First, entire fairness is the highest standard **[**18]** of review in corporate law. It is applied in the controller merger context as a substitute for the dual statutory protections of disinterested board and stockholder approval, because both protections are potentially undermined by the influence of the controller. However, as this case establishes, that undermining influence does not exist in every controlled merger setting, regardless of the circumstances. The simultaneous deployment of the procedural protections employed here create a countervailing, offsetting influence of equal—if not greater—force. That is, where the controller irrevocably and publicly disables itself from using its control to dictate the outcome of the negotiations and the shareholder vote, the controlled merger then acquires the shareholder-protective characteristics of third-party, arm's-length mergers, which are reviewed under the business judgment standard.

Second, the dual procedural protection merger structure optimally protects the minority stockholders in controller buyouts. As the Court of Chancery explained:

> [W]hen these two protections are established up-front, a potent tool to extract good value for the minority is established. From inception, the controlling **[**19]** stockholder knows that it cannot bypass the special committee's ability to say no. And, the controlling stockholder knows it cannot dangle a majority-of-the-minority vote before the special committee late in the process as a deal-closer rather than having to make a price move.

Third, and as the Court of Chancery reasoned, applying the business judgment standard to the dual protection merger structure:

> . . . is consistent with the central tradition of Delaware law, which defers to the informed decisions of impartial directors, especially when those decisions have been approved by the disinterested stockholders on full information and without coercion. Not only that, the adoption of this rule will be of benefit to minority stockholders because it will provide a strong incentive for controlling stockholders to accord minority investors the transactional structure that respected scholars believe will provide them the best protection, a structure where stockholders get the benefits of independent, empowered negotiating agents to **bargain for the best price and say no** if the agents believe the deal is not advisable for any proper reason, plus the critical ability to determine for themselves **[**20]** whether to accept any deal that their negotiating agents recommend to them. A transactional structure with both these protections is fundamentally different from one with only one protection.[11]

Fourth, the underlying purposes of the dual protection merger structure utilized **[*645]** here and the entire fairness standard of review both converge and are fulfilled at the same critical point: **price**. Following *Weinberger v. UOP, Inc*., this Court has consistently held that, although entire fairness review comprises the dual components of fair dealing and fair price, in a non-fraudulent transaction "price may be the preponderant consideration outweighing other features of the merger."[12] The dual protection merger structure requires two price-related pretrial determinations: first, that a fair price was achieved by an empowered, independent committee that acted with care;[13] and, second, that a fully-informed, uncoerced majority of the minority stockholders voted in favor of the price that was recommended by the independent committee.

The New Standard Summarized

To summarize our holding, in controller buyouts, the business judgment standard of review will be applied *if and only if*: (i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority.[14]

---

[11] Emphasis added.

[12] *Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983)*.

[13] In *Americas Mining*, for example, it was not possible to make a pretrial determination that the **[**21]** independent committee had negotiated a fair price. After an entire fairness trial, the Court of Chancery held that the price was not fair. *See* ***Ams. Mining Corp. v. Theriault, 51 A.3d 1213, 1241-44 (Del. 2012)***.

[14] The Verified Consolidated Class Action Complaint would have survived a motion to dismiss under this new standard. First, the complaint alleged that Perelman's offer "value[d] the company at just four times" MFW's profits per share and "five

If a plaintiff that can plead a reasonably conceivable set of facts showing that any or all of those enumerated conditions did not exist, that complaint would state a claim for relief that would entitle the plaintiff to proceed and conduct discovery.[15] If, after discovery, triable issues of fact remain about whether either or both of the dual procedural protections **[**23]** **[*646]** were established, or if established were effective, the case will proceed to a trial in which the court will conduct an entire fairness review.[16]

This approach is consistent with *Weinberger, Lynch* and their progeny. A controller that employs and/or establishes only one of these dual procedural protections would continue to receive burden-shifting within the entire fairness standard of review framework. Stated differently, unless *both* procedural protections **[**24]** for the minority stockholders are established *prior to trial*, the ultimate judicial scrutiny of controller buyouts will continue to be the entire fairness standard of review.[17]

Having articulated the circumstances that will enable a controlled merger to be reviewed under the business judgment standard, we next address whether those circumstances have been established as a matter of undisputed fact and law in this case.

Dual Protection Inquiry

To reiterate, in this case, the controlling stockholder conditioned its offer upon the MFW Board agreeing, *ab initio*, to both procedural protections, *i.e*., approval by a Special Committee and by a majority of the minority stockholders. For the combination of an effective committee process and majority-of-the-minority vote to qualify (jointly) for business judgment review, each of these protections must be effective singly to warrant a burden shift.

We begin by reviewing the record relating to the independence, mandate, and process of the Special Committee. In *Kahn v. Tremont Corp*., this Court held that "[t]o obtain the benefit of burden shifting, the controlling stockholder must do more than establish a perfunctory special committee **[**25]** of outside directors."[18]

Rather, the special committee must "function in a manner which indicates that the controlling stockholder did not dictate the terms of the transaction and that the committee exercised real bargaining power 'at an arms-length.'"[19] As we have previously noted, deciding whether an independent committee was effective in negotiating a price is a process so fact-intensive and inextricably intertwined with the merits of an entire fairness review (fair dealing and fair price) that a pretrial

times 2010 pre-tax cash flow," and that these ratios were "well below" those calculated for recent similar transactions. Second, the **[**22]** complaint alleged that the final Merger price was two dollars per share *lower* than the trading price only about two months earlier. Third, the complaint alleged particularized facts indicating that MWF's share price was depressed at the times of Perelman's offer and the Merger announcement due to short-term factors such as MFW's acquisition of other entities and Standard & Poor's downgrading of the United States' creditworthiness. Fourth, the complaint alleged that commentators viewed both Perelman's initial $24 per share offer and the final $25 per share Merger price as being surprisingly low. These allegations about the sufficiency of the price call into question the adequacy of the Special Committee's negotiations, thereby necessitating discovery on all of the new prerequisites to the application of the business judgment rule.

[15] *Cent. Mortg. Co. v. Morgan Stanley Mortg. Capital Holdings LLC, 27 A.3d 531, 536-37 (Del. 2011)*. *See also* *Winshall v. Viacom Int'l, Inc., 76 A.3d 808 (Del. 2013)*; *White v. Panic, 783 A.2d 543, 549 n.15 (Del. 2001)* (We have emphasized on several occasions that stockholder "[p]laintiffs may well have the 'tools at hand' to develop the necessary facts for pleading purposes," including the inspection of the corporation's books and records under *Del. Code Ann. tit. 8, § 220*. There is also a variety of public sources from which the details of corporate act actions may be discovered, including governmental agencies such as the U.S. Securities and Exchange Commission.).

[16] ***Ams. Mining Corp. v. Theriault, 51 A.3d 1213, 1240-41 (Del. 2012)***.

[17] ***Id. at 1241***.

[18] *Kahn v. Tremont Corp., 694 A.2d 422, 429 (Del. 1997)* (citation omitted). *See* *Emerald Partners v. Berlin, 726 A.2d 1215, 1222-23 (Del. 1999)* (describing that the special committee must exert "real bargaining power" in order for defendants to obtain a burden shift); *see also* *Beam v. Stewart, 845 A.2d 1040, 1055 n. 45 (Del. 2004)* (citing *Kahn v. Tremont Corp., 694 A.2d 422, 429-30 (Del. 1997))* (noting that the test articulated in *Tremont* requires a determination as to whether the committee members "*in fact*" functioned independently).

[19] *Kahn v. Tremont Corp, 694 A.2d at 429* (citation omitted).

determination of burden shifting is often impossible.[20] Here, however, the Defendants have successfully established a record of independent committee **[**26]** effectiveness and process that warranted a grant of summary judgment entitling them to a burden shift prior to trial.

We next analyze the efficacy of the majority-of-the-minority vote, and we conclude that it was fully informed and not coerced. That is, the Defendants also established a pretrial majority-of-the-minority vote record that constitutes an independent **[*647]** and alternative basis for shifting the burden of persuasion to the Plaintiffs.

The Special Committee Was Independent

The Appellants do not challenge the independence of the Special Committee's Chairman, Meister. They claim, however, that the three other Special Committee members — Webb, Dinh, and Byorum — were beholden to Perelman because of their prior business and/or social dealings with Perelman or Perelman-related entities.

The Appellants first challenge the independence of Webb. They urged that Webb and Perelman shared a "longstanding and lucrative business partnership" between 1983 and 2002 which included acquisitions of thrifts and financial institutions, and which led to a 2002 asset sale to Citibank in **[**27]** which Webb made "a significant amount of money." The Court of Chancery concluded, however, that the fact of Webb having engaged in business dealings with Perelman nine years earlier did not raise a triable fact issue regarding his ability to evaluate the Merger impartially.[21] We agree.

Second, the Appellants argued that there were triable issues of fact regarding Dinh's independence. The Appellants demonstrated that between 2009 and 2011, Dinh's law firm, Bancroft PLLC, advised M&F and Scientific Games (in which M&F owned a 37.6% stake), during which time the Bancroft firm earned $200,000 in fees. The record reflects that Bancroft's limited prior engagements, which were inactive by the time the Merger proposal was announced, were fully disclosed to the Special Committee soon after it was formed. The Court of Chancery found that the Appellants failed to proffer any evidence to show that **[**28]** compensation received by Dinh's law firm was material to Dinh, in the sense that it would have influenced his decisionmaking with respect to the M&F proposal.[22] The only evidence of record, the Court of Chancery concluded, was that these fees were "*de minimis*" and that the Appellants had offered no contrary evidence that would create a genuine issue of material fact.[23]

The Court of Chancery also found that the relationship between Dinh, a Georgetown University Law Center professor, and M&F's Barry Schwartz, who sits on the Georgetown Board of Visitors, **[**29]** did not create a triable issue of fact as to Dinh's independence. No record evidence suggested that Schwartz could exert influence on Dinh's position at Georgetown based on his recommendation regarding the Merger. Indeed, Dinh had earned tenure as a professor at Georgetown before he ever knew Schwartz.

The Appellants also argue that Schwartz's later invitation to Dinh to join **[*648]** the board of directors of Revlon, Inc. "illustrates the ongoing personal relationship between Schwartz and Dinh." There is no record evidence that Dinh expected to be asked to join Revlon's board at the time he served on the Special Committee. Moreover, the Court of Chancery noted, Schwartz's invitation for Dinh to join the Revlon board of directors occurred months after the Merger was approved and did not raise a triable fact issue concerning Dinh's independence from Perelman. We uphold the Court of Chancery's findings relating to Dinh.

Third, the Appellants urge that issues of material fact permeate Byorum's independence and, specifically, that Byorum "had a business relationship with Perelman

[20] ***Ams. Mining Corp. v. Theriault, 51 A.3d 1213 (Del. 2012)***.

[21] *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1051 (Del. 2004)* ("Allegations that [the controller] and the other directors . . . developed business relationships before joining the board . . . are insufficient, without more, to rebut the presumption of independence.").

[22] *See In re Gaylord Container Corp. S'holder Litig., 753 A.2d 462, 465 n.3 (Del. Ch. 2000)* (no issue of fact concerning director's independence where director's law firm "has, over the years, done some work" for the company because plaintiffs did not provide evidence showing that the director "had a material financial interest" in the representation).

[23] *See Ct. Ch. R. 56(e)* ("An adverse party may not rest upon the mere allegations or denials in the adverse party's pleading, but the adverse party's response, by affidavits or otherwise provided in this rule, must set forth specific facts showing that there is a genuine issue for trial.").

from 1991 to 1996 through her executive position at Citibank." The Court of Chancery concluded, however, the Appellants **[**30]** presented no evidence of the nature of Byorum's interactions with Perelman while she was at Citibank. Nor was there evidence that after 1996 Byorum had an ongoing economic relationship with Perelman that was material to her in any way. Byorum testified that any interactions she had with Perelman while she was at Citibank resulted from her role as a senior executive, because Perelman was a client of the bank at the time. Byorum also testified that she had no business relationship with Perelman between 1996 and 2007, when she joined the MFW Board.

The Appellants also contend that Byorum performed advisory work for Scientific Games in 2007 and 2008 as a senior managing director of Stephens Cori Capital Advisors ("Stephens Cori"). The Court of Chancery found, however, that the Appellants had adduced no evidence tending to establish that the $100,000 fee Stephens Cori received for that work was material to either Stephens Cori or to Byorum personally.[24] Stephens Cori's engagement for Scientific Games, which occurred years before the Merger was announced and the Special Committee was convened, was fully disclosed to the Special Committee, which concluded that "it was not material, and it **[**31]** would not represent a conflict."[25] We uphold the Court of Chancery's findings relating to Byorum as well.

To evaluate the parties' competing positions on the issue of director independence, the Court of Chancery applied well-established Delaware legal principles.[26] To show that a director is not independent, a plaintiff must demonstrate that the director is "beholden" to the controlling party **[*649]** "or so under [the controller's] influence that [the director's] discretion would be sterilized."[27] Bare allegations that directors are friendly with, travel in the same social circles as, or have past business relationships with the proponent of a transaction or the person they are investigating are **[**32]** not enough to rebut the presumption of independence.[28]

A plaintiff seeking to show that a director was not independent **[**33]** must satisfy a materiality standard. The court must conclude that the director in question had ties to the person whose proposal or actions he or she is evaluating that are sufficiently substantial that he or she could not objectively discharge his or her fiduciary duties.[29] Consistent with that predicate materiality requirement, the existence of some financial ties between the interested party and the director, without more, is not disqualifying. The inquiry must be whether, applying a subjective standard, those ties were *material*, in the sense that the alleged ties could have affected the impartiality of the individual director.[30]

---

[24] The Court of Chancery observed that Stephens Cori's fee from the Scientific Games engagement was "only one tenth of the $1 million that Stephens Cori would have had to have received for Byroum not to be considered independent under NYSE rules."

[25] Although the Appellants note that Stephens Cori did some follow-up work for Scientific Games in 2011, it is undisputed that work was also fully disclosed to the Special Committee, and that Stephens Cori did not receive any additional compensation as a result.

[26] The record does not support the Appellants' contention that that the Court of Chancery "relied heavily" on New York Stock Exchange ("NYSE") rules in assessing the independence of the Special Committee, and that the application of such rules "goes against longstanding Delaware precedent." The Court of Chancery explicitly acknowledged that directors' compliance with NYSE independence standards "does not mean that they are necessarily independent under [Delaware] law in particular circumstances." The record reflects that the Court of Chancery discussed NYSE standards on director independence for illustrative purposes. *See, e.g., In re J.P. Morgan Chase & Co. S'holder Litig., 906 A.2d 808, 823-24 (Del. Ch. 2005)*. However, the Court of Chancery's factual and legal determinations regarding the Special Committee's independence were premised on settled Delaware law. *Id. at 824*.

[27] *Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993)* (citing *Aronson v. Lewis, 473 A.2d 805, 815 (Del. 1984))*.

[28] *Beam ex rel. Martha Stewart Living Omnimedia v. Stewart, 845 A.2d 1040, 1051-52 (Del. 2004)*.

[29] *Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1167 (Del.1995)* ("[A] shareholder plaintiff [must] show the materiality of a director's self-interest to the . . . director's independence. . . .") (citation omitted); *see Brehm v. Eisner, 746 A.2d 244, 259 n. 49 (Del. 2000)* ("The term 'material' is used in this context to mean relevant and of a magnitude to be important to directors in carrying out their fiduciary duty of care in decisionmaking.").

[30] *See Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156 (Del. 1995)* (adopting a subjective standard for **[**34]** determining an individual director's financial self-interest). *See also, Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 363 (Del.1993)* (affirming Court of Chancery's requirement that "a shareholder show . . . the materiality of a director's self-interest to the given

The Appellants assert that the materiality of any economic relationships the Special Committee members may have had with Mr. Perelman "should not be decided on summary judgment." But Delaware courts have often decided director independence as a matter of law at the summary judgment stage.[31] In this case, the Court of Chancery noted, that despite receiving extensive discovery, the Appellants did "nothing . . . to compare the actual circumstances of the [challenged directors] to the ties [they] contend affect their impartiality" and "fail[ed] to **[**35]** proffer any real evidence of their economic circumstances."

The Appellants could have, but elected not to, submit any [Rule 56](#) affidavits, either factual or expert, in response to the Defendants' summary judgment motion. The Appellants argue that they were entitled to wait until trial to proffer evidence compromising the Special Committee's independence. That argument misapprehends how [Rule 56](#) operates.[32] [Court of Chancery Rule 56](#) states that "the adverse [non-moving] party's response, by affidavits or as otherwise provided in this rule, **[*650]** must set forth specific facts showing that there is a genuine issue for trial."[33]

The Court of Chancery found that to the extent the Appellants **[**36]** claimed the Special Committee members, Webb, Dinh, and Byorum, were beholden to Perelman based on prior economic relationships with him, the Appellants never developed or proffered evidence showing the materiality of those relationships:

> Despite receiving the chance for extensive discovery, the plaintiffs have done nothing . . . to compare the actual economic circumstances of the directors they challenge to the ties the plaintiffs contend affect their impartiality. In other words, the plaintiffs have ignored a key teaching of our Supreme Court, requiring a showing that a specific director's independence is compromised by factors material to her. As to each of the specific directors the plaintiffs challenge, the plaintiffs fail to proffer any real evidence of their economic circumstances.

The record supports the Court of Chancery's holding that none of the Appellants' claims relating to Webb, Dinh or Byorum raised a triable issue of material fact concerning their individual independence or the Special Committee's collective independence.[34]

The Special Committee Was Empowered

It is undisputed that the Special Committee was empowered to hire its own legal and financial advisors, and it retained Willkie Farr & Gallagher LLP as its legal advisor. After interviewing four potential financial advisors, the Special Committee engaged Evercore Partners ("Evercore"). The qualifications and independence of Evercore and Willkie Farr & Gallagher LLP are not contested.

Among the powers given the Special Committee in the board resolution was the authority to "report to the Board its recommendations and conclusions with respect to the [Merger], including a determination and recommendation as to whether the Proposal is fair and in the best interests of the stockholders . . . ." The Court of Chancery also found that it was "undisputed that the [S]pecial [C]ommittee was empowered not simply to 'evaluate' the offer, like some special committees with weak mandates, but to negotiate with [M&F] over the terms of its offer to buy out the noncontrolling stockholders.[35] This negotiating power was

---

director's independence" as a "restatement of established Delaware law"); *see also, e.g.*, [Grimes v. Donald, 673 A.2d 1207, 1216 (Del. 1996)](#) (stating, in the context of demand futility, that a stockholder must show that "a majority of the board has a *material* financial or familial interest" (emphasis added and citation omitted)).

[31] *See, e.g.*, [In re Transkaryotic Therapies, Inc., 954 A.2d 346, 369-70 (Del. Ch. 2008)](#) (no issue of material fact concerning directors' alleged conflict of loyalty); [In re Gaylord Container Corp. S'holder Litig., 753 A.2d 462, 465 (Del. Ch. 2000)](#) (concluding that directors were independent on a motion for summary judgment).

[32] [In re Gaylord Container Corp. S'holder Litig., 753 A.2d at 465 n.3](#).

[33] *See also* [Burkhart v. Davies, 602 A.2d 56, 59 (Del. 1991)](#) (citing [Celotex v. Corp. v. Catrett, 477 U.S. 317, 322-23, 106 S. Ct. 2548, 91 L. Ed. 2d 265 (1986))](#).

[34] *See* [In re W. Nat'l Corp. S'holders Litig., 2000 Del. Ch. LEXIS 82, 2000 WL 710192, at *6 (Del. Ch. May 22, 2000)](#) (to survive summary judgment, nonmoving party "must affirmatively **[**37]** state facts—not guesses, innuendo, or unreasonable inferences . . . .").

[35] *See, e.g.*, ***Ams. Mining Corp. v. Theriault, 51 A.3d 1213, 1244-46 (Del. 2012)*** (noting that a special committee that could only "evaluate" an offer had a "narrow mandate"); [Brinckerhoff v. Tex. E. Prods. Pipeline Co., LLC, 986 A.2d 370, 381 (Del. Ch. 2010)](#) (observing that a special committee should have the mandate to "review, evaluate, negotiate, and

accompanied by the clear authority to say no definitively to [M&F]" and to "make [**38] that decision stick." MacAndrews & Forbes promised that it would not proceed with any going private proposal that did not have the support of the Special Committee. Therefore, the Court of Chancery concluded, "the MFW committee did not have to fear that if it bargained too hard, MacAndrews & Forbes could bypass the committee and make a tender offer directly to the minority stockholders."

[*651] The Court of Chancery acknowledged that even though the Special Committee had the authority to negotiate and "say no," it did not have the authority, as a practical matter, to sell MFW to other buyers. MacAndrews & Forbes stated in its announcement that it was not interested in selling its 43% stake. Moreover, under Delaware law, MacAndrews & Forbes had no duty to sell its block, which was large enough, again **[**39]** as a practical matter, to preclude any other buyer from succeeding unless MacAndrews & Forbes decided to become a seller. Absent such a decision, it was unlikely that any potentially interested party would incur the costs and risks of exploring a purchase of MFW.

Nevertheless, the Court of Chancery found, "this did not mean that the MFW Special Committee did not have the leeway to get advice from its financial advisor about the strategic options available to MFW, including the potential interest that other buyers might have *if MacAndrews & Forbes was willing to sell*."[36] The undisputed record shows that the Special Committee, with the help of its financial advisor, did consider whether there were other buyers who might be interested in purchasing MFW, and whether there were other strategic options, such as asset divestitures, that might generate more value for minority stockholders than a sale of their stock to MacAndrews & Forbes.

The Special Committee Exercised Due Care

The Special Committee insisted from the outset that MacAndrews (including any "dual" employees who worked for both MFW and MacAndrews) be screened off from the Special Committee's process, to ensure that **[**40]** the process replicated arm's-length negotiations with a third party. In order to carefully evaluate M&F's offer, the Special Committee held a total of eight meetings during the summer of 2011.

From the outset of their work, the Special Committee and Evercore had projections that had been prepared by MFW's business segments in April and May 2011. Early in the process, Evercore and the Special Committee asked MFW management to produce new projections that reflected management's most up-to-date, and presumably most accurate, thinking. Consistent with the Special Committee's determination to conduct its analysis free of any MacAndrews influence, MacAndrews — including "dual" MFW/MacAndrews executives who normally vetted MFW projections — were excluded from the process of preparing the updated financial projections. Mafco, the licorice business, advised Evercore that all of its projections would remain the same. Harland Clarke updated its projections. On July 22, 2011, Evercore received new projections from HCHC, which incorporated the updated projections from Harland Clarke. Evercore then constructed a valuation model based upon all of these updated projections.

The updated projections, **[**41]** which formed the basis for Evercore's valuation analyses, reflected MFW's deteriorating results, especially in Harland's check-printing business. Those projections forecast EBITDA for MFW of $491 million in 2015, as opposed to $535 million under the original projections.

On August 10, Evercore produced a range of valuations for MFW, based on the updated projections, of $15 to $45 per share. Evercore valued MFW using a variety of accepted methods, including a discounted cash flow ("DCF") model. Those valuations generated a range of fair value of $22 to $38 per share, and a premiums **[*652]** paid analysis resulted in a value range of $22 to $45. MacAndrews & Forbes's $24 offer fell within the range of values produced by each of Evercore's valuation techniques.

Although the $24 Proposal fell within the range of Evercore's fair values, the Special Committee directed Evercore to conduct additional analyses and explore strategic alternatives that might generate more value for MFW's stockholders than might a sale to MacAndrews. The Special Committee also investigated the possibility of other buyers, *e.g.*, private equity buyers, that might be interested in purchasing MFW. In addition, the Special Committee **[**42]** considered whether other strategic options, such as asset divestitures, could achieve superior value for MFW's stockholders. Mr. Meister testified, "The Committee made it very clear to Evercore that we were interested in any and all possible avenues of increasing value to the stockholders,

to recommend, or reject, a proposed merger").

[36] Emphasis added.

including meaningful expressions of interest for meaningful pieces of the business."

The Appellants insist that the Special Committee had "no right to solicit alternative bids, conduct any sort of market check, or even consider alternative transactions." But the Special Committee did just that, even though MacAndrews' stated unwillingness to sell its MFW stake meant that the Special Committee did not have the practical ability to market MFW to other buyers. The Court of Chancery properly concluded that despite the Special Committee's inability to solicit alternative bids, it *could* seek Evercore's advice about strategic alternatives, including *values that might be available if MacAndrews was willing to sell*.

Although the MFW Special Committee considered options besides the M&F Proposal, the Committee's analysis of those alternatives proved they were unlikely to achieve added value for MFW's stockholders. **[**43]** The Court of Chancery summarized the performance of the Special Committee as follows:

> [t]he special committee did consider, with the help of its financial advisor, whether there were other buyers who might be interested in purchasing MFW, and whether there were other strategic options, such as asset divestitures, that might generate more value for minority stockholders than a sale of their stock to MacAndrews & Forbes.

On August 18, 2011, the Special Committee rejected the $24 a share Proposal, and countered at $30 per share. The Special Committee characterized the $30 counteroffer as a negotiating position. The Special Committee recognized that $30 per share was a very aggressive counteroffer and, not surprisingly, was prepared to accept less.

On September 9, 2011, MacAndrews & Forbes rejected the $30 per share counteroffer. Its representative, Barry Schwartz, told the Special Committee Chair, Paul Meister, that the $24 per share Proposal was now far less favorable to MacAndrews & Forbes—but more attractive to the minority—than when it was first made, because of continued declines in MFW's businesses. Nonetheless, MacAndrews & Forbes would stand behind its $24 offer. Meister responded **[**44]** that he would not recommend the $24 per share Proposal to the Special Committee. Later, after having discussions with Perelman, Schwartz conveyed MacAndrews's "best and final" offer of $25 a share.

At a Special Committee meeting the next day, Evercore opined that the $25 per share *price was fair* based on generally accepted valuation methodologies, including DCF and comparable companies analyses. At its eighth and final meeting on **[*653]** September 10, 2011, the Special Committee, although empowered to say "no," instead unanimously approved and agreed to recommend the Merger at a price of $25 per share.

Influencing the Special Committee's assessment and acceptance of M&F's $25 a share price were developments in both MFW's business and the broader United States economy during the summer of 2011. For example, during the negotiation process, the Special Committee learned of the underperformance of MFW's Global Scholar business unit. The Committee also considered macroeconomic events, including the downgrade of the United States' bond credit rating, and the ongoing turmoil in the financial markets, all of which created financing uncertainties.

In scrutinizing the Special Committee's execution of its **[**45]** broad mandate, the Court of Chancery determined there was no "evidence indicating that the independent members of the special committee did not meet their duty of care . . . ." To the contrary, the Court of Chancery found, the Special Committee "met frequently and was presented with a rich body of financial information relevant to whether and at what *price* a going private transaction was advisable." The Court of Chancery ruled that "the plaintiffs d[id] not make any attempt to show that the MFW Special Committee failed to meet its duty of care . . . ." Based on the undisputed record, the Court of Chancery held that, "there is no triable issue of fact regarding whether the [S]pecial [C]ommittee fulfilled its duty of care." In the context of a controlling stockholder merger, a pretrial determination that the *price* was negotiated by an empowered independent committee that acted with care would shift the burden of persuasion to the plaintiffs under the entire fairness standard of review.[37]

Majority of Minority Stockholder Vote

We now consider the second procedural protection invoked by M&F — the majority-of-the-minority **[**46]** stockholder vote.[38] Consistent with the second

---

[37] *Kahn v. Lynch Commc'n Sys. (Lynch I), 638 A.2d 1110, 1117 (Del. 1994)*.

[38] The MFW board discussed the Special Committee's recommendation to accept the $25 a share offer. The three directors affiliated with MacAndrews & Forbes, Perelman,

condition imposed by M&F at the outset, the Merger was then put before MFW's stockholders for a vote. On November 18, 2011, the stockholders were provided with a proxy statement, which contained the history of the Special Committee's work and recommended that they vote in favor of the transaction at a price of $25 per share.

The proxy statement disclosed, among other things, that the Special Committee had countered M&F's initial $24 per share offer at $30 per share, but only was able to achieve a final offer of $25 per share. The proxy statement disclosed that the MFW business divisions had discussed with Evercore whether the initial projections Evercore received reflected management's latest thinking. It also disclosed that the updated projections were lower. The **[**47]** proxy statement also included the five separate price ranges for the value of MFW's stock that Evercore had generated with its different valuation analyses.

Knowing the proxy statement's disclosures of the background of the Special Committee's work, of Evercore's valuation ranges, and of the analyses supporting **[*654]** Evercore's *fairness opinion*, MFW's stockholders — representing more than 65% of the minority shares — approved the Merger. In the controlling stockholder merger context, it is settled Delaware law that an uncoerced, informed majority-of-the-minority vote, without any other procedural protection, is itself sufficient to shift the burden of persuasion to the plaintiff under the entire fairness standard of review.[39] The Court of Chancery found that "the plaintiffs themselves do not dispute that the majority-of-the-minority vote was fully informed and uncoerced, because they fail to allege any failure of disclosure or any act of coercion."

Both Procedural Protections Established

Based on a highly extensive record,[40] the Court of Chancery concluded that the procedural protections upon which the Merger was conditioned—approval **[**48]** by an independent and empowered Special Committee and by a uncoerced informed majority of MFW's minority stockholders—had *both* been undisputedly established *prior to trial*. We agree and conclude the Defendants' motion for summary judgment was properly granted on all of those issues.

Business Judgment Review Properly Applied

We have determined that the business judgment rule standard of review applies to this controlling stockholder buyout. Under that standard, the claims against the Defendants must be dismissed unless no rational person could have **[**49]** believed that the merger was favorable to MFW's minority stockholders.[41] In this case, it cannot be credibly argued (let alone concluded) that no rational person would find the Merger favorable to MFW's minority stockholders.

Conclusion

For the above-stated reasons, the judgment of the Court of Chancery is affirmed.

End of Document

Schwartz, and Bevins, and the CEOs of HCHC and Mafco, Dawson and Taub, recused themselves from the discussions. The remaining eight directors voted unanimously to recommend the $25 a share offer to the stockholders.

[39] *Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985)*.

[40] The Appellants received more than 100,000 pages of documents, and deposed all four Special Committee members, their financial advisors, and senior executives of MacAndrews and MFW. After eighteen months of discovery, the Court of Chancery found that the Appellants offered no evidence to create a triable issue of fact with regard to: (1) the Special Committee's independence; (2) the Special Committee's power to retain independent advisors and to say no definitively; (3) the Special Committee's due care in approving the Merger; (4) whether the majority-of-the-minority vote was fully informed; and (5) whether the minority vote was uncoerced.

[41] *E.g.*, *In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 74 (Del. 2006)* ("[W]here business judgment presumptions are applicable, the board's decision will be upheld unless it cannot be 'attributed to any rational business purpose.'" (quoting *Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971))*).

Kahn v. Tremont Corp.

Supreme Court of Delaware

February 27, 1997, Submitted ; June 10, 1997, Decided

No. 170, 1996

Reporter

694 A.2d 422 *; 1997 Del. LEXIS 205 **

ALAN RUSSEL KAHN, Plaintiff Below, Appellant, v. TREMONT CORPORATION, SUSAN E. ALDERTON, RICHARD J. BOUSHKA, J. LANDIS MARTIN, GLENN R. SIMMONS, HAROLD C. SIMMONS, MICHAEL A. SNETZER, THOMAS P. STAFFORD, AVY H. STEIN, and VALHI, INC., Defendants Below, Appellees.

Subsequent History: **[**1]** Released for Publication June 16, 1997.

Prior History: Court Below: Court of Chancery of the State of Delaware in and for New Castle County. No. 12339.

Disposition: Reversed and Remanded.

Counsel: Norman M. Monhait, Esquire and Carmella P. Keener, Esquire, Rosenthal, Monhait, Gross & Goddess, P.A., Wilmington, Delaware. Of Counsel: Sidney B. Silverman, Esquire (argued) Silverman, Harnes & Harnes, New York, New York, for Appellant.

Jesse A. Finkelstein, Esquire, Richards, Layton & Finger, Wilmington, Delaware. Of Counsel: Timothy R. McCormick, Esquire and Jacob Marshall, Esquire, Thompson & Knight, Dallas, Texas, for Appellees Tremont Corporation, Richard J. Boushka, Thomas P. Stafford, and Avy H. Stein.

Henry N. Herndon, Jr., Esquire and Joseph C. Schoell, Esquire Morris, James, Hitchens & Williams, Wilmington, Delaware. Of Counsel: Donald E. Scott, Esquire (argued) and Lester C. Houtz, Esquire, Bartlit, Beck, Herman, Palenchar & Scott, Denver, Colorado, for Appellees Valhi, Inc., Susan E. Alderton, J. Landis Martin, Harold C. Simmons, Glenn R. Simmons, and Michael A. Snetzer.

Judges: Before WALSH, HOLLAND, **[**2]** and BERGER, Justices and RIDGELY, Presiding Judge * and QUILLEN, Judge, * constituting the Court En Banc. QUILLEN, Judge, concurring. BERGER, Justice, with whom RIDGELY, Presiding Judge, joins dissenting.

Opinion by: WALSH

Opinion

[*423] WALSH, Justice, with whom HOLLAND, Justice joins.

This is an appeal by a plaintiff-shareholder, Alan R. Kahn ("Kahn"), from a decision of the Court of Chancery which approved the purchase by Tremont Corporation ("Tremont") of 7.8 million shares of the Common Stock of NL Industries, Inc. ("NL"). The shares, constituting 15% of NL's outstanding stock, were purchased from Valhi, Inc. ("Valhi"), a corporation which was 90 percent owned by a trust for the family of Harold C. Simmons ("Simmons"). [1] In turn. Valhi was **[*424]** the owner of a majority of NL's outstanding stock and controlled Tremont through the ownership of 44% of its outstanding shares.

[3]** Kahn alleges that Simmons effectively controlled the three related companies and through his influence, structured the purchase of NL shares in a manner which benefited himself at the expense of Tremont. Following a six day trial, the Court of Chancery concluded that due to Simmons status as a controlling shareholder, the transaction must be evaluated under the entire fairness standard of review and not the more deferential business judgment rule. Nevertheless, the court found that Tremont's utilization of a Special Committee of

* Appointed pursuant to Art. IV, § 12 of the Delaware Constitution and Supreme Court Rules 2 and 4.

[1] The Simmons' Trusts did not control Valhi directly, but did so through its 100% ownership of the stock in Contran Corporation ("Contran"), which in turn, owned 90% of the outstanding stock of Valhi.

disinterested directors was sufficient to shift the burden on the fairness issue to Kahn. With the burden shifted, the court concluded that both the price and the process were fair to Tremont.

Kahn has raised two contentions in this appeal: (i) that the court erred on its burden of proof allocation regarding the entire fairness of the transaction and (ii) that the circumstances surrounding the purchase of NL shares indicate that the process was tainted and the price unfair to Tremont. After careful review of the record, we conclude tat under the circumstances the Special Committee did not operate in an independent or informed manner and therefore, the Court **[**4]** of Chancery erred in shifting the burden of persuasion to Kahn. Accordingly the judgment of the Court of Chancery is reversed and the matter remanded for a new fairness determination with the burden of proof upon the defendants.

I

The lengthy presentation before the Court of Chancery requires a full exposition of the factual background of the dispute for analysis on appeal. Tremont is a Delaware corporation with its principal executive offices located in Denver, Colorado. Through its subsidiaries, Tremont produces titanium sponge, ingot and mill products. NL is a New Jersey corporation which derives a majority of its earnings from the manufacture and sale of titanium dioxide ("TiO2"), a chemical used to impart whiteness or opacity. NL conducts this business through its European subsidiary Krones, which, accounts for 85% to 90% of NL's total revenue. Valhi is also a Delaware corporation which, through subsidiary stock ownership, is engaged in a variety of businesses, including the production and sale of hardware, forest products, refined sugar, and the fast food restaurant business.

The individual defendants, collectively the board of directors of Tremont, are Susane E. Alderton, **[**5]** Richard J. Boushka, J. Landis Martin, Glenn R. Simmons, Harold C. Simmons, Michael A. Snetzer, Thomas P. Stafford and Avy H. Stein. Aside from their service on the Tremont board, several defendants hold influential positions with other Simmons' controlled entities. Harold Simmons is chairman of the board of Valhi, NL, and Contran, and the CEO of Contran and Valhi. J. Landis Martin is both the president and CEO of NL and Tremont Susan E. Alderton serves as the vice president and treasurer of Tremont and NL. Glenn R. Simmons is the vice chairman of the board of Valhi as well as the vice chairman of the board and vice president of Contran. Michael A. Snetzer is the president of Valhi and Contran and a director of NL and Contran.

Kahn alleges that the defendants willingly participated in a series of improper transactions, beginning in 1990, which were orchestrated by Simmons for his own benefit. Specifically, he argues that the purchase of NL shares by Tremont was the final step in a series of transactions whereby Simmons was able to shift liquidity from several of his controlled companies to Valhi. Under the theory advanced by Kahn, two preceding transactions, a repurchase program and **[**6]** a "Dutch auction," were initiated in order to artificially inflate the price of NL shares. By increasing NL's per share price, Simmons was able to divest himself, at the expense of Tremont, of the stock in a failing company for above market prices.

In late 1990, NL's board believed that the current market price of NL's stock, then selling between $ 10 and $ 11 per share, was significantly undervalued. Accordingly, on October 2, 1990, the board authorized a repurchase program in the open market for up to five million shares. On the prior day NL **[*425]** stock had closed at § 10.12 per share. Over the first three months of the program, through January 10, 1991, NL repurchased almost two million shares, at a total cost of over $ 22 million and an average price of approximately $ 11 per share.

Satisfied with this response, NL suspended its repurchases from January through May of 1991. From May to July 1991, however, NL resumed buying and purchased 733,700 shares on the open market for a total cost of $ 10 million or approximately $ 13.50 a share. The repurchase program was again suspended from August of 1991 to September 11, 1991. Following this brief hiatus, NL once again reinstated **[**7]** its open-market repurchases and continued to repurchase shares into early 1992. All told, NL repurchased over 3 million of its own shares at an average price of $ 12 per share.

In June of 1991, NL shares were trading at or above $ 15 per share. At this point NL as the result of selling a large block of Lockheed stock, was holding approximately $ 500 million in cash to be used for investment purposes. In August 1991, with the market price of the stock at $ 16. NL's management decided that it would be advantageous for the company to buy additional NL shares beyond the five million already authorized in the share repurchase program.

Accordingly on August 6, 1991, the NL board voted to approve a Dutch auction self-tender offer for 10 million shares of NL.

Under the Dutch auction mechanism, each shareholder of NL would decide how many, if any, shares to tender and at what price within a designated price range. After the expiration of the auction period, NL would determine the lowest uniform price, within a preset range of $ 14.50 to $ 17.50, that would enable it to purchase 10 million shares. All of the shares tendered at or below the sale price would be purchased at the sale price **[**8]** subject to proration. In the event that more than 10 million shares were tendered at or below the sale price, NL had the option to purchase an additional 1.3 million shares.

On the date the Dutch auction was announced, Valhi owned approximately 68% of the 63.4 million outstanding shares of NL. Valhi tendered all of its shares, at $ 16, recognizing that with proration it would sell, at most, approximately 10 million shares. At the close of the Dutch auction, $ 16 per share proved to be the lowest price within the range at which NL could purchase the shares. On September 12, 1991, NL accepted for purchase 11,268,024 shares, 10,928,750 of which were acquired from Valhi. Shortly following the close of the Dutch auction, NL's stock price fell from $ 16 to around $ 13.50.

Upon completion of the Dutch auction, Valhi had sold 10.9 million shares of NL and had reduced its ownership interest in the company from 68% to 62%. If Valhi could sell an additional 7.8 million shares of NL and reduce its ownership interest to below 50%, it would be able to reap two significant benefits. First, it would receive a tax savings of approximately $ 11.8 million on its proceeds from the Dutch auction, **[**9]** a potential savings of $ 1.52 per share. Secondly, Valhi would be in a position to deconsolidate NL from its financial statements, thereby improving its access to capital markets. In order to obtain these benefits, however, Valhi needed to sell 7.8 million shares of NL amounting to 15% of NL's outstanding stock, by the end of calendar year 1991.

To explore the prospect of a further sale of NL shares, Snetzer, Valhi's President, contacted two potential purchasers, RCM Capital and Keystone Inc. Although both maintained significant holdings of NL shares, neither was interested in further purchases. Snetzer also contacted Salomon Brothers and requested an opinion concerning the marketability of the stock. Snetzer was advised by Salomon Brothers that its equity syndicate groups in the U.S. and Europe as well as its private equity people were in agreement that Valhi would incur an illiquidity discount of 20%, or greater, against NL's then market price in order to sell this unregistered stock in a series of private transactions. Snetzer did not retain Salomon to negotiate a sale because in his view Valhi was unwilling to sell the block of NL shares at that price.

Finding the alternatives **[**10]** unacceptable, Valhi decided to approach Tremont, which had **[*426]** $ 100 million in excess liquidity and was in the process of searching for a productive investment opportunity. [2] Snetzer was of the opinion that an "all in the family" transaction would be more desirable since it had the potential to yield additional benefits for both companies. As a 44% owner of Tremont, Valhi would be more likely to accept an appropriate discount from market because it would still own an indirect 44% interest in the shares. In addition, a lower discount from market might be acceptable to Tremont because its management had access to better information concerning NL's business prospects than any unrelated buyers whom Salomon had considered. As a better informed purchaser, Tremont would be less susceptible to risk than would be a stranger and might be willing to pay a price closer to market. Based on this reasoning on September 18, 1991, Snetzer wrote to Landis Martin, the President and CEO of Tremont, to propose the sale of 7.8 million shares of NL stock.

[11]** After speaking with Snetzer, Martin wrote to Tremont's three outside directors, Richard Boushka, Thomas Stafford, and Avy Stein, asking them to formulate an appropriate response to Valhi's offer. The three men were thereafter designated by the Tremont board as a Special Committee for the purpose of considering the proposal and recommending a course of action. Although the three men were deemed "independent" for purposes of this transaction, all had

---

[2] In October 1990, Tremont's corporate predecessor, Baroid Corp., divided itself into two parts, each to be publicly traded. As part of the spin-off, the new company contributed $ 100 million of capital to Tremont for acquisition purposes. Tremont had disclosed to its stockholders that the company intended to use this capital to attempt acquisitions, including "participation in the acquisition activities conducted by NL, Valhi and other companies that may be deemed to be controlled by Harold C. Simmons" and "could involve … the acquisition of securities or other assets from such related parties." Prior to the purchase of the NL shares from Valhi, Tremont's excess capital had been invested temporarily in Treasury bills.

significant prior business relationships with Simmons or Simmons' controlled companies.

Stein, a lawyer, was affiliated with the law firm which represented Simmons on several of his corporate takeovers and had worked closely with Martin. In 1984 Stein left the law firm to organize and promote various business ventures. Over the next five years, Martin invested in projects which Stein was promoting despite their poor performance. In October of 1988, Stein's business ventures had all but dried up when Martin, then at NL, offered Stein a consulting position at $ 10,000 a month and bonuses to be paid at Martin's discretion. Stein remained in this position for one year, earning bonuses totaling $ 325,000, before taking a position with two **[**12]** subsidiaries of Continental Bank, N.A.. Stafford was employed by NL in connection with Simmons' proxy contest to acquire control of Lockheed and received $ 300,000 in fees. Boushka was initially named to Simmons slate of directors in connection with the Lockheed proxy contest and was paid a fee of $ 20,000.

Of the three Special Committee members, Stein was the most closely connected to management. Nevertheless, he assumed the role of chairman of the Special Committee and directed its operations. Stafford and Boushka deferred to Stein in the selection of both the financial and legal advisors for the Special Committee. The Court of Chancery noted that Stein's selection of advisors was not reassuring.

In choosing a financial advisor, the Special Committee considered several banking firms, both national and regional. In the end, at Stein's recommendation, the Special Committee retained Continental Partners ("Continental"), a company with whom Stein was affiliated. Continental is a wholly-owned subsidiary of Continental bank which, in prior years, had earned significant fee income from Simmons related companies. The record also reflects that Martin, not a member of the Special Committee, **[**13]** signed the retainer agreement with Continental Partners. The Special Committee's selection of a legal advisor also took an unusual form. David Garten, General Counsel for both Tremont and NL, recommended C. Neel Lemon of Thompson & Knight as the Special Committee's counsel. In addition, Garten assumed the responsibility for performing the conflicts check. Lemon had previously represented a Special Committee of NL in connection with **[*427]** a proposed merger between NL and Valhi and had also represented an underwriter in connection wit a proposed convertible debt offering by Valhi.

On October 8, 1991, Boushka and Stein, along wit their advisors, met with representatives of NL to receive a presentation on the business, operating results and prospects of NL. The following day, they met with representatives of Valhi for a presentation of the business purposes behind Valhi's proposal, specifically the tax benefits Valhi hoped to achieve by deconsolidating NL from its balance sheet. In the afternoon following each presentation, a second meeting was held so that the Special Committee members, Continental and the legal advisors could analyze the material presented in the morning sessions.

Stafford, **[**14]** who was in Europe on other business, was unable to attend any of the Special Committee meetings. He kept abreast of events through telephone conferences with the other two members. Boushka attended the morning sessions but did not attend the afternoon sessions. Of the three members of the Special Committee only Stein attended all four meetings and, more importantly he was the only member who attended the review sessions with the Special Committee's advisors. In addition to the presentations, the Special Committee met twice, later in October, to consider the Valhi proposal prior to the final negotiations.

In considering the NL shares purchase, the Special Committee relied heavily upon the financial analysis performed by NL and its advisor Continental. During the October 8 meeting, NL provided information including its economic projections for the future price of TiO_2, estimates of NL's earnings and the assumptions underlying these projections. With respect to the future price of TiO_2, NL's projections assumed that an existing slump would end in late 1992 and higher prices and profits would return in the years 1993-1996.

The Special Committee requested Continental independently to **[**15]** assess the reasonableness of NL's projections. In performing a market analysis, Continental utilized five different methodologies to determine the value of the NL stock. These included a comparable company analysis, a comparable transaction analysis, a discounted cash flow analysis, an asset value/replacement cost analysis and a market value analysis. The results of this study were presented at the Special Committee's October 30 meeting. Continental determined that the intrinsic value of the NL shares was between $ 13 and $ 20 per share. In addition to this report, Boushka requested that an independent consultant provide a separate analysis concerning future TiO2 prices. Although Boushka did not receive this report prior to the Special Committee's vote on October 30, the consultant appeared to support NL's projections for TiO2 prices.

In hindsight, the price of TiO2 would continue to be much more volatile than either NL's or Continental's predictions. During the late 1980's NL experienced record earnings when TiO2 was in short supply and prices were high. Beginning in 1990 however, prices began to fall as Europe entered into a recession and supply began to catch up with the demand. **[**16]** By year-end 1991, the price of TiO2 had dropped 20% from its high in 1989 and 15% from 1990. As a result, by the end of 1991 NL's profits had turned to losses and it was projected that 1992's operating results would be worse. In fact, in 1992, NL was forced to suspend its dividend as its year-end losses totaled $ 76.44 million. As of the time of the transaction, it was anticipated that world TiO2 prices would not begin to stabilize until 1995-1997.

Valhi's initial proposal to Tremont, made at the October 9 Special Committee meeting, was $ 14.50 per share, with no registration rights or other provisions to enhance the liquidity of the shares. On the previous day NL stock had closed at $ 13 per share. By the October 21 Special Committee meeting, Continental had developed a preliminary estimate of value in the $ 12.50 to $ 23 range. Following this meeting, Stein contacted Snetzer and informed him that some provision to afford liquidity to the buyer of the unregistered shares would be necessary. He also attempted to negotiate a per share price below the $ 14.50 offer. In response, Snetzer suggested Valhi might be willing to lower the **[*428]** asking price below $ 14 into the high $ 13 **[**17]** range. On that day NL stock closed slightly over $ 13 per share.

Stein and Snetzer also met in person to negotiate the non-price terms of the transaction. At the meeting the two discussed solutions to Tremont's liquidity concerns such as registration and co-sale rights, but did not broach the topic of a liquidity discount. Stein also told Snetzer that Tremont would not be willing to consummate a deal near the range suggested by Snetzer -- the low to mid $ 13s. At its October 30 meeting the Special Committee decided to seek a transaction at or below $ 12 5/8 per share. Continental indicated that it would be willing to deliver a fairness opinion supporting this price. Stein then met with Snetzer and offered to purchase the stock for $ 11.25. Eventually it was agreed that the price would be $ 11.75 per share with Valhi receiving a proration of NL's fourth quarter dividend, amounting to $ 800,000. In addition Tremont was to receive the registration and co-sale rights as protection for the limited liquidity of the investment. On this date NL stock closed at $ 12 3/4.

Stein presented the results of his negotiation with Snetzer to the entire Committee which, on October 30, 1991, **[**18]** agreed to recommend the transaction to the entire Tremont board. The Tremont board then met and approved the recommendation of the Special Committee, with the three most interested members of the board (H. Simmons, G. Simmons, and Snetzer) abstaining and the other two members (Martin and Alderton) voting with the Special Committee to provide a quorum.

II

Kahn's attack on both the negotiating process and the resulting price must be evaluated under the standards of Delaware corporate law involving interested transactions by controlling shareholders. In discharging our appellate function, we view the factual findings of the Court of Chancery with considerable deference but exercise *de novo* review concerning the application of legal standards. *See* *Levitt v. Bouvier, Del. Supr., 287 A.2d 671 (1972)*.

Ordinarily, in a challenged transaction involving self-dealing by a controlling shareholder the substantive legal standard is that of entire fairness, with the burden of persuasion resting upon the defendants. [3] *Weinberger v. UOP, Inc., Del. Supr., 457 A.2d 701, 710 (1983)*; *See* *Rosenblatt v. Getty Oil Co., Del. Supr., 493 A.2d 929, 937 (1985)*. The burden, however, may be **[**19]** shifted from the defendants to the plaintiff through the use of a well functioning committee of independent directors. *Kahn v. Lynch Communication Sys., Del. Supr., 638 A.2d 1110, 1117 (1994)*. Regardless of where the burden lies, when a controlling shareholder stands on both sides of the transaction the conduct of the parties will be viewed under the more exacting standard of entire fairness as opposed to the more deferential business judgment standard. *Id. at 1116*.

[3] The Court of Chancery determined that the sale of NL stock to Tremont was an "all in the family" transaction, with Simmons acting as the controlling shareholder of both the buyer and the seller. This ruling was not challenged by the defendants in this appeal.

Entire fairness remains applicable even when an independent committee is utilized because the underlying factors which raise the specter of impropriety can never be completely eradicated and still require careful judicial scrutiny. Weinberger, 457 A.2d at 710. This policy reflects **[**20]** the reality that in a transaction such as the one considered in this appeal, the controlling shareholder will continue to dominate the company regardless of the outcome of the transaction. Citron v. E.I. Du Pont de Nemours & Co., Del. Ch., 584 A.2d 490, 502 (1990). The risk is thus created that those who pass upon the propriety of the transaction might perceive that disapproval may result in retaliation by the controlling shareholder. *Id.* Consequently, even when the transaction is negotiated by a special committee of independent directors no court could be certain whether the transaction fully approximated what truly independent parties would have achieved in an arm's length negotiation. Id. Cognizant of this fact, we have chosen to apply the entire fairness standard to "interested transactions" **[*429]** in order to ensure that all parties to the transaction have fulfilled their fiduciary duties to the corporation and all its shareholders. Kahn, 638 A.2d at 1110.

Having established the appropriate legal standard by which the sale of NL stock will be reviewed, we turn to the issue of which party bears the burden of proof. Delaware has long adhered to the principle that the controlling **[**21]** or dominant shareholder is initially allocated the burden of proving that the transaction was entirely fair. Id. at 1117. In *Rosenblatt,* however, we stated that "approval of a [transaction], as here, by an informed vote of a majority of the minority shareholders, while not a legal prerequisite, shifts the burden of proving the unfairness of the transaction entirely to the plaintiffs." Rosenblatt, 493 A.2d at 937. To obtain the benefit of burden shifting, the controlling shareholder must do more than establish a perfunctory special committee of outside directors. Rabkin v. Olin Corp., Del. Ch., 1990 Del. Ch. LEXIS 50, Chandler, V.C., 1990; *reprinted in* 16 Del. J. Corp. L. 851, 861-62 (1991)., aff'd, *Del. Supr., 586 A.2d 1202 (1990)*. Rather, the committee must function in a manner which indicates that the controlling shareholder did not dictate the terms of the transaction and that the committee exercised real bargaining power "at an arms-length." *Id.*

Here, Tremont, with Valhi's approval, established a Special Committee consisting of three outside directors. In evaluating the composition of Tremont's Special Committee, the Court of Chancery confessed to **[**22]** "having reservations concerning the establishment of the Special Committee and the selection of its advisors." The court's reservations arose from two main concerns. First, Stein was the dominant member of the Special Committee and played a key role in the negotiations. The Chancellor questioned the Special Committee's decision to leave the bulk of the work in the hands of one "who had a long and personally beneficial relationship with Mr. Martin [and Simmons' controlled companies]."

The court's second concern was prompted by its recognition that in complicated financial transactions such as this, professional advisors have the ability to influence directors who are anxious to make the right decision but who are often *in terra cognito.* As the Chancellor noted, "the selection of professional advisors for the Special Committee doesn't give comfort; it raises questions." Notably, Tremont's General Counsel suggested the name of an appropriate legal counsel to the Special Committee, and that individual was promptly retained. The Special Committee chose as its financial advisor a bank which had lucrative past dealings with Simmons-related companies and had been affiliated with Stein **[**23]** trough his employment with a connected bank.

Despite these reservations and the appearance of conflict, the Chancellor concluded that the Special Committee's advisors satisfied their professional obligations to the Special Committee. The Chancellor further concluded that the Special Committee had discharged its duties in an informed and independent manner. These findings were sufficient, in the Chancellor's view, to shift to the plaintiff the burden of proving that the transaction was unfair.

In our view, the Court of Chancery's determination that the Special Committee of Tremont's outside directors was fully informed, active and appropriately simulated an arms length transaction, is not supported by the record. It is clear that Boushka and Stafford abdicated their responsibility as committee members by permitting Stein, the member whose independence was most suspect, to perform the Special Committee's essential functions. In particular, Stafford's absence from all meetings with advisors or fellow committee members, rendered him ill-suited as a defender of the interests of minority shareholders in the dynamics of fast moving negotiations. Similarly, the circumstances surrounding **[**24]** the retaining of the Special Committee's advisors, as well as the advice given cast serious doubt on the effectiveness of the Special Committee.

In our view, the Special Committee established to negotiate the purchase of the block of NL stock did not function independently. All three directors had previous affiliations with Simmons or companies which he controlled and, as a result, received significant **[*430]** financial compensation or influential positions on the boards of Simmons' controlled companies. Of the three directors, Stein was arguably the one most beholden to Simmons. In 1988 Stein was paid $ 10,000 a month as a consultant to NL and received over $ 325,000 in bonuses. The Special Committee's advisors did little to bolster the independence of the principals. The financial advisor, Continental Partners, was recommended by Stein and quickly retained by the full Special Committee. In the past, an affiliate bank of Continental had derived significant fees from Simmons controlled companies and at the time of the transaction was affiliated with Stein's current employer. In addition to being recommended by the General Counsel for NL and Tremont, the Special Committee's legal advisor **[**25]** had previously been retained by Valhi in connection with a convertible debt offering and by NL with respect to a proposed merger with Valhi.

From its inception, the Special Committee failed to operate in a manner which would create the appearance of objectivity in Tremont's decision to purchase the NL stock. As this Court has previously stated in defining director independence: "it is the care, attention and sense of individual responsibility to the performance of one's duties . . . that generally touches on independence." *Aronson v. Lewis, Del. Supr., 473 A.2d 805, 816 (1984)*. The record amply demonstrates that neither Stafford nor Boushka possessed the "care, attention and sense of responsibility" necessary to afford them the status of independent directors. The result was that Stein, arguably the least detached member of the Special Committee, became, *de facto,* a single member committee -- a tenuous role. Stein conducted all negotiations over price and ancillary terms of the proposed purchase with Martin, and did so without the participation of the remaining two directors. "If a single member committee is to be used, the member should, like Caesar's wife, be above reproach." **[**26]** *Lewis v. Fuqua, Del. Ch., 502 A.2d 962, 967 (1985)*.

The record is replete with examples of how the lack of the Special Committee's independence fostered an atmosphere in which the directors were permitted to default on their obligation to remain fully informed. Most notable, was the failure of all three directors to attend the informational meetings with the Special Committee's advisors. These meetings were scheduled so that the Special Committee could explore, through the exchange of ideas with its advisors, the validity of the Valhi proposal and what terms the board should demand in order to make the purchase more beneficial to Tremont. Although Boushka had requested an independent analysis with respect to the future of the TiO2 market, and one was ordered, the report was not read prior to the Special Committee's October 30 vote on the purchase of the NL stock. [4] The failure of the individual directors to fully participate in an active process, severely limited the exchange of ideas and prevented the Special Committee as a whole from acquiring critical knowledge of essential aspects of the purchase. In sum, we conclude that the Special Committee did not operate in a manner **[**27]** which entitled the defendants to shift from themselves the burden which encumbers a controlled transaction. *Accord* *Kahn, 638 A.2d at 1110*.

III

Although our invalidation of the role of the Independent Committee requires a remand for an entire fairness determination with the burden shifted, Kahn has asserted certain claims of "unfair dealing" which we address for the guidance of the parties and the Court of Chancery.

In *Weinberger* this Court stated that the test of fairness has two aspects: fair price and fair dealing. *Weinberger, 457 A.2d at 711*. See **[**28]** *also* *Cinerama v. Technicolor, Inc., Del. Supr., 663 A.2d 1156 (1995)*. The element of "fair dealing" focuses upon the conduct of the corporate fiduciaries in effectuating the transaction. These concerns include **[*431]** how the purchase was initiated, negotiated structured and the manner in which director approval was obtained. *Mills Acquisition Co. v. Macmillan, Inc., Del. Supr., 559 A.2d 1261, 1280 (1988)*. The price element relates to the economic and financial considerations relied upon when valuing the proposed purchase including: assets, market values, future prospects, earnings, and other factors which effect the intrinsic value of the transaction. *Weinberger, 457 A.2d at 711*. This Court and the Court of Chancery have

[4] This report takes on particular significance in light of the fact that Continental in evaluating Valhi's proposal, had relied upon NL's pricing forecast for TiO2. Without the benefit of this independent analysis, the directors, as buyers, relied solely on the projections of NL, the seller. Indeed, Stafford was not aware of the need for a third party analysis because he erroneously thought that Continental had made its own independent forecast.

historically applied this heightened standard to ensure that individuals who purport to act as fiduciaries in the face of conflicting loyalties exercise their authority in light of what is best for all entities. Id.

Kahn alleges the Court of Chancery erred in several respects in its entire fairness analysis. As to the fair dealing component Kahn argues that: (1) the initiation and the timing of the purchase were unfair; (2) the Special Committee's performance **[**29]** was deficient to an extent that it compromised the integrity of the negotiation process: and (3) Valhi failed to make material disclosures to Tremont. We address only the initiation and timing claim and the disclosure claim as they may find application in any proceedings on remand.

A.

In evaluating the fair dealing component of the transaction, the Court of Chancery determined that the initiation and timing of the purchase was not prejudicial to Tremont. Although the purchase was initiated and timed by Simmons-controlled Valhi, the court found this to be unimportant when considering the nature of the transaction, i.e., a straightforward purchase of a block of stock. Valhi's decision to offer the stock to Tremont was predicated on its desire to obtain over $ 11 million in tax benefits. This fact was fully disclosed and explained to the Special Committee which arguably bargained to share in those benefits. The record supports the Chancellor's conclusion that the Committee was afforded adequate time to fully consider Valhi's proposal and to assess its merits. Snetzer, Valhi's president, first proposed the transaction to Tremont in September of 1991 and indicated Valhi's need to conclude **[**30]** the purchase by the end of that calendar year. Although the Tremont board did not take advantage of the entire time period provided under the terms of Valhi's offer they were afforded sufficient time to consider the proposal.

Initiation by the seller, standing alone, is not incompatible with the concept of fair dealing so long as the controlling shareholder does not gain financial advantage at the expense of the controlled company. *Kahn v. Lynch Communication Sys., Del. Supr., 669 A.2d 79, 85 (1995)*. While Valhi obtained a significant financial advantage in the timing of the purchase it did not do so at the expense of Tremont. We conclude that there is ample support in the record for the Court of Chancery's finding that the initiation and timing of the transaction was not unfair to Tremont.

B.

With respect to the disclosure issue, Kahn argues that Valhi was required to disclose that two previous companies had rejected an offer to purchase the block of NL stock and that Salomon Brothers had issued an informal opinion which opined that a 20% or greater illiquidity discount from market would be required in order to conclude a sale. In evaluating this claim the Court of Chancery **[**31]** correctly stated that "[a] controlling shareholder … must disclose fully all material facts and circumstances surrounding the transaction." *Kahn, 669 A.2d at 88*. This standard of disclosure is not unlike that adopted by this Court in defining the level of disclosure necessary where shareholder action is implicated. "An omitted fact is material if there is a substantial likelihood that, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder." *Rosenblatt, 493 A.2d at 944* (quoting *TSC Industries v. Northway, 426 U.S. 438, 449, 48 L. Ed. 2d 757, 96 S. Ct. 2126 (1976)*.

Applying the materiality standard, the Court of Chancery determined that the decisions of RCM Capital and Keystone not to purchase the block of NL stock from Valhi were not material. The court noted that **[*432]** their reasons for not wanting to purchase the stock were simply the general concerns that any potential purchaser would have reason to know without specific disclosure; "namely, that the purchaser would own a minority share in a company that it did not control and that the market might react negatively when it learned that a principal stockholder (Valhi) was selling shares." Kahn's argument **[**32]** as to the materiality of this information is further undercut by the fact that Valhi never reached the stage of discussing price or terms with either of the potential buyers. Thus, disinterest of third parties was clearly not the type of information required to be disclosed. We find the Court of Chancery's analysis as to the disclosure of RCM Capitol's and Keystone's decisions not to pursue a purchase with Valhi to be supported by the record.

Kahn's second disclosure argument concerns Salomon Brother's advice to Valhi concerning an appropriate illiquidity discount. Although questioning the significance of this information the Chancellor for analysis purposes, assumed that the Salomon opinion would have been material to the Special Committee. The court went on to conclude, however, that, even if material, this information fell within a "narrow residual category of privileged information" which did not need to be disclosed. The Chancellor speculated that if the device of the independent committee is to effectively replicate an arms-length negotiation this information cannot be required to be disclosed by a seller.

We do not adopt the court's conclusion that the Salomon opinion falls **[**33]** within a category of "privileged" information. We find no authority in Delaware or elsewhere, and counsel for defendants can point to none, which supports the Chancellor's decision to carve out a "privilege" exception to the materiality standard [5]. Under the facts here present, we find Valhi had no duty to disclose information which might be adverse to its interests because the normal standards of arms-length bargaining do not mandate a disclosure of weaknesses. The significance of the illiquidity discount to this transaction lies not in whether Valhi had a duty to disclose it but whether an informed independent committee had a duty to discover it.

[34]** IV

Although the Chancellor made extensive findings incident to his fair price analysis he did so in a procedural construct which required Kahn to prove unfairness of price. In resolving issues of valuation the Court of Chancery undertakes a mixed determination of law and fact. *Kahn v. Household Acquisition Corp. Del. Supr., 591 A.2d 166, 175 (1991)*. We recognize the thoroughness of the Chancellor's fair price analysis and the considerable deference due his selection from among the various methodologies offered by competing experts. *Lynch Communications, 669 A.2d at 87*. But here, the process is so intertwined with price that under *Weinberger's* unitary standard a finding that the price negotiated by the Special Committee might have been fair does not save the result. *Cf.* *Lynch Communication Systems, 669 A.2d 79*.

Arguably as the Chancellor found, the resulting price might be deemed to be at the lowest level in a broad range of fairness. But this does not satisfy the *Weinberger* test. Although often applied as a bifurcated or disjunctive test, the concept of entire fairness requires the court to examine all aspects of the transaction in an effort to determine whether **[**35]** the deal was entirely fair. *Weinberger, 457 A.2d at 711*. When assigned the burden of persuasion, this test obligates the directors or their surrogates, to present evidence which demonstrates that the cumulative manner by which it discharged all of its fiduciary duties produced a fair transaction. *Cinerama, 663 A.2d at 1163*.

In our recent decision in *Kahn v. Lynch Communications,* we were confronted with a situation in which the actions of the majority **[*433]** shareholder dominated the negotiation process and stripped the independent committee of its ability to negotiate in an arms-length manner. After concluding that the Court of Chancery erred in shifting the burden of proof with regard to entire fairness to the controlling shareholder, we remand the matter to the Court of Chancery for "a redetermination of the entire fairness . . . with the burden of proof remaining on Alcatel, the dominant and interested shareholder." *Kahn, 638 A.2d at 1122*. A similar course is appropriate here, it is the responsibility of the Court of Chancery to make the requisite factual determinations under the appropriate standards, which underlie the concept of entire fairness. Whether the defendants **[**36]** shouldering the burden of proof will be able to demonstrate entire fairness is in the first instance, a task committed to the Chancellor.

In the event, the Court of Chancery determines that the defendants have not demonstrated the entire fairness of the disputed transaction we assume that it will grant appropriate relief within its broad equitable authority. *Weinberger, 457 A.2d 701 at 714*.

* * * *

REVERSED and REMANDED.

Concur by: QUILLEN

Concur

QUILLEN, Judge, concurring.

With regard to the burden of proof on the issue of fairness, I concur in the decision reached by Justice Walsh in his excellent opinion, in my opinion, the burden of proof in the case clearly should *not* shift from the defendants to the plaintiff on the issue of fairness. Somewhat ironically, in reaching this conclusion I do not find it necessary to go beyond the basic facts as found by the Chancellor. See *Kahn v. Tremont Corp., et al., Del. Ch., 1996 Del. Ch. LEXIS 40*, Allen, C. (1996, *revised* Mar. 27, 1996) (herein referred to as *"Op.*

[5] If disclosure is required under the materiality test, information can be withheld only under a recognized claim of privilege. This Court has previously held the relationship between a corporation and its attorney to be such a recognized privilege. *Zirn v. VLI Corp., Del. Supr., 621 A.2d 773, 781 (1993)* *(citing* *UpJohn Co. v. United States, 449 U.S. 383, 66 L. Ed. 2d 584, 101 S. Ct. 677 (1981))*.

Below"). I also concur with Justice Walsh's opinion and decision that the initiation and timing of the purchase were not prejudicial to Tremont Corporation and his further **[**37]** opinion and decisions on the disclosure issues. As to these latter two points, which essentially affirm the Chancellor, I merely note that the Court appears unanimous.

This case is a derivative suit wherein the plaintiff, a stockholder of Tremont Corporation ("Tremont"), alleges that Tremont paid too much for 15% of the stock of NL Industries, Inc. ("NL") in a purchase from Valhi Corporation ("Valhi") through an unfair process. Valhi, controlled by Harold Simmons, itself owned 44.4% of Tremont and 62.5% of NL. The burden of proof on the issue of fairness turns on the independence of Tremont's Special Committee ("Committee") which recommended the purchase. Justice Walsh has ably reviewed the facts and his recitation is more than sufficient context for this modest endeavor.

I accept the Chancellor's statement of the nature of the proceedings and the facts of the case. *Op. Below* 1-15. I also accept the Chancellor's conclusion in his strongest remark of several, that it is "perfectly appropriate in the circumstances" for Tremont to use its cash reserves to buy stock of NL. *Op. Below* 48-49. It is indeed important the law not "chill" transactions between related companies that **[**38]** can be mutually productive and beneficial to society. See *Op. Below 3.* As noted above, while I join in the reversal, I rely on the Chancellor's findings of basic fact to reach my own conclusion on the burden of proof. Although the same evidence can relate to both the issue of Committee independence and the issue of fairness, the issue of this Committee's independence in this peculiar factual context requires a separate focus from the ultimate issue of entire fairness.

The Chancellor's opinion found: a parent-subsidiary transaction existed, "the context in which the greatest risk of undetectable bias may be present" *(Op. Below* 17-18); Committee member Avy H. Stein who had prior profitable connections to Harold Simmons and his companies played the lead Committee role *(Op. Below* 19, including n.12); Mr. Stein suggested the selection of a financial adviser for the Committee who had prior ties to both Mr. Stein and Mr. Simmons *(Op. Below* 9-10 including n.5 and n.6, and 19-20); the suggestion for the Committee's legal advisors came from Tremont's General Counsel *(Op. Below* 9-10, including n.5 and n.6, and 19-20); NL, in the thirteen months prior to the subject transaction, **[**39]** repurchased **[*434]** over 20% of its own shares at least raising an issue of manipulated price inflation *(Op. Below* 5-7); this transaction by Valhi, probably not available in 1991 with a non-Simmons enterprise, was a multi-million dollar one for Valhi from a tax savings standpoint and had to be accomplished in the last quarter of 1991 *(Op. Below* 7-8); Valhi's chief negotiator knew that an illiquidity discount was appropriate and the block was in fact worth less than market *(Op. Below* 8, 24); in a very short period NL's stock price fell from over $ 16 per share in late summer 1991 to $ 12.75 on the date of the purchase October 30, 1991, at least raising the question of business viability *Op. Below* 6-7, 12-24); the Committee relied heavily on regularly prepared projections of NL's management with incomplete help from its own consultant *(Op. Below* 11-12, 31-32); notwithstanding knowledge of the appropriateness of a discount, Valhi's first negotiating suggestion was a premium price and the results of the Committee's negotiations on other issues, splitting the fourth quarter dividend and registration and co-sale rights are not self-verifying on the independence issue *(Op.* **[**40]** *Below* 1, 13-14 including n.8); and the price, as finally negotiated, was found to be "as small a discount as could be accepted as fair," a finding that hardly forecloses questions as to independence *(Op. Below* 33).

In light of the above-enumerated factors, the independence of the Special Committee, integrity in a process sense was clearly not substantial enough to shift the burden of persuasion to the plaintiff on the issue of fairness. To me, the case cries for Missouri skepticism; the burden should be on the control group to demonstrate entire fairness. While it can be of critical importance to the ultimate result whether or not the burden is shifted, failure to shift the burden is not necessarily outcome determinative. Compare *Nixon v. Blackwell, Del. Supr., 626 A.2d 1366, 1376, 1381 (1993)*. Justice Walsh's decision appropriately remands the case to the Court of Chancery for the requisite factual determinations.

As to remedy, if any proves to be appropriate, I join Justice Walsh's opinion that all options are open to the Chancellor's discretion. *Lynch v. Vickers Energy Corp., Del. Supr., 429 A.2d 497, 507-08 (1981)* Quillen dissenting); *Weinberger, 457 A.2d 701 at **[**41]** 703-04*.

Dissent by: BERGER

Dissent

BERGER, Justice, with whom RIDGELY, President Judge, joins dissenting.

The majority's thorough and well reasoned decision reverses the trial court's equally thorough and well reasoned decision. According to the majority, the Court of Chancery did not err in its legal analysis but in its evaluation of the facts -- particularly with respect to the Special Committee members' independence, level of knowledge and involvement in the negotiations. The trial court recognized these issues and was satisfied, after six days of trial, that the Special Committee members were informed, active and loyal to the interests of Tremont. That finding is supported by the record and should be accorded deference. I respectfully dissent.

Lewis v. Fuqua

Court of Chancery of Delaware, New Castle

June 21, 1985, Submitted ; November 12, 1985, Decided

Civil Action No. 7188

Reporter

502 A.2d 962 *; 1985 Del. Ch. LEXIS 547 **

HARRY B. LEWIS, Plaintiff, v. J. B. FUQUA, et al, Defendants

Subsequent History: [1]** Revised November 14, 1985.

Prior History: On defendants' motion to dismiss in response to the recommendation of a special litigation committee.

Disposition: DENIED.

Counsel: Joseph A. Rosenthal, Esquire, and Norman M. Monhait, Esquire, Morris And Rosenthal, P.A., Wilmington, and Of Counsel: Steven Oestreich, Esquire, Wolf, Popper, Ross, Wolf & Jones, New York, New York, Attorneys for Plaintiff.

A. Gilchrist Sparks, III, Esquire, and Michael Houghton, Esquire, Morris, Nichols, Arsht & Tunnell, Wilmington, Of Counsel: Collin Brown, Esquire, Attorneys for Defendants.

E. Norman Veasey, Esquire, Richards, Layton & Finger, Wilmington, Attorney for Defendants.

Judges: Hartnett, Vice Chancellor.

Opinion by: HARTNETT

Opinion

[*964] The corporate defendant, Fuqua Industries, Inc., moved to dismiss this stockholder derivative action pursuant to a recommendation of a Special Litigation Committee appointed by the Board of the corporation to inquire into the validity of the claims set forth in the Complaint. The motion must be denied because the movant has neither borne its burden of showing that the Special Litigation Committee was independent nor that the Committee established a reasonable basis for its conclusions. **[**2]** Nor would dismissal of the suit at this juncture be in the best interests of the corporation.

I

Harry Lewis, the plaintiff, a shareholder of Fuqua Industries, Inc., a Delaware corporation, filed this stockholder derivative action on behalf of the corporation alleging the usurpation of a corporate opportunity by the individual defendants. Mr. Lewis alleged that J. B. Fuqua, Chairman of the Board and Chief Executive Officer of Fuqua Industries, along with thirteen of the other fourteen individual defendants breached their fiduciary duty to the corporation by diverting a valuable corporate opportunity to themselves. The plaintiff made no pre-suit demand on the Board of Directors of the corporation to bring an action to redress the alleged wrongs but alleged in his Complaint that any pre-suit demand on the Board of Fuqua Industries, pursuant to Chancery Rule 21.1, was excused because it would have been futile.

The Complaint alleged that J. B. Fuqua diverted an opportunity to purchase stock in the Triton Group Limited ("Triton") from Fuqua Industries, Inc. to himself and fourteen other individual defendants -- thirteen of whom are present or former directors or officers of the corporation, **[**3]** or both. Triton is a Delaware holding company whose primary assets are a $160 million ($2.59 per share) tax loss, two real estate projects and some cash. Triton had two classes of stock outstanding, both of which were publicly traded: Triton Common Stock, and Triton Series A Convertible Preferred Stock. The Triton Preferred Stock carried voting rights and each share was convertible into 24.5 shares of Triton Common Stock. In the fall of 1982 Fuqua Industries became interested in Triton and began discussions with American Financial Corporation ("AFC") about acquiring AFC's interest in Triton. AFC was Triton's largest shareholder at this time. Fuqua Industries' interest in Triton centered around Triton's substantial tax loss which could be carried forward and its intention was to acquire one or more profitably operating companies and then use Triton's tax loss carry-forward to shelter the future earnings of these acquisitions from income taxes. Fuqua Industries was hopeful that it could duplicate the success it had in the past with a similar investment -- the acquisition of Pier 1 corporation. AFC's ownership in Triton included both Triton Common and Preferred Stock.

On March **[**4]** 3, 1983, discussions between Fuqua Industries and AFC culminated in the purchase of 425,365 shares of Triton Preferred Stock from AFC by Fuqua Industries at an equivalent price of $ .45 per share. Prior to this purchase, on February **[*965]** 25, 1983, Mr. J. B. Fuqua purchased from AFC 2 million shares of Triton Common Stock. On March 7, 1983, fourteen of the other individual defendants -- upon the solicitation of J. B. Fuqua -- purchased AFC's remaining 1,260,450 shares of Triton Common Stock. All of the AFC Triton Common Stock in question was purchased at a price of $ .45 per share. The end result of these transactions was that Fuqua Industries acquired all of AFC's Triton Preferred Stock and J. B. Fuqua and other individual defendants acquired all of AFC's Triton Common Stock.

After this sale AFC suggested that in order to assure a more orderly change in control of Triton, someone should also buy out the interest of Anthony B. Walsh in Triton. Mr. Walsh, along with two other persons allied with him, occupied three seats on Triton's Board of Directors. In response to AFC's suggestion, J. B. Fuqua caused Fuqua Industries to purchase the Walsh Block's shares of Triton at **[**5]** a price equal to $ .30 more per share than was paid to AFC for its stock in Triton. The Walsh Block included 79,420 shares of Triton Preferred Stock and 315,780 shares of Triton Common Stock (1.1% of the outstanding Triton Common Stock). Following the purchase of the Walsh Block, Mr. Walsh and the two other directors aligned with him resigned from Triton's Board of Directors. J. B. Fuqua, thereupon, became the Chairman of Triton's Board of Directors, naming two nominees to fill the two remaining seats. The Board of Fuqua Industries never formally rejected the opportunity of the corporation to purchase the Common Stock shares of Triton owned by AFC.

II

Plaintiff contends that the purchase of the Triton Common Stock by J. B. Fuqua and the other individual defendants amounted to the usurpation of a corporate opportunity which belonged to Fuqua Industries, Inc. The Complaint alleged that Fuqua Industries never abandoned its interest in acquiring Triton Common Stock, nor did the Board of Directors of the corporation formally reject the opportunity of the corporation to purchase the Triton Common Stock on behalf of Fuqua Industries. In response to these allegations in the Complaint, **[**6]** the Board of Directors of Fuqua Industries formed a Special Litigation Committee of one person to review the merits of plaintiff's claims.

The Board of Directors named Terry Sanford as the single member Committee. Mr. Sanford, although a member of the Board of Directors of Fuqua Industries, had not participated in the purchase of the Triton stock. He was, however, named as a defendant in this action and was a member of the Board at the time of the alleged wrongs. Mr. Sanford, who is well known nationally, has had a distinguished career, including being President of Duke University and Governor of North Carolina. Through his affiliation with Duke University and his extensive political career, Mr. Sanford has had numerous contacts with J. B. Fuqua. J. B. Fuqua, in turn, has made several contributions to Duke University and is presently a Trustee of the University.

The Sanford Committee, along with its counsel -- the distinguished law firm of Rogers and Hardin -- employed an array of methods to gather the information upon which to base the conclusions of the Committee. In its investigation, the Sanford Committee and its counsel reviewed the pleadings and numerous documents and **[**7]** interviewed many people whom the Committee thought could provide relevant information, taking four and a half months to perform its investigation. During this time Mr. Sanford kept in touch with the Committee's counsel through telephone conferences and three personal meetings. The final result of the Sanford Committee investigation, not surprisingly, was a recommendation that Fuqua Industries not pursue any legal action against any present or former officer or director of the Company or any of its wholly owned subsidiaries and **[*966]** that the corporation seek to have the suit dismissed.

III

The Delaware Supreme Court in *Zapata v. Maldonado, Del. Supr., 430 A.2d 779 (1981)* set forth a procedure for Court review of a report of a Special Litigation Committee appointed to review a stockholder's derivative suit where the committee recommends that a motion to dismiss suit be filed.

A motion to dismiss brought in response to a report of a

Special Litigation Committee is a hybrid motion created by *Zapata* which takes qualities from a Chancery Rule 41(a)(2) motion to dismiss and a Chancery Rule 56 motion for summary judgment.

According to the *Zapata* Court:

> "After an **[**8]** objective and thorough investigation of a derivative suit, an independent committee may cause its corporation to file a pretrial motion to dismiss in the Court of Chancery. The basis of the motion is the best interests of the corporation, as determined by the committee. The motion should include a thorough written record of the investigation and its findings and recommendations. Under appropriate Court supervision, akin to proceedings on summary judgment, each side should have an opportunity to make a record on the motion. As to the limited issues presented by the motion noted below, the moving party should be prepared to meet the normal burden under Rule 56 that there is no genuine issue as to any material fact and that the moving party is entitled to dismiss as a matter of law. The Court should apply a two-step test to the motion.
>
> First, the Court should inquire into the independence and good faith of the committee and the bases supporting its conclusions. Limited discovery may be ordered to facilitate such inquiries. The corporation should have the burden of proving independence, good faith and a reasonable investigation, rather than presuming independence, good faith and **[**9]** reasonableness. If the Court determines either that the committee is not independent or has not shown reasonable bases for its conclusions, or, if the Court is not satisfied for other reasons relating to the process, including but not limited to the good faith of the committee, the Court shall deny the corporation's motion. If, however, the Court is satisfied under Rule 56 standards that the committee was independent and showed reasonable bases for good faith findings and recommendations, the Court may proceed, in its discretion, to the next step." 430 A.2d at 788 (citations omitted)

IV

The first matter to be considered, therefore, is whether the moving parties have sustained their burden of showing that the Special Litigation Committee was independent. As set forth in *Zapata*, in making that determination I must apply Chancery Rule 56 standards. The standard for a Rule 56 motion for summary judgment is that the movant has the burden of demonstrating the absence of any material issue of fact, and any doubt as to the existence of such an issue will be resolved against him. Nash v. Connell, Del. Ch., 34 Del. Ch. 20, 99 A.2d 242 (1953); Brown v. Ocean Drilling & Exploration **[**10]** Co., Del. Supr., 403 A.2d 1114 (1979).

Unlike in Kaplan v. Wyatt, Del. Ch., 484 A.2d 501 (1984), *aff'd.*, Del. Supr., 499 A.2d 1184 (1985), where the Special Litigation Committee consisted of two members, the Committee here consisted of but one person -- Terry Sanford. Although Mr. Sanford is well renowned, there are circumstances which must lead the Court to have questions as to his independence. He was a member of the Board of Directors of Fuqua Industries at the time the challenged actions took place; he is one of the defendants in this suit; he has had numerous political and financial dealings with J. B. Fuqua who is the chief executive officer **[*967]** of Fuqua Industries and who allegedly controls the Board; he is President of Duke University which is a recent recipient of a $10 million pledge from Fuqua Industries and J. B. Fuqua; and J. B. Fuqua has, in the past, made several contributions to Duke University and is a Trustee of that University.

These potential conflicts of interest or divided loyalties, when considered as a whole, raise a question of fact as to whether Terry Sanford could act independently. This is not to say that he actually acted improperly, **[**11]** but I find that the moving party has not borne its burden of showing the absence of any possible issue of fact material to the issue of the independence of Mr. Sanford. See Warshaw v. Calhoun, Del. Ch., 42 Del. Ch. 437, 213 A.2d 539 (1965), *aff'd.*, Del. Supr., 43 Del. Ch. 148, 221 A.2d 487 (1966).

The only instance in American Jurisprudence where a defendant can free itself from a suit by merely appointing a committee to review the allegations of the complaint is in the context of a stockholder derivative suit. A defendant who desires to avail itself of this unique power to self destruct a suit brought against it ought to make certain that the Special Litigation Committee is truly independent. If a single member committee is to be used, the member should, like Caesar's wife, be above reproach.

Terry Sanford is, unfortunately, the sole member of the

Committee. His past and present associations raise a question of fact as to his independence. This alone is grounds to deny the motion to dismiss under the first test set forth in *Zapata*.

V

Although not necessary to do so in view of my holding that there is a question of fact as to whether the Special Litigation Committee **[**12]** was independent, I will also consider the issue of the reasonableness of the investigation by the Sanford Committee, and the reasonableness of the basis for the findings and recommendations of the Committee. *Kaplan v. Wyatt, Del. Ch., 484 A.2d 501, 508 (1984)*, *aff'd.*, *Del. Supr., 499 A.2d 1184 (1985)*.

I find that the Sanford Committee addressed all the issues presented in the complaint and also researched an additional issue of whether the Company's directors had a personal interest in the challenged transaction. The investigation spanned four and a half months and was thorough and exhaustive as to all possible claims for recovery. I therefore find that the investigation conducted by the Committee was reasonable.

The plaintiff also attacks the reasonableness of the basis of the Sanford Committee's conclusions. I find that the movant has not borne its burden of establishing a reasonable basis for the conclusions of the Sanford Committee.

VI

The Sanford Committee investigation focused on two possible theories of recovery by plaintiff: a corporate opportunity theory and an interested director theory. As to the corporate opportunity theory, the Committee concluded that, **[**13]** under applicable Delaware law, the opportunity to purchase Triton Common Stock was not a corporate opportunity at all, but instead an opportunity which the individuals were entitled to treat as their own. As will be seen, the conclusion reached by the Committee on this issue is flawed and therefore did not have a reasonable basis.

A.

In determining the possible existence of a corporate opportunity the Sanford Committee recognized three possible tests: (1) the expectancy test, (2) the line of business test, and (3) the fairness test. Claiming that the application of any of these tests by this Court has been varying and imprecise, the Sanford Committee chose to find that the most often used test is the fairness test. In reviewing the fairness test, as it applies to the challenged transaction, the **[*968]** Sanford Committee pinpointed a so-called "Delaware Variation". It found that the initial formulation of the fairness test was announced in *Guth v. Loft, Del. Supr., 23 Del. Ch. 255, 5 A.2d 503 (1939)*. The Sanford Committee, however, decided that later Delaware cases have modified the *Guth* fairness test so that, in its view, it is no longer necessary to consider whether **[**14]** an opportunity came to the attention of a corporate manager or director in his individual or corporate capacity. See, *Science Accessories v. Summagraphics, Del. Supr., 425 A.2d 957, 963 (1980)*. The Sanford Committee therefore decided that four elements now must be considered in determining the existence of a corporate opportunity under the fairness test: (1) the "interest or expectancy" test, also called the "essential" test; (2) the "line of business" test; (3) the "practical advantage" test; and (4) the "use of corporate resources" test. The Sanford Committee concluded that none of the elements necessary as to these four tests were present in the challenged transaction and, therefore, no corporate opportunity existed to have been diverted.

B.

In the application of the first so-called "interest or expectancy" test to determine whether a corporate opportunity existed at all, the Sanford Committee found that the opportunity to purchase Triton Common Stock was not essential to Fuqua Industries, nor did the failure to purchase Triton Common Stock cause any affirmative harm to the Corporation. The Sanford Committee concluded that when the directors decided to purchase the Triton **[**15]** Common Stock for themselves, the corporation had no contractual right to purchase the stock and, therefore, had no present interest in the purchase of the stock. The Sanford Committee also decided that Fuqua Industries ceased to have an expectancy in the purchase of the Triton Common Stock because although the corporation had an apparent expectancy in the purchase of the stock, it had rejected the opportunity -- thus negating its expectancy.

The Sanford Committee did concede, however, a necessity for a scrutiny of Fuqua Industries' alleged decision not to purchase the Triton Common Stock because the decision was made by the very people who ultimately bought the stock. The Sanford Committee decided, however, that because the Board of Fuqua Industries had rejected the opportunity to purchase the stock on behalf of the corporation before the directors decided to purchase the stock for themselves, the directors were disinterested when they voted to reject the purchase. The Sanford Committee therefore found that a court would scrutinize the decision not to purchase the stock for the corporation under the business judgment test as opposed to the much more burdensome intrinsic fairness **[**16]** test.

By relying on the business judgment test, the Sanford Committee concluded that the directors had a valid business reason for rejecting the opportunity to purchase the Triton Common Stock: the fear of adverse consequences in the reflection of Triton's losses on Fuqua Industries' financial statement. The Sanford Committee therefore concluded that there was no identifiable corporate opportunity under the first "interest", "expectancy", or "essential" test.

Even assuming, arguendo, that the Sanford Committee was correct and the rule of *Guth* has been modified, the conclusions of the Committee ignore the fact that no Delaware court has yet gone so far as to extend the protection of the business judgment rule to a transaction in which the directors who are passing on the transaction have a conflict of interest or divided loyalties. Cf. *Pogostin v. Rice, Del. Supr., 480 A.2d 619 (1984)*; *Aronson v. Lewis, Del. Supr., 473 A.2d 805 (1984)*; *Weinberger v. UOP, Del. Supr., 457 A.2d 701 (1983)*. It also ignores the fact that it is undisputed that the Board never formally rejected the opportunity and it is a question of fact as to whether the Board actually so agreed. **[*969]** **[**17]** This conclusion of the Sanford Committee therefore did not have a reasonable basis.

C.

The Sanford Committee's analysis of the other three tests to determine if a corporate opportunity existed, also led the Committee to conclude that there was none. In the application of the second or so-called "line of business" test the Sanford Committee conceded that the opportunity to purchase the Triton Common Stock was in Fuqua Industries' line of business. The Committee, however, interpreted case law as suggesting that if there is evidence of a company policy against acquiring a particular opportunity it will negate a finding that the opportunity was in the corporation's line of business. See, e.g., *Equity Corp. v. Milton, 221 A.2d 494, 497 (1966)*; *American Investment Co. v. Lichtenstein, E.D. Mo., 134 F. Supp. 857 (1959)* (applying Delaware law).

The Sanford Committee found that Fuqua Industries would have to put Triton's losses on its financial statement, if it acquired any Triton Common Stock, and that this was inconsistent with Fuqua's then policy of maintaining a high earnings profile. This inconsistent policy, in the view of the Sanford Committee, negated the fact that the **[**18]** opportunity to purchase the Triton Common Stock was in Fuqua Industries' line of business. In all the cases cited by the Committee in support of that proposition, however, the Corporations involved were able to show that they had actually turned down a chance to realize a similar prior opportunity. Here, Fuqua Industries had not only not turned down a similar opportunity; it had actually exploited a similar opportunity in the Pier 1 acquisition. As will be discussed, there is also a factual question as to whether Triton's losses would have to be shown on Fuqua Industries' Financial Statement. The Sanford Committee has therefore not borne its burden of showing that its conclusion on this issue had a reasonable basis.

D.

The Sanford Committee further concluded, in analyzing the third so-called "practical advantage" test to determine if a corporate opportunity existed, that the acquisition of the Triton Common Stock would not have been a practical advantage to Fuqua Industries. In making this determination, the Sanford Committee cited *Equity Corp., supra*, for the proposition that one must take a short term view in determining the practical advantage to the Corporation. The **[**19]** Committee decided that the application of this principle to the challenged transaction showed that the placement of Triton's losses on Fuqua Industries' financial statements would have hampered the Company's high earnings profile and would therefore have been a short term disadvantage. There is a factual question, however, as to whether Triton's losses would have had to have been shown on Fuqua Industries financial statements. Plaintiff calls attention to Accounting Principles Board Opinion No. 18 which appears to require a corporation which holds 20% or more of the voting stock of an investee company to place the losses of the investee company on its books only in proportion to its share of the investee company's common stock. Plaintiff argues that if Fuqua Industries had purchased the common stock of Triton which the directors ended up purchasing for themselves, Fuqua Industries would have had over 20% of the voting stock of Triton (Triton Preferred Stock has voting rights), but it would have owned only 1.1% of Triton's common stock. Plaintiff therefore argues that Fuqua Industries would only have had to place 1.1% of Triton's losses on its financial statement. Plaintiff has, **[**20]** therefore, raised a question of fact as to whether the purchase of all the available Triton stock by Fuqua Industries would have had an undesirable effect on Fuqua Industries Financial Statements. The Sanford Committee has, therefore, not borne its burden of showing that its conclusion on this issue had a reasonable basis.

[*970] E.

Finally, in addressing the fourth so-called "use of corporate resources" test to determine if a corporate opportunity existed, the Sanford Committee found no showing that defendants used any corporate funds in acquiring the opportunity, or that there was any abusive use of corporate resources. The Committee was undoubtedly correct in its finding that no corporate funds were used by the directors when they purchased the Triton stock for themselves but this is not dispositive as to whether a corporate opportunity existed.

VII

The Sanford Committee next addressed the second possible theory of recovery -- the interested director issue. This theory of recovery focuses on the Walsh Block transaction in which Fuqua Industries purchased Triton Common and Preferred Stock at $ .30 more per share than paid by the individual defendants. In regard to this **[**21]** interested director issue, the Committee recognized three separate tests of liability: (1) a test based on *Section 144* of the Delaware General Corporation Law (*8 Del. C. § 144*); (2) the business judgment test; and (3) the intrinsic fairness test.

A.

Title 8, § 144, Del. C. provides that if a majority of disinterested directors approve a transaction after full disclosure of all material facts as to such transaction the transaction cannot be challenged. The Sanford Committee conceded that *8 Del. C. § 144* was not applicable here, however, because, although the transaction may have been approved, the approval did not take place at a formal Board meeting or necessarily after full disclosure of all material facts. In the eyes of the Sanford Committee, therefore, the business judgment rule test and the intrinsic fairness rule test were the only viable tests which could be used.

B.

The business judgment rule would only be applicable, however, if there was a majority of disinterested directors and there had been no domination of the Board by one or more directors. Conversely, the intrinsic fairness test must be used if there was a majority of interested directors or a **[**22]** dominating director. The significant difference between the two tests is who has the burden of proof. Cf. *Schreiber v. Pennzoil Co., Del. Ch., 419 A.2d 952 (1980)*.

The Sanford Committee decided that a determination of whether the AFC and Walsh deals were one or two separate transactions would govern whether a court would deem the directors to have been free of conflict of interest or not. The Sanford Committee never specifically addressed the question of domination but merely opined that if the AFC and Walsh deals were treated as two separate transactions, then the Fuqua Industries directors would not have had any conflict of interest, and therefore, the Court would apply the business judgment rule. To the contrary, the Sanford Committee at least impliedly conceded that if the Court treated the AFC and Walsh deals as one transaction then the defendants would appear to have been personally interested in the transaction and the Court would apply the intrinsic fairness test. From a review of facts, it seems likely that the AFC and Walsh transactions were interrelated and not separate transactions. By the Committee's own analysis, therefore, the appropriate test would be the **[**23]** intrinsic fairness test. The Committee's conclusion on this issue, therefore, did not have a reasonable basis.

C.

The possible application of the intrinsic fairness test itself presents problems for the directors, as the Sanford Committee conceded. The Sanford Committee's analysis of Delaware case law uncovered two primary points of focus the Committee believed a Court would use in applying the **[*971]** intrinsic fairness test to the challenged transactions: (1) the profit motive of the interested directors or (2) the intrinsic fairness of the transaction to the Corporation. The Sanford Committee conceded that, as the individual defendants surely entered into the transaction with a profit motive in mind, the profit motive point of focus presented the more probable chance of recovery for the plaintiffs. After deciding that $ .75 per share was a fair price for the Triton stock, the Sanford Committee concluded that the intrinsic fairness of the transaction to Fuqua Industries made recovery by the plaintiff less probable.

The value of the Triton stock is debatable, however, and the Committee, therefore, has not borne its burden of showing that $ .75 was a fair price for the Triton **[**24]** stock and that its conclusion on this issue had a reasonable basis.

D.

In concluding its analysis of the interested director issue, the Sanford Committee decided that there would be little chance of recovery for plaintiff if the Court found the directors to be disinterested and therefore applied the business judgment rule. The Sanford Committee conceded, however, that if the Court found the directors to be interested and applied the intrinsic fairness test the probability of recovery was greater, and was even better if the Court accepted the profit motive point of focus. I agree with the Committee's conclusion that it seems reasonably likely, from the present record, that the individual defendant-directors were interested directors and therefore the business judgment rule would afford no defense to the defendants.

VIII

In summary, the Sanford Committee, based upon what it deemed to be the two possible theories of recovery, recommended that Fuqua Industries pursue no further action against the individual defendants. The Sanford Committee completely ruled out any recovery under the corporate opportunity theory and it decided that any possible recovery under the interested director **[**25]** theory would be limited to approximately $94,000; ($ .30 X the number of shares of Triton Common Stock purchased by the Company from the Walsh Block). It therefore found that this would be insufficient to justify the expense of further litigation.

The Sanford Committee, not surprisingly, also made a determination that the continued maintenance of this suit is not in the best interests of Fuqua Industries.

It found that the individual defendants had acted in good faith and therefore the pursuit of recovery to vindicate a corporate right was not justified. It further determined that the expense, low probability of recovery, the possible amount of a meager recovery, the disruptive effect on the corporate management and morale, and the possible obligation to indemnify the defendant directors, were decisive factors in their recommendation that Fuqua Industries move for dismissal of this action.

The issue of the good faith of the defendants is a question of fact which cannot be resolved on the present record, before the plaintiffs have had the opportunity to conduct discovery. As previously discussed, the other critical findings of the Committee are not reasonable considering the present **[**26]** record.

IX

Even if the conclusions and recommendations of the Special Litigation Committee had a reasonable basis, this suit should still not be dismissed at this preliminary stage of the proceedings before the plaintiffs have had an opportunity to conduct discovery.

In *Zapata, supra*, the Delaware Supreme Court held that even if the Court determined that the Special Litigation Committee was independent, acted in good faith, and showed a reasonable basis for its conclusions, the Court could, in its discretion, **[*972]** proceed to a second step and apply its own independent business judgment as to whether the motion to dismiss should be granted. The Court stated at *430 A.2d 789*:

> "The second step provides, we believe, the essential key in striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation's best interests as expressed by an independent investigating committee. The Court should determine, applying its own independent business judgment, whether the motion should be granted. This means, of course, that instances could arise where a committee can establish its independence and sound bases for its good faith **[**27]** decisions and still have the corporation's motion denied. The second step is intended to thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation's interest. The Court of Chancery of course must carefully consider and weigh how compelling the corporate interest in dismissal is when faced with a non-frivolous lawsuit. The Court of Chancery should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation's best interests.
>
> If the Court's independent business judgment is satisfied, the Court may proceed to grant the motion, subject, of course, to any equitable terms or conditions the Court finds necessary or desirable."

The gravamen of the claim of the plaintiff in this suit is that the directors of Fuqua Industries diverted an opportunity of the corporation to purchase Triton common stock to themselves for their own personal financial gain. If this is true, it is difficult to imagine a more egregious breach of fiduciary **[**28]** duty. In the present corporate litigation climate, a stockholder's welfare rests almost solely on the judgment and independence of his directors. Any reasonably valid claim that the directors acted because of a conflict of interest involving their own selfish economic interest should bear close scrutiny by an impartial tribunal -- not a one-man committee appointed by the alleged wrong doers.

It may be that ultimately the directors will be able to show that they did not divert a corporate opportunity to themselves. Thus far they have not done so. Plaintiff should be given an opportunity to pursue discovery so that the truth of his allegations may be tested.

The motion to dismiss is therefore dismissed.

IT IS SO ORDERED.

Lonergan v. EPE Holdings LLC

Court of Chancery of Delaware

October 8, 2010, Submitted; October 11, 2010, Decided

C.A. No. 5856-VCL

Reporter
5 A.3d 1008 *; 2010 Del. Ch. LEXIS 207 **

EUGENE LONERGAN, SR., on Behalf of Himself and All Others Similarly Situated, Plaintiff, v. EPE HOLDINGS LLC, ENTERPRISE GP HOLDINGS, L.P., OSCAR S. ANDRAS, RALPH S. CUNNINGHAM, RICHARD H. BACHMANN, RANDA DUNCAN WILLIAMS, THURMON M. ANDRESS, CHARLES E. McMAHEN, EDWIN E. SMITH, and B.W. WAYCASTER, Defendants.

Counsel: [1]** Seth D. Rigrodsky, Brian D. Long, RIGRODSKY & LONG, P.A., Wilmington, Delaware; Donald J. Enright, Elizabeth K. Tripodi, Rosalee B. Connell, FINKELSTEIN THOMPSON LLP, Washington, District of Columbia; Attorneys for Plaintiff.

Rolin P. Bissell, Tammy L. Mercer, YOUNG CONAWAY STARGATT & TAYLOR, LLP, Wilmington, Delaware; Karl S. Stern, Kenneth P. Held, VINSON & ELKINS L.L.P., Houston, Texas; Attorneys for Defendants EPE Holdings LLC, Enterprise GP Holdings L.P., Oscar S. Andras, Ralph S. Cunningham and Richard H. Bachmann.

Gregory P. Williams, Catherine G. Dearlove, Srinivas M. Raju, Blake Rohrbacher, RICHARDS, LAYTON & FINGER, P.A., Wilmington, Delaware; Attorneys for Defendants Thurmon M. Andress, Charles E. McMahen, and B.W. Waycaster.

Judges: LASTER, Vice Chancellor.

Opinion by: LASTER

Opinion

[*1011] LASTER, Vice Chancellor.

The plaintiff holds limited partner units ("LP units") in defendant Enterprise GP Holdings, L.P. ("Holdings"), a publicly traded Delaware master limited partnership ("MLP"). On behalf of a putative class of all holders of LP units, he challenges a merger between Holdings and non-party Enterprise Products Partners L.P. (the "Partnership"), a second publicly traded Delaware MLP. I refer to the merger **[**2]** and its related components as the "Proposed Transaction." Through its 100% ownership of the Partnership's general partner, Holdings controls the Partnership. Based on conflicts of interest and alleged disclosure violations, the plaintiff seeks to enjoin the Proposed Transaction. This decision addresses a motion to expedite. Because the complaint does not plead a colorable claim, the motion is denied.

I. FACTUAL BACKGROUND

The facts are drawn from the complaint and the documents it incorporates by reference. The principal documents are the Preliminary Registration Statement on Form S-4 for securities to be issued in connection with the Proposed Transaction (the "Form S-4") and the First Amended and Restated Agreement of Limited Partnership of Enterprise GP Holdings L.P. (the "Holdings LP Agreement"). At this procedural stage, the plaintiff receives the benefit of all plausible inferences.

A. The Two-Tier MLP Structure

Despite its non-party status, the Partnership plays a critical role in the case. The Partnership describes itself as "a leading North American provider of midstream energy services to producers and consumers of natural gas, natural gas liquids ('NGLs'), crude oil, refined **[**3]** products, and certain petrochemicals." The Partnership's LP units trade on the New York Stock Exchange under the symbol "EPD."

According to the Form S-4,

> The Partnership's energy asset network links producers of natural gas, NGLs, and crude oil from some of the largest supply basins in the United

> States, Canada and the Gulf of Mexico with domestic consumers and international markets. The Partnership's assets include: 49,100 miles of onshore and offshore pipelines; approximately 200 million barrels of storage capacity for NGLs, refined products, and crude oil; and 27 billion cubic feet of natural gas storage capacity. The Partnership's midstream energy operations include: natural gas **[*1012]** transportation, gathering, processing and storage, NGL transportation, fractionation, storage, and import and export terminaling; crude oil and refined products transportation, storage and terminaling; offshore production platforms; petrochemical transportation and storage; and a marine transportation business that operates primarily on the United States Inland and Intercoastal Waterway systems and in the Gulf of Mexico.

Form S-4 at 1. These operations generate cash. Because it is structured as a pass-through **[**4]** entity, the Partnership can distribute its cash in a tax-efficient manner. It is widely understood, and the complaint alleges, that MLPs are popular investments precisely because they distribute most of their free cash flow. Investors purchase LP units for yield, and MLPs try to increase their yield over time.

Holdings is also a publicly traded Delaware MLP. Its LP units trade on the New York Stock Exchange under the ticker symbol "EPE." Holdings controls the Partnership through its 100% ownership of the limited liability company that serves as the Partnership's general partner (the "Partnership GP"). For simplicity, except where context requires, I will refer to Holdings as the general partner of the Partnership without referencing the intervening entity.

Investors in Holdings LP units want yield, just like investors in Partnership LP units. Rather than owning operating assets, Holdings predominantly owns interests in the Partnership. Directly or through affiliates, Holdings owns:

. A 2% economic interest in the Partnership attributed to Holdings' general partner interest.

. 21,563,177 Partnership LP units, representing approximately 3.4% of the outstanding limited partner interest.

. **[**5]** All of the Partnership's incentive distribution rights ("IDRs"), which entitle the holder to a contractually defined share of the Partnership's distributable cash.

When the Partnership makes distributions, these interests generate cash for Holdings. Holdings then makes distributions to its own unitholders.

In the two-tier MLP structure, the same underlying operating assets provide cash for distributions at both the Holdings and Partnership levels. But because Holdings receives the bulk of its distributions through the IDRs, its cash distribution profile differs from the Partnership. The IDRs are structured so that when distributions from the Partnership increase, the percentage of cash received by the IDRs increases. IDRs incentivize a general partner, whose economic general partner interest in the MLP is otherwise fixed and relatively small, to manage the MLP to maximize cash flow for the LP units. The IDRs are a form of pay for performance, with performance measured in distributable cash. In MLP lingo, as the operating partnership performs better, the general partner "rides up the splits" and receives a greater share of the incremental cash generated by its efforts. Those cash flows **[**6]** are also attractive to investors, which enables general partners to take their entities public. Investors who purchase LP interests in a publicly traded general partner hope to receive the upside of greater distributions from the "high splits" on the IDRs. Investors who purchase limited partner interests in the lower-tier entity trade the upside of the IDRs for the more stable and reliable cash flows that result from a prior claim on the operating partnership, up to an established level of quarterly distributions.

While helpful as a means of incentivizing general partner performance and aligning **[*1013]** interests, IDRs have downsides. Most obviously, the overhang of the IDR claim on cash flows limits the distributions available to the LP units. This reduces the attractiveness of LP units, resulting in a lower trading price and making them less attractive as a source of new money or as an acquisition currency. [1] Equally important, as the operating partnership performs better, the increasing IDR claim drives up its cost of equity capital, which limits its ability to undertake new projects. [2]

---

[1] One might fairly respond that without the incentivizing effects of the IDRs, the general partner would **[**7]** have greater reason to shirk, which would reduce the attractiveness of the LP units. As always, there is no free lunch, and both effects logically are present to varying and contestable degrees.

[2] For additional discussion of IDRs and the issues they present, see John Goodgame, *Master Limited Partnership*

The IDRs held by Holdings exemplify these challenges. Holdings received approximately 15.3% of the cash distributed by the Partnership in August 2010, and Holdings would be entitled to 25% of any incremental increase in Partnership distributions beyond the current level of $ 0.575 per Partnership LP unit. At the current level of distributions, Holdings will receive an additional $ 0.10379 per quarter for each new LP unit issued by the Partnership.

B. A Web Of Conflicts

The two-tier MLP structure creates a web of conflicts. As noted, Holdings is the Partnership's general partner and controls the Partnership. Holdings' general partner is defendant EPE Holdings, LLC ("Holdings **[**8]** GP"). All of the member interests in Holdings GP are owned by non-party Dan Duncan LLC ("DDLLC"). All of the member interests of DDLLC are owned by three individuals who serve as voting trustees under a voting trust agreement. Under a second voting trust agreement, the same three individuals own a majority of the voting stock of Enterprise Products Company ("EPCO"), a privately held corporation. EPCO beneficially owns 76% of Holdings' outstanding LP units and 27% of the Partnership's outstanding LP units. Control of the entire two-tier structure ultimately rests with the three voting trustees.

The three voting trustees are Randa Duncan Williams, Ralph S. Cunningham, and Richard H. Bachmann. Williams is also director of Holdings GP and Chairman of EPCO. Cunningham is a director, President, and CEO of Holdings GP and a director of EPCO. Bachmann is Executive Vice President and a director of Holdings GP; President, CEO, Chief Legal Officer, and a director of EPCO, and Executive Vice President, Secretary, and Chief Legal Officer of Partnership GP.

The Holdings GP board of directors (the "Board") has eight members. All eight members have been named as defendants. As noted, three of the members **[**9]** are the voting trustees. One member, O.S. Andras, was formerly President (from 1998 until 2004), CEO (from 1998 to 2005), Vice Chairman (from 2004 to 2005), and a director (from 1998 to 2006) of Partnership GP; and President and CEO of EPCO (from 1996 to 2001). The remaining four members -- Thurman M. Andress, Charles E. McMahen, Edwin E. Smith, and B.W. Waycaster -- are facially independent, outside directors.

Prior to its consideration of the Proposed Transaction, the members of the Board's Audit, Conflicts and Governance Committee (the "Audit Committee") were Andress, McMahen, and Smith. Early in the process, Smith recused himself because **[*1014]** he, alone of the three individuals, owns a greater number of Partnership LP units than Holdings LP units, which could be viewed as creating a potential economic conflict with his obligations to Holdings. Waycaster, who has no such conflict, was added to the Board and joined the Audit Committee.

C. The Proposed Transaction

The Proposed Transaction will flatten the two-tier MLP structure. Holdings will merge into a subsidiary of the Partnership, and each Holdings LP unit will be converted into 1.5 Partnership LP units. Immediately after the merger, **[**10]** Holdings' IDRs, its 21,563,177 Partnership LP units, and its 2% general partner interest in the Partnership will be cancelled.

Holdings GP is not receiving preferential treatment. Holdings GP currently owns a 0.01% general partner interest in Holdings. Just prior to the merger, this interest will be re-characterized as a non-economic general partner interest and a 0.01% limited partnership interest, represented by 13,921 Holdings LP units. In the merger, the Holdings LP units will be converted into Partnership LP units at the same exchange ratio. Holdings GP's non-economic general partner interest in Holdings will be converted into a non-economic general partner interest in the Partnership, and Holdings GP will continue after the Proposed Transaction as the Partnership's general partner. Control over the Partnership will therefore remain with Holdings GP and ultimately the three voting trustees.

For its part, EPCO will receive less favorable treatment than unaffiliated holders. Pursuant to a Distribution Waiver Agreement, EPCO has agreed to waive its rights to quarterly distributions on a designated number of Partnership LP units for five years after the Proposed Transaction closes. **[**11]** In the first year, distributions will be waived for 30,610,000 Partnership LP units. The number of units covered by the waiver will decline in each subsequent year until in the fifth year it reaches 17,690,000 Partnership LP units. The waiver has the effect of increasing the amount of distributable cash available for unaffiliated holders during the five-year

---

Governance, [60 Bus. Law. 471, 477-79, 504-05 (2005)](), and Phillip R. Clark & Peter O. Hansen, *Understanding Master Limited Partnerships: What Every Oil and Gas Lawyer Needs To Know,* 54 Rocky Mtn. Min. L. Inst. § 22.03 (2008).

period. Based on the quarterly distribution rate of $ 0.575 per limited partner unit paid by the Partnership in the second quarter of 2010, the waived distributions total approximately $ 275 million. If distributions increase, so will that figure.

The exchange ratio of 1.5 Partnership LP units for each Holdings LP unit represents an approximately 16% premium to the closing price of Holdings units on September 3, 2010, the last trading day before the public announcement of the proposed merger. It represents an approximately 40% premium over the average closing price of Holdings units during the one-year period ended September 3, 2010. Based on pro forma estimates, the quarterly cash distributions to be received by former Holdings LP unitholders post-merger should be 54% greater than Holdings distributions pre-merger. The Proposed **[**12]** Transaction is expected to be accretive to the distributions received by Holdings unitholders in each year through 2015, the last year for which projections were developed. Since investors hold LP units for yield, distributions are a critical metric.

D. The Path To The Proposed Transaction

According to the Form S-4, "[u]nitholders of the Partnership and the investment community . . . focused on the Partnership's cost of capital after other midstream publicly traded partnerships . . . acted to reduce their long-term cost of capital by eliminating or reducing their IDRs **[*1015]** through merger or other actions." Form S-4 at 36. During the summer of 2010, the Partnership's counsel met with Bachmann, Cunningham, and members of Partnership management to discuss the "trends in simplification of publicly traded partnerships." *Id.* They also reviewed proposed federal tax legislation addressing the treatment of "carried interests" that would have an earliest possible effective date of January 1, 2011. Under the proposed legislation, a potential simplification transaction that generally would be non-taxable to unitholders under current law would be taxable under the proposed law. In layman's terms, Holdings **[**13]** LP unitholders won't pay tax if a deal closes in 2010. They face a real risk of paying tax if the legislation passes and a deal closes in 2011. For holders of Holdings LP units, and particularly for EPCO, having to pay tax makes a big difference.

On July 7, 2010, Partnership management proposed to the Holdings Audit Committee that the two MLPs pursue a simplification transaction. Later that day, the Holdings Audit Committee spoke with the EPCO voting trustees about the idea. During the call, the EPCO voting trustees made clear that they would entertain an offer from the Partnership that the Audit Committee approved as fair and reasonable, but they would not sell to a third party and would not entertain any third-party proposals.

Over the following days, the Audit Committee assembled a team of independent advisors. It retained Baker & Hostetler LLP as its legal counsel and Richards Layton & Finger, P.A. as special Delaware counsel. It hired Morgan Stanley as its financial advisor. Recognizing the potential conflicts of interest in a transaction between Partnership and Holdings, the Holdings GP Board formally delegated to the Audit Committee full power to negotiate and accept or reject **[**14]** any deal.

In early August, negotiations began in earnest. On August 3, the Partnership proposed an exchange ratio of 1.377 Partnership LP units for each Holdings unit, representing a 2.6% premium over the July 30 closing price. After a week of analysis by its advisors, the Holdings Audit Committee rejected the offer and declined to counter.

A day later, the Partnership proposed an increased exchange ratio of 1.40 Partnership LP units per Holdings LP unit, but conditioned the proposal on EPCO waiving distributions for a specified number of units from 2011 to 2014. The waiver was needed to make the proposal neutral with regard to Partnership distributions. Put differently, the Partnership was saying that without the waiver, the proposed exchange ratio would give too much value to the holders of Holdings LP units. The Audit Committee decided the price was still too low, rejected the offer, and declined to counter. Talks officially broke down on August 12.

On August 23, the Partnership reopened the bidding at 1.475 Partnership LP units per Holdings LP unit conditioned on EPCO waiving its distributions for a specified number of units from 2011 to 2015. On August 30, the Holdings Audit Committee **[**15]** countered at a ratio of 1.535.

At this point, the Partnership made what it described as its "final offer": 1.50 Partnership LP units per Holdings LP unit with the EPCO waiver. After consulting with its advisors, the Holdings Audit Committee agreed on the ratio. Once formal agreements had been negotiated, Morgan Stanley opined that the transaction was fair from a financial point of view to the unaffiliated holders of Holdings LP units, and the Audit Committee conferred on the Proposed Transaction its "Special Approval" for purposes of the Holdings LP Agreement.

[*1016] E. The Current Litigation

The Proposed Transaction was announced on September 7, 2010. The preliminary Form S-4 was filed with the Securities and Exchange Commission on September 16, 2010. On September 29, 2010, the plaintiff filed his complaint and moved simultaneously for an expedited hearing on an application for preliminary injunction.

II. LEGAL ANALYSIS

A motion to expedite should be granted only if "the plaintiff has articulated a sufficiently colorable claim and shown a sufficient possibility of a threatened irreparable injury, as would justify imposing on the defendants and the public the extra (and sometimes substantial) **[**16]** costs of an expedited preliminary injunction proceeding." *Giammargo v. Snapple Beverage Corp., 1994 Del. Ch. LEXIS 199, 1994 WL 672698, at *2 (Del. Ch. Nov. 15, 1994)* (Allen, C.). The complaint fails to assert a sufficiently colorable claim.

A. The Implied Covenant Of Good Faith And Fair Dealing

The complaint contains the types of allegations commonly advanced by stockholder plaintiffs when challenging a merger involving a corporation. In such a pleading, the plaintiff asserts claims for breaches of fiduciary duty. Here, the plaintiff seeks to cloak familiar breach of fiduciary duty theories in the guise of the implied covenant of good faith and fair dealing. The complaint thus asserts at the outset that the defendants have been sued "for their breaches of duties arising under the implied contractual covenant of good faith and fair dealing." Compl. P 1. Later the complaint asserts that the defendants "owe the Company's unitholders, as a matter of law, duties arising under the implied contractual covenant of good faith and fair dealing." *Id.* P 11; *see id.* PP 12-14.

Reminiscent of *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986)*, the complaint alleges that "the Board of [Holdings GP], **[**17]** which controls and manages [Holdings], failed to conduct an adequate and fair sales process to sell [Holdings] prior to agreeing to the Proposed Transaction." Compl. P 6. It continues: "In agreeing to a sale without conducting a fair and adequate sales process, gathering information about the Company's net worth, or soliciting other bids, [the] Individual Defendants are allowing [Holdings] to be purchased at well below the Company's true value." Compl. P 7.

Reminiscent of *Kahn v. Lynch Communications Systems., Inc., 638 A.2d 1110 (Del. 1994)*, the complaint asserts that

> [t]he Proposed Transaction . . . represents a classic case of a party standing on both sides of the transaction. In particular, EPCO and its affiliates own a majority stake in [Holdings] and significant equity interests in [the Partnership] as well, creating divided loyalties that have led to the agreement of [sic] a grossly unfair merger to the detriment of the [Holdings'] minority unitholders.

Compl. P 6. In light of this conflict, the complaint insists that the Proposed Transaction be conditioned on the "approval of a 'majority of the minority' of outstanding units." *Id.* "Given that one primary entity -- EPCO and its **[**18]** affiliates -- control 76% of the units of [Holdings], and that this majority shareholder [sic] stands on both sides of the transaction, [the] Individual Defendants should have conditioned the Proposed Transaction on approval of the majority vote of the minority unitholders not affiliated with EPCO." *Id.* P 66; *see id.* PP 64-65, 67.

The complaint also alleges the defendants failed to disclose all material information reasonably available in connection **[*1017]** with the LP unitholder vote. The complaint identifies fourteen items that the Form S-4 allegedly failed to disclose. *See* Compl. PP 81-88.

The complaint frames each of these theories using the implied covenant of good faith and fair dealing because the Holdings LP Agreement eliminates default fiduciary duties in accordance with the authority granted by the Delaware Limited Partnership Act (the "LP Act"). *Section 17-1101(d)* of the LP Act provides:

> To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, the partner's or other person's duties may be expanded **[**19]** or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair

> dealing.

6 Del. C. § 17-1101(d).

Two sections of the Holdings LP Agreement eliminate all fiduciary duties. Section 7.9(e) states:

> Except as expressly set forth in this Agreement, neither [Holdings GP] nor any other Indemnitee shall have any duties or liabilities, including fiduciary duties, to the Partnership or any Limited Partner and the provisions of this Agreement, to the extent that they restrict or otherwise modify the duties and liabilities, including fiduciary duties, of [Holdings GP] or any other Indemnitee otherwise existing at law or in equity, are agreed by the Partners to replace such other duties and liabilities of [Holdings GP] or such other Indemnitee. [3]

Section 7.10(d) further provides:

> Any standard of care and duty imposed by this Agreement or under the Delaware Act or any applicable law, rule or regulation shall be modified, waived or limited, to the extent permitted by law, as required to permit [Holdings GP] to act under this Agreement and to make any decision pursuant to the authority **[**20]** prescribed in this Agreement, so long as such action is reasonably believed by [Holdings GP] to be in, or not inconsistent with, the best interests of [Holdings].

In light of these provisions, the only duties owed by Holdings GP flow from (i) contractual standards set forth in the Holdings LP Agreement and (ii) the implied covenant of good faith and fair dealing. The complaint does not identify any provision of the Holdings LP Agreement that the Proposed Transaction might violate. It relies solely on the implied covenant.

The implied covenant is not a substitute for fiduciary duty analysis. "The covenant is 'best understood as a way of implying **[**21]** terms in the agreement' . . . . Existing contract terms control, however, such that implied good faith cannot be used to circumvent the parties' bargain, or to create a free-floating duty unattached to the underlying legal documents." Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 441 (Del. 2005) (quoting E.I. DuPont de Nemours & Co. v. Pressman, 679 A.2d 436, 443 (Del.1996)) (other citations omitted). **[*1018]** The Court must focus on "what the parties likely would have done if they had considered the issues involved." Cincinnati SMSA Ltd. P'ship v. Cincinnati Bell Cellular Sys. Co., 708 A.2d 989, 992 (Del. 1998). It must be "clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of . . . had they thought to negotiate with respect to that matter." Katz v. Oak Indus. Inc., 508 A.2d 873, 880 (Del. Ch. 1986) (Allen, C.). "The doctrine thus operates only in that narrow band of cases where the contract as a whole speaks sufficiently to suggest an obligation and point to a result, but does not speak directly enough to provide an explicit answer." Airborne Health, Inc. v. Squid Soap, LP, 984 A.2d 126, 146 (Del. Ch. 2009).

Wielding **[**22]** the implied covenant is a "cautious enterprise." Nemec v. Shrader, 991 A.2d 1120, 1125 (Del. 2010). Implying contract terms is an "occasional necessity . . . to ensure [that] parties' reasonable expectations are fulfilled," but "[t]his quasi-reformation . . . should be a rare and fact-intensive exercise, governed solely by issues of compelling fairness." Dunlap v. State Farm & Cas. Co., 878 A.2d 434, 442 (Del. 2005) (internal quotation marks omitted). Delaware law "will only imply contract terms when the party asserting the implied covenant proves that the other party has acted arbitrarily or unreasonably, thereby frustrating the fruits of the bargain that the asserting party reasonably expected." Nemec, 991 A.2d at 1126. "Parties have a right to enter into good and bad contracts[;] the law enforces both." Id. at 1126.

When an LP agreement eliminates fiduciary duties as part of a detailed contractual governance scheme, Delaware courts should be all the more hesitant to resort to the implied covenant. Fiduciary duty review empowers courts to determine how a governance scheme should operate under particularized factual circumstances. Although the availability of *ex post* fiduciary review **[**23]** inherently produces some degree of uncertainty, "there is good reason to suppose it can be efficient." Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1055 n.48 (Del. Ch. 1997) (Allen, C.).

When parties exercise the authority provided by the LP Act to eliminate fiduciary duties, they take away the

[3] "Indemnitee" is defined to include "(a) [Holdings GP], any Departing General Partner and any Person who is or was an Affiliate of [Holdings GP] or any Departing General Partner, (b) any Person who is or was a member, director, officer, fiduciary or trustee of [Holdings, and] (c) any Person who is or was an officer, member, partner, director, employee, agent or trustee of [Holdings GP] or any Departing General Partner or any Affiliate of [Holdings GP] or any Departing General Partner, or any Affiliate of such Person." Holdings LP Agreement at A-4.

most powerful of a court's remedial and gap-filling powers. As a result, parties must draft an LP agreement as completely as possible, and they bear the risk of incompleteness. If the parties have agreed how to proceed under a future state of the world, then their bargain naturally controls. But when parties fail to address a future state of the world -- and they necessarily will because contracting is costly and human knowledge imperfect -- then the elimination of fiduciary duties implies an agreement that losses should remain where they fall. [4] After all, if the parties wanted courts to be in the business of shifting losses after the fact, then they would not have eliminated the most powerful tool for doing so.

Respecting the elimination of fiduciary duties requires that courts not **[*1019]** bend an alternative and less powerful tool into a fiduciary substitute. The nature of the implied covenant of good faith and fair dealing is "quite different from the congeries of duties that are assumed by a fiduciary." *Katz, 508 A.2d at 879 n.7*. "Delaware's implied duty of good faith and fair dealing is not an equitable remedy for rebalancing economic interests after events that could have been anticipated, but were not . . . ." *Nemec, 991 A.2d at 1128*. To use the implied covenant to replicate fiduciary review "would vitiate the limited reach of the concept of the implied duty of good faith and fair dealing." *Id.* To the extent the complaint seeks to re-introduce fiduciary review through the backdoor of the implied covenant, it fails to state a colorable claim.

B. The *Revlon* and *Lynch* Allegations

The **[**25]** complaint contains assorted allegations about what should have been done to develop alternatives, negotiate the Proposed Transaction, and test its fairness. As discussed above, the contentions fall loosely into two categories: (i) assertions that there should have been a search for alternative transactions *(Revlon)* and (ii) insistence on the need for a majority-of-the-minority vote *(Lynch).*

Both categories of allegations err in assuming that Delaware common law decisions identify particular steps that fiduciaries must follow. The Delaware Supreme Court has clarified on multiple occasions that "there is no single blueprint that a board must follow to fulfill its duties." [5] Rather than establishing conduct requirements in the manner of a legislature or regulatory agency, *Revlon* and its progeny identify a recurring situation in which Delaware courts apply a heightened *standard of review.* In a final stage transaction -- be it a cash sale, a break-up, or a transaction like a change of control that fundamentally alters ownership rights -- there are sufficient dangers to merit employing enhanced scrutiny, which requires that defendant fiduciaries "bear the burden of persuasion to show that **[**26]** their motivations were proper and not selfish" *and* that "their actions were reasonable in relation to their legitimate objective." *Mercier v. Inter-Tel (Delaware), Inc., 929 A.2d 786, 810 (Del. Ch. 2007)*. Framed more specifically for the M&A context, enhanced scrutiny places the burden on the defendant fiduciaries to show that they acted reasonably to obtain for their beneficiaries the best value reasonably available under the circumstances. *Paramount Commc'ns Inc. v. QVC Network, Inc., 637 A.2d 34, 48-49 (Del. 1994)*.

The entire fairness standard under *Lynch* is likewise a standard of review. It does not require specific transactional features like a majority-of-the-minority vote. Using specific transactional features can change the standard of review. *See, e.g., In re CNX Gas Corp. S'holders Litig., 2010 Del. Ch. LEXIS 139, 2010 WL 2705147, at *4-6 (Del. Ch. July 5, 2010)* (describing alternative standards of judicial review resulting from different combinations of transactional features and certifying interlocutory appeal to resolve conflict), *appeal refused, 2010 Del. LEXIS 324, 2010 WL 2690402 (Del. 2010)* (TABLE). They also can be evidence of fairness.

---

[4] More completely, losses remain where they fall absent renegotiation. A relational contract like an LP agreement provides ample opportunities to renegotiate. The Distribution **[**24]** Waiver Agreement is one example. Rather than insisting on full distribution rights, EPCO waived distributions over a five-year period for the benefit of unaffiliated holders of Partnership LP units. In another example, Holdings GP voluntarily relinquished the 50% tier of its IDRs in 2002. *See Goodgame, supra, at 504*.

[5] *Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286 (Del. 1989)*; *accord* *Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 243 (Del. 2009)* ("there are no legally prescribed steps that directors must follow to satisfy their *Revlon* duties"). *See generally* *In re Dollar Thrifty S'holders Litig., 2010 Del. Ch. LEXIS 192, 2010 WL 3503471, at *17 (Del. Ch. Sept. 8, 2010)* ("[A]t bottom *Revlon* is a test of reasonableness; directors are generally free to select the path to value maximization, so long as they choose a reasonable route to get there."); *In re Netsmart Techs., Inc. S'holders Litig., 924 A.2d 171, 192 (Del. Ch. 2007)* *("[Revlon]* does not, of course, require every board to follow a judicially prescribed **[**27]** checklist of sales activities.").

E.g., *Weinberger v.* ***[*1020]*** *UOP, Inc., 457 A.2d 701, 709 n.7 (Del. 1983)* (observing that the use of an independent negotiating committee "is strong evidence that the transaction meets the test of fairness"). But regardless of whether any features are deployed, a Delaware court "determines entire fairness based on all aspects of the entire transaction." *Valeant Pharms. Int'l v. Jerney, 921 A.2d 732, 746 (Del. Ch. 2007)*; *accord Weinberger, 457 A.2d at 711* ("All aspects of the issue must be examined as a whole since the question is one of entire fairness.").

Holdings is **[**28]** a limited partnership, and the Holdings LP Agreement establishes a contractual standard of review that supplants fiduciary duty analysis. Under Section 7.9(a) of the Holdings LP Agreement, when a decision involves a conflict of interest,

> any resolution or course of action by [Holdings GP] or its Affiliates in respect of such conflict of interest shall be permitted and deemed approved by all Partners, and shall not constitute a breach of this Agreement or of any agreement contemplated herein or therein, or of any duty stated or implied by law or equity, if the resolution or course of action in respect of such conflict of interest is (i) approved by Special Approval, (ii) approved by the vote of a majority of the Units excluding Units owned by [Holdings GP] and its Affiliates, (iii) on terms no less favorable to [Holdings] than those generally being provided to or available from unrelated third parties or (iv) fair and reasonable to [Holdings], taking into account the totality of the relationships between the parties involved (including other transactions that may be particularly favorable or advantageous to the Partnership).

Holdings LP Agreement § 7.9(a). By using the term "or," Section 7.9(a) **[**29]** establishes four alternative standards of review. If the Proposed Transaction meets any of the four, then it "shall be permitted and deemed approved by all Partners, and shall not constitute a breach of this Agreement or of any agreement contemplated herein or therein, or of any duty stated or implied by law or equity." *Id.* None of the four standards of review requires that Holdings GP check off a specific laundry list of actions.

Section 7.9(a)(ii) disposes of the plaintiff's contention that the implied covenant of good faith and fair dealing requires that the Proposed Transaction be conditioned on a majority-of-the-minority vote. Section 7.9(a)(ii) identifies approval "by the vote of a majority of the Units excluding Units owned by [Holdings GP] and its Affiliates" as one of the four alternative means by which a transaction can be validated. Section 7.9(a) necessarily contemplates that a transaction can be validated under Section 7.9(i), (iii), or (iv), which do not require a majority-of-the-minority vote. "[T]he implied covenant cannot be invoked to override express provisions of a contract." *Kuroda v. SPJS Holdings, L.L.C., 971 A.2d 872, 888 (Del. Ch. 2009)*.

Section 7.9(a)(iii) similarly **[**30]** disposes of the plaintiff's contention that implied covenant requires an "adequate and fair sales process." The standard of review described in Section 7.9(a)(iii) contemplates "terms no less favorable to [Holdings] than those generally being provided to or available from unrelated third parties." To meet that standard, Holdings GP might want (but would not be required) to explore third-party alternatives or test a transaction in the market. The inclusion of Section 7.9(a)(iii) shows that the drafters of the Holdings LP Agreement contemplated third-party-sale standards. It would have been easy to mandate a sales process, even to the point of requiring **[*1021]** specific auction procedures. The Holdings LP Agreement does not contain any such requirement.

Read more generally, the complaint asserts that the implied covenant constrains the defendants' ability to rely on Section 7.9(a)(i), which allows a transaction to be validated if "approved by Special Approval." That concept in turn is defined as "approval by a majority of the members of the Audit and Conflicts Committee." Holdings LP Agreement at A-8. It is undisputed that the Audit Committee granted Special Approval, and the defendants naturally **[**31]** rely heavily on that fact in contending that the plaintiff's claims are not colorable. The plaintiff responds that Special Approval cannot permit the defendants to engage in any conflicted transaction, no matter how unfair or inequitable, free of any judicial scrutiny. Charitably read, the complaint can be construed to contend that if Special Approval is unavailable because of violations of the implied covenant, and if there is no majority-of-the-minority vote, then the Proposed Transaction should be enjoined because the defendants cannot satisfy the standards set forth in Sections 7.9(a)(iii) and (iv).

The plaintiff correctly contends that the implied covenant constrains the Special Approval process. When considering the LP agreement of a different MLP (coincidentally an MLP-affiliate of Holdings and the Partnership), I wrote:

> While I agree that [the Special Approval] provisions establish a weighty defense, the syllogism of "if Teppco Audit Committee approval, then judgment for the defendants" does not automatically follow. In language employed by Vice Chancellor Lamb when rejecting a similarly absolutist interpretation of a special approval provision, it is "much too simplistic." *U.S. Bank Nat'l Assoc. v. U.S. Timberlands Klamath Falls, L.L.C., 864 A.2d 930, 2004 WL 5388052, at *12 (Del. Ch. Dec. 22, 2004)*. **[**32]** At a minimum, the approval must have been given in compliance with the implied covenant of good faith and fair dealing, which a partnership agreement "may not eliminate." *6 Del. C. § 17-1101(d)*.

Brinckherhoff v. Texas E. Prods. Pipeline Co., LLC, 986 A.2d 370, 390 (Del. Ch. 2010) [hereinafter, *"TEPPCO"].* Paraphrasing *Katz,* it could well be "clear from what was expressly agreed upon *[i.e.,* Special Approval by independent persons] that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of *[e.g.,* arbitrary or bad faith action by those persons] . . . had they thought to negotiate with respect to that matter." *Katz, 508 A.2d at 880*.

But to recognize the legal principle does not mean the plaintiff has pled a colorable claim. To do so, the plaintiff would need to allege particularized facts from which this Court could infer that the members of the Audit Committee acted arbitrarily or in bad faith. In *TEPPCO*, for example, "the merger which received 'special approval' would extinguish strong claims against a controller, his colleagues, and his principal entities." *986 A.2d at 390*. The factual record readily supported the inference **[**33]** that "'a principal purpose of the merger was the termination of the then pending derivative claims.'" *Id. at 383* (quoting *Merritt v. Colonial Foods, Inc., 505 A.2d 757, 763 (Del. Ch. 1986)* (Allen, C.)). There was also reason to question "whether the committee actually got value for the Derivative Action" such that "the consideration was fair *with* the Derivative Action." *Id. at 393, 394*. The record as a whole suggested that the committee might well have approved "the deal that the Special Committee would have negotiated anyway," and that the negotiations offered only "the illusion of resistance followed by the reality of submission." *Id. at 393*. **[*1022]** The operative LP agreement in *TEPPCO* also did not contain additional contractual standards regulating the Special Approval process, such as "the right to make the special approval determination in its 'sole discretion' or under a similar contractual grant of authority." *Id. at 390*.

The current complaint fails to raise a colorable challenge to the Special Approval decision. The complaint cites conflicts faced by directors who did not serve on the Audit Committee (most notably the three voting trustees) but does not raise *any* challenge to the disinterestedness **[**34]** or independence of the members of the Audit Committee. The complaint asserts generally that the individual defendants own interests in both Holdings and the Partnership and reproduces in abbreviated fashion the ownership table from the Form S-4. The table shows that each of the Audit Committee members who made the Special Approval decision owns more Holdings LP units than Partnership LP units. Rather than creating a disabling conflict, their cross-ownership (assuming it were material) would align their interests with the holders of Holdings LP units.

The complaint's conclusory allegations about an inadequate deal process do not imply arbitrary or bad faith conduct, particularly in light of what the Form S-4 says the Audit Committee actually did, the terms it negotiated, and the financial analyses conducted by Morgan Stanley. *Cf. Lyondell, 970 A.2d at 243-44* (finding stronger challenges to a sale process were insufficient to support claim that directors breached their fiduciary duties by acting in bad faith). When a party seeks to invoke the implied covenant, "[g]eneral allegations of bad faith conduct are not sufficient." *Kuroda, 971 A.2d at 888*.

Finally, unlike the LP agreement in *TEPPCO*, **[**35]** the Holdings LP Agreement contains additional provisions that expand the decisional discretion of Holdings GP and limit the ability of a limited partner to challenge its decisions, including a grant of Special Approval by the Audit Committee. For example, Section 7.10(b) states:

> [Holdings GP] may consult with legal counsel, accountants, appraisers, management consultants, investment bankers and other consultants and advisers selected by it, and any act taken or omitted to be taken in reliance upon the opinion (including an Opinion of Counsel) of such Persons as to matters that [Holdings GP] reasonably believes to be within such Person's professional or expert competence shall be conclusively presumed to have been done or omitted in good faith and in accordance with such opinion.

The Audit Committee received a fairness opinion from Morgan Stanley, and a fair summary of the opinion and underlying financial analyses appears in the Form S-4.

The complaint does not allege (and a plaintiff could not colorably contend) that rendering a fairness opinion was not within Morgan Stanley's professional expert competence. On the present allegations, the grant of Special Approval must be "conclusively **[**36]** presumed to have been . . . in good faith."

The complaint does not plead a colorable challenge to the Special Approval decision. A colorable claim under the implied covenant would require more particularized facts and a more refined legal theory. A dashed-off effort to translate a cookie-cutter complaint from the world of corporations into the language of MLPs will not do the trick.

C. Additional Theories

In a reply letter in support of the motion to expedite, the plaintiff contends that the members of the Audit Committee, *"independent though they may be facially categorized,* [are] subject to inherent **[*1023]** conflicts of interest" because EPCO stands on both sides of the Proposed Transaction. (Emphasis added). In a controlling stockholder squeeze-out, independent directors are deemed subject to inherent coercion because of the controller's domineering presence. *See* CNX Gas, 2010 Del. Ch. LEXIS 139, 2010 WL 2705147, at *5-8 (describing doctrine). The doctrine of inherent coercion has not been extended to limited partnerships. R.S.M. Inc. v. Alliance Capital Mgmt. Hldgs. L.P., 790 A.2d 478, 498 n.28 (Del. Ch. 2001) ("[I]t would seem unwise to expand this doctrinal anomaly into the limited partnership setting."). This **[**37]** variation on the implied covenant claim is not colorable.

The plaintiff also writes in his reply letter that Special Approval might be ineffective because the Audit Committee is defined in the Holdings LP Agreement as "a committee of the Board of Directors of [Holdings GP] composed entirely of three or more directors who meet the independence, qualification and experience requirements established by the Securities Exchange Act and the rules and regulations of the Commission thereunder and by the New York Stock Exchange." Holdings LP Agreement at A-2. According to the plaintiff, "NYSE rules require members of an audit committee to be independent of the company and its management and to have not [sic] any relationship with the company or others that, when viewed from the perspective of a reasonable investor, appears to impair the exercise of independent judgment." No supporting authority, citation, or additional information is provided. There is no quotation from any source, only paraphrasing. In a footnote, the plaintiff claims that its "research" recently uncovered social and charitable connections between the members of the Audit Committee and EPCO. Plaintiff's counsel admitted during **[**38]** the hearing on the motion to expedite that the "research" consisted of cribbing from complaints in pending derivative actions.

The new legal theory about the qualifications of the Audit Committee members does not implicate the implied covenant of good faith and fair dealing. It instead would claim that a contractual provision of the Holdings LP Agreement was violated. It is not currently pled, and there is no need for me to comment on an unpled claim.

D. The Disclosure Allegations

The complaint also alleges that the defendants have violated the implied covenant of good faith and fair dealing by failing to disclose all material information reasonably available in connection with the LP unitholder vote. In the corporate context, the duty of disclosure is a fiduciary duty that "derives from the duties of care and loyalty." *Pfeffer v. Redstone, 965 A.2d 676, 684 (Del. 2009)*. The duty to disclose all material information reasonably available when seeking stockholder action represents "the application in a specific context of the board's fiduciary duties." *Malpiede v. Townson, 780 A.2d 1075, 1086 (Del. 2001)*. The duty not to speak falsely that applies whenever directors choose to communicate **[**39]** with stockholders similarly flows from a board's fiduciary duties. *Malone v. Brincat, 722 A.2d 5, 14 (Del. 1998)*. Likewise in the limited partnership context, absent contractual modification, a general partner owes fiduciary duties that include a "duty of full disclosure." *Sussex Life Care Assocs. v. Strickler, 1989 Del. Ch. LEXIS 67, 1988 WL 156833, at *4 (Del. Ch. June 13, 1989)* ("There can be no question but that partners owe fiduciary duties to their fellow partners . . . and this duty has been held to encompass a duty of full disclosure . . . ." (citing *Boxer v. Husky Oil Co., 429 A.2d 995 (Del. Ch. 1981)*). A limited partner who wishes to assert a disclosure claim therefore "must allege either a fiduciary **[*1024]** duty or a contractual duty to disclose." *Albert v. Alex. Brown Mgmt. Servs., Inc., 2005 Del. Ch. LEXIS 133, 2005 WL 2130607, at *3 (Del. Ch. Aug. 26, 2005)*.

As discussed above, the Holdings LP Agreement eliminates all fiduciary duties, which therefore cannot support a disclosure obligation. The complaint does not identify a contractual duty to disclose material information in connection with the Proposed Transaction. To the contrary, in connection with the Proposed Transaction, the Holdings LP Agreement requires only that the **[**40]** limited partners be given notice of a meeting at which the vote on the merger will be held and that "[a] copy or a summary of the Merger Agreement shall be included in or enclosed with the notice." Holdings LP Agreement § 14.3(a).

In light of the specific informational rights provided in Section 14.3, the absence of any generalized contractual obligation, and the express elimination of fiduciary duties, I cannot infer an obligation to disclose all material information from the implied covenant of good faith and fair dealing. It would have been easy for the Holdings LP Agreement to provide for the disclosure of all material information. Rather than suggesting a gap that needs to be filled, the Holdings LP Agreement reflects a conscious decision to eliminate all fiduciary duties, including the duty of disclosure. *See Arnold v. Society for Sav. Bancorp, Inc., 650 A.2d 1270, 1287 (Del. 1994)* (interpreting plain meaning of phrase "breach of fiduciary duty" in *8 Del. C. § 102(b)(7)* as encompassing fiduciary disclosure requirements, which "were well-established when *Section 102(b)(7)* was enacted and were nonetheless not excepted expressly from coverage").

Nor is this a situation where "compelling **[**41]** fairness" requires that I invoke the implied covenant. *Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 442 (Del. 2005)*. A Delaware Supreme Court decision from the corporate realm demonstrates that there is nothing inequitable about the level of disclosure provided by the Holdings LP Agreement -- a meeting notice and copy or summary of the merger agreement. In *Stroud v. Grace, 606 A.2d 75 (Del. 1992)*, the controlling stockholders in a privately held corporation planned to amend the corporation's charter and by-laws at the company's annual meeting. *Id. at 79-80*. Because the minority's votes were not needed, no proxies were solicited. *Id. at 80*. The only information distributed in connection with the meeting was the statutorily required notice of meeting and a summary of the proposed charter amendments. *Id. at 80, 85*; *see 8 Del. C. § 222(a)* (requiring written notice of meeting); *8 Del. C. § 242(b)(1)* (requiring that notice of meeting at which a charter amendment will be considered "set forth such amendment in full or a brief summary of the changes to be effected thereby"). A stockholder plaintiff asserted that the board of directors had a fiduciary duty to disclose all material information, **[**42]** and the Court of Chancery agreed. *Stroud, 606 A.2d at 86*.

On appeal, the Delaware Supreme Court reversed. The Supreme Court held that when directors were not seeking stockholder action, *viz.* not soliciting proxies, they only needed to comply with the statutory requirements. *Id. at 87*.

> [U]nder all of the circumstances here, the board had no duty to disclose anything beyond the requirements of *section 242(b)(1)* of the General Corporation Law. The board complied with its statutory duty and included with its notice both the certificates of incorporation and the proposed amendments. . . . Nor is the board's conduct inequitable.

Id. at 87. No additional disclosure was necessary. *Id.* The Supreme Court admonished the Court of Chancery to "act with caution and restraint when ignoring **[*1025]** the clear language of the General Corporation Law in favor of other legal or equitable principles." *Id.*

In *Stroud,* because the directors were not soliciting proxies, the fiduciary duty of disclosure was limited, and the meeting notice and a summary of the charter amendments sufficed. Under the Holdings LP Agreement, all fiduciary duties, including the duty of disclosure, have been eliminated. The meeting notice and **[**43]** summary or copy of the merger agreement called for by the Holdings LP Agreement parallel the information deemed sufficient in *Stroud.* In light of *Stroud,* it is not possible to say that the defendants have acted "arbitrarily or unreasonably," as would be required to invoke the implied covenant. *Nemec, 991 A.2d at 1125-26*. To the contrary, because the LP Act specifically authorizes the elimination of fiduciary duties, this Court must act with "caution and restraint" and decline to use the implied covenant as a basis for "ignoring the clear language" of Section 1101(d) and the Holdings LP Agreement. *Stroud, 606 A.2d at 87*.

The plaintiff's disclosure claims are not colorable because the implied covenant cannot support a generalized duty to disclose all material information reasonably available. As the Form S-4 shows, the absence of a Delaware disclosure duty does not mean that holders of LP units will lack for information. Publicly traded MLPs remain subject to the federal securities laws. Limited partners also retain a state law remedy for common law fraud. *E.g., Gaffin v. Teledyne, Inc., 611 A.2d 467, 472 (Del. 1992)*; *NACCO Indus., Inc. v.*

Applica, Inc., 997 A.2d 1, 26-33 (Del. Ch. 2009). **[**44]** What the plaintiff does not have is a colorable state law disclosure claim.

III. CONCLUSION

The motion to expedite is denied. The case will proceed on a non-expedited schedule. **IT IS SO ORDERED.**

Caution
As of: October 21, 2022 8:18 PM Z

Manti Holdings, LLC v. Authentix Acquisition Co.

Supreme Court of Delaware

May 12, 2021, Submitted; September 13, 2021, Decided

No. 354, 2020

Reporter
261 A.3d 1199 *; 2021 Del. LEXIS 286 **

MANTI HOLDINGS, LLC, MALONE MITCHELL, WINN INTERESTS, LTD., EQUINOX I. A TX, GREG PIPKIN, CRAIG JOHNSTONE, TRI-C AUTHENTIX, LTD., DAVID MOXAM, LAL PEARCE, and JIM RITTENBURG, Petitioners Below, Appellants/Cross-Appellees, v. AUTHENTIX ACQUISITION COMPANY, INC., Respondent Below, Appellee/Cross-Appellant.

Subsequent History: Motion for Reargument filed 9/27/21; Denied 10/1/21. Case Closed October 1, 2021.

Prior History: [1]** Court Below - Court of Chancery of the State of Delaware. C.A. No. 2017-0887-SG. Upon appeal from the Court of Chancery.

Manti Holdings, LLC v. Authentix Acquisition Co., 2020 Del. Ch. LEXIS 262, 2020 WL 4596838 (Del. Ch., Aug. 11, 2020)

Disposition: AFFIRMED.

Core Terms

stockholders, appraisal, rights, Refrain, merger, stock, waive, parties, mandatory, provisions, entity, ex ante, charter, contractual, public policy, preferred stock, Holdings, sophisticated, agreeing, waivers, bylaws, certificate of incorporation, Fee-Shifting, ordering, pre-judgment, terms, merger agreement, statutory right, fair value, termination

Case Summary

Overview

HOLDINGS: [1]-Because *Del. Code Ann. tit. 8, § 262* did not prohibit common stockholders from agreeing to an ex ante waiver of mandatory appraisal rights, consistent with the flexibility provided to corporations by *Del. Code Ann. tit. 8, §§ 102(b)(1)*, *109(b)* and the strong public policy favoring private ordering, sophisticated and informed stockholders represented by counsel validly agreed in a stockholders agreement to waive their appraisal rights in exchange for valuable consideration; [2]-The waiver was not a stock restriction under *Del. Code Ann. tit. 8, § 151(a)* because it imposed personal obligations on stockholders rather than restricting stock rights; [3]-The corporation could enforce the waiver because *Del. Code Ann. tit. 8, § 218(c)* did not bar corporations from entering into stockholders agreements, which was within the *Del. Code Ann. tit. 8, § 122(13)* power to make contracts.

Outcome
Judgment affirmed.

LexisNexis® Headnotes

Business & Corporate Law > Corporations > Shareholder Actions > Appraisal Actions & Dissent Rights

HN1[] **Shareholder Actions, Appraisal Actions & Dissent Rights**

As a matter of public policy, there are certain fundamental features of a corporation that are essential to that entity's identity and cannot be waived. Nonetheless, the individual right of a stockholder to seek a judicial appraisal is not among those fundamental features that cannot be waived.

Business & Corporate Law > ... > Appraisal Actions & Dissent Rights > Right to Dissent > Procedural Matters

Mergers & Acquisitions Law > Mergers > Rights of Dissenting Shareholders

Business & Corporate Law > ... > Shareholder Actions > Appraisal Actions & Dissent Rights > Remedies

HN2[] Right to Dissent, Procedural Matters

Del. Code Ann. tit. 8, § 262 does not prohibit sophisticated and informed stockholders, who were represented by counsel and had bargaining power, from voluntarily agreeing to waive their appraisal rights in exchange for valuable consideration.

Civil Procedure > ... > Summary Judgment > Entitlement as Matter of Law > Appropriateness

Civil Procedure > ... > Summary Judgment > Summary Judgment Review > Standards of Review

Civil Procedure > Judgments > Summary Judgment > Entitlement as Matter of Law

Civil Procedure > ... > Summary Judgment > Entitlement as Matter of Law > Legal Entitlement

Civil Procedure > Appeals > Standards of Review > De Novo Review

HN3[] Entitlement as Matter of Law, Appropriateness

The Court of Chancery's grant of summary judgment is reviewed de novo. Summary judgment is appropriate if, viewing the facts in the light most favorable to the nonmoving party, there are no disputed issues of material fact, and the moving party has demonstrated that it is entitled to judgment as a matter of law.

Business & Corporate Compliance > ... > Contracts Law > Standards of Performance > Illusory Promises

Contracts Law > Contract Interpretation

HN4[] Standards of Performance, Illusory Promises

The principles of contract interpretation under Delaware law are well-established. When interpreting a contract, Delaware courts read the agreement as a whole and enforce the plain meaning of clear and unambiguous language. Contracts will be interpreted to give each provision and term effect and not render any terms meaningless or illusory. When a contract is clear and unambiguous, the court will give effect to the plain meaning of the contract's terms and provisions. Language is ambiguous if it is susceptible to more than one reasonable interpretation. An interpretation is unreasonable if it produces an absurd result or a result that no reasonable person would have accepted when entering the contract. The parties' steadfast disagreement over interpretation will not, alone, render the contract ambiguous.

Mergers & Acquisitions Law > General Business Considerations > Securities Laws

Securities Law > ... > Scope of Provisions > Definitions > Covered Securities

Securities Law > Blue Sky Laws > Offers & Sales

HN5[] General Business Considerations, Securities Laws

Whether a merger meets the statutory definition for a sale of securities under federal or state securities law has no bearing on whether a merger is structured as a sale of equity securities under a stockholders agreement.

Civil Procedure > ... > Defenses, Demurrers & Objections > Affirmative Defenses > Waiver

HN6[] Affirmative Defenses, Waiver

Under Delaware law, waiver is the intentional relinquishment of a known right. A waiver may be either express or implied, but either way, it must be unequivocal. The contractual waiver of a statutory right must be clear to be enforceable. The standards for proving waiver under Delaware law are quite exacting, and the facts relied upon to prove waiver must be unequivocal.

Business & Corporate Law > ... > Appraisal Actions & Dissent Rights > Right to Dissent > Procedural Matters

Mergers & Acquisitions Law > Mergers > Rights of Dissenting Shareholders

Business & Corporate Law > ... > Shareholder Actions > Appraisal Actions & Dissent Rights > Remedies

HN7[] Right to Dissent, Procedural Matters

A stockholder may only commence an appraisal proceeding within 120 days after the effective date of the merger or consolidation. *Del. Code Ann. tit. 8, § 262(e)*.

Contracts Law > Contract Interpretation

HN8[] Contracts Law, Contract Interpretation

Delaware courts read contracts as a whole, and interpretations that are commercially unreasonable or that produce absurd results must be rejected.

Business & Corporate Law > ... > Corporate Existence, Powers & Purpose > Existence > Distinct & Separate Legal Entity

HN9[] Existence, Distinct & Separate Legal Entity

It is a fundamental principle of Delaware law that a corporation is an entity, capable of forming a contract, with an identity separate from its stockholders.

Business & Corporate Compliance > ... > Contracts Law > Contract Formation > Execution & Delivery

HN10[] Contract Formation, Execution & Delivery

The parties to a contract are bound by its terms and have a corresponding right to enforce them.

Civil Procedure > Appeals > Standards of Review > De Novo Review

Governments > Legislation > Interpretation

Civil Procedure > Appeals > Standards of Review > Questions of Fact & Law

HN11[] Standards of Review, De Novo Review

Statutory interpretation is a question of law, which is reviewed de novo. The most important consideration for a court in interpreting a statute is the language the General Assembly used in writing the statute. The first step in this analysis is to determine whether or not the statute is ambiguous. A statute is ambiguous only if it is reasonably susceptible to different interpretations, or if a literal reading of the statute would lead to an unreasonable or absurd result not contemplated by the legislature. The fact that the parties disagree about the meaning of the statute does not create ambiguity. If the statute is found to be clear and unambiguous, then the plain meaning of the statutory language controls. On the other hand, if the statute is ambiguous it will be construed in a way that will promote its apparent purpose and harmonize it with other statutes within the statutory scheme.

Business & Corporate Law > Corporations > Articles of Incorporation & Bylaws > Amendments to Articles of Incorporation

Business & Corporate Law > Corporations > Articles of Incorporation & Bylaws > Interpretation of Articles of Incorporation

Business & Corporate Law > ... > Corporate Finance > Initial Capitalization & Stock Subscriptions > Classes of Stock

HN12[] Articles of Incorporation & Bylaws, Amendments to Articles of Incorporation

A limitation or restriction on a class or series of stock, under *Del. Code Ann. tit. 8, § 151(a)*, shall be stated and expressed in the corporation's certificate of incorporation or in the authorizing board resolutions.

Business & Corporate Compliance > ... > Contracts Law > Types of Contracts > Bilateral Contracts

Business & Corporate Law > ... > Corporate Finance > Dividends & Reacquisition of

Shares > Cancellation & Redemption

Business & Corporate Law > ... > Directors & Officers > Terms in Office > Elections

Business & Corporate Law > Types of Transactions > Transfers of Stock

Business & Corporate Law > ... > Meetings & Voting > Special Meetings > Fundamental Changes

HN13[] Types of Contracts, Bilateral Contracts

Del. Code Ann. tit. 8, § 218(a) authorizes one stockholder or 2 or more stockholders to form a stockholders agreement and does not impose any limitations on the number or percentage of a corporation's stockholders that can form a stockholders agreement. Given Delaware's public policy favoring private ordering, a total-percentage-of-stockholders limitation should not be added to § 218 where none exists. Accordingly, there is no merit to an argument that any performance duty imposed under a bilateral agreement binding all of a corporation's stockholders is a stock restriction.

Business & Corporate Law > Types of Transactions > Transfers of Stock

HN14[] Types of Transactions, Transfers of Stock

A corporation must make the necessary disclosures in order to issue stock with restrictions.

Business & Corporate Law > ... > Corporate Finance > Dividends & Reacquisition of Shares > Cancellation & Redemption

Mergers & Acquisitions Law > Mergers > Rights of Dissenting Shareholders

Business & Corporate Law > ... > Appraisal Actions & Dissent Rights > Right to Dissent > Procedural Matters

Business & Corporate Law > ... > Shareholder Actions > Appraisal Actions & Dissent Rights > Fair Market Value

HN15[] Dividends & Reacquisition of Shares, Cancellation & Redemption

Del. Code Ann. tit. 8, § 262(a) provides that any stockholder of a corporation of the State of Delaware that meets the predicate requirements for filing an appraisal petition shall be entitled to an appraisal by the Court of Chancery of the fair value of the stockholder's shares of stock.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Good Faith

HN16[] Fiduciary Duties, Duty of Good Faith

At its core, the Delaware General Corporation Law is a broad enabling act that allows immense freedom for businesses to adopt the most appropriate terms for the organization, finance, and governance of their enterprise provided the statutory parameters and judicially imposed principles of fiduciary duty are honored. Delaware's corporate statute is widely regarded as the most flexible in the nation because it leaves parties to the corporate contract (managers and stockholders) with great leeway to structure their relationships, subject to relatively loose statutory constraints and to the policing of director misconduct through equitable review.

Business & Corporate Law > Corporations > Articles of Incorporation & Bylaws > Amendments to Articles of Incorporation

Business & Corporate Law > Corporations > Articles of Incorporation & Bylaws > Interpretation of Articles of Incorporation

Business & Corporate Law > Corporations > Articles of Incorporation & Bylaws > Interpretations of Bylaws

Business & Corporate Law > Corporations > Articles of Incorporation & Bylaws > Amendments to Bylaws

HN17[] Articles of Incorporation & Bylaws, Amendments to Articles of Incorporation

The public policy favoring private ordering is reflected in Del. Code Ann. tit. 8, § 102(b)(1), which allows a corporate charter to contain virtually any provision that is related to the corporation's governance and not contrary to the laws of the State of Delaware. Del. Code Ann. tit. 8, § 109(b) provides similarly broad authorization for bylaws that are not inconsistent with law or with the certificate of incorporation, and which relate to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers, or employees.

Business & Corporate Law > Corporations > Articles of Incorporation & Bylaws > Amendments to Bylaws

Business & Corporate Law > Corporations > Articles of Incorporation & Bylaws > Interpretation of Articles of Incorporation

Business & Corporate Law > Corporations > Articles of Incorporation & Bylaws > Interpretations of Bylaws

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Good Faith

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Loyalty

HN18[] **Articles of Incorporation & Bylaws, Amendments to Bylaws**

Although the Delaware General Corporation Law is a broad and enabling statute, it is not bereft of mandatory terms. For example, the certificate of incorporation may not contain any provision that would impose liability on a stockholder for the attorneys' fees or expenses of the corporation or any other party in connection with an internal corporate claim. Del. Code Ann. tit. 8, § 102(f). Similarly, while a corporate charter may include 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 as a director, the charter may not eliminate or limit the liability of a director for breaches of the duty of loyalty, acts of bad faith, or any transaction from which the director derived an improper personal benefit. § 102(b)(7). In addition to these express prohibitions, corporate charters and bylaws may not contain provisions that are contrary to, as stated in § 102(b)(1), or inconsistent with, as stated in Del. Code Ann. tit. 8, § 109(b), Delaware law because they transgress a public policy settled by the common law or implicit in the General Corporation itself.

Business & Corporate Law > ... > Appraisal Actions & Dissent Rights > Right to Dissent > Procedural Matters

Mergers & Acquisitions Law > Mergers > Rights of Dissenting Shareholders

Business & Corporate Law > ... > Shareholder Actions > Appraisal Actions & Dissent Rights > Remedies

HN19[] **Right to Dissent, Procedural Matters**

The plain language of Del. Code Ann. tit. 8, § 262 does not prohibit stockholders from agreeing to waive their appraisal rights.

Business & Corporate Law > ... > Appraisal Actions & Dissent Rights > Right to Dissent > Procedural Matters

Governments > Legislation > Interpretation

HN20[] **Right to Dissent, Procedural Matters**

The General Assembly's use of the word "shall" appears to grant stockholders a mandatory right to seek a judicial appraisal. Del. Code Ann. tit. 8, § 262(a).

Governments > Legislation > Interpretation

HN21[] **Legislation, Interpretation**

When construing a statute, "shall" generally signals a mandatory requirement while "may" is permissive. Further, the mandatory "shall" normally creates an obligation impervious to judicial discretion.

Business & Corporate Law > Corporations > Shareholder Actions > Appraisal Actions & Dissent Rights

HN22[] **Shareholder Actions, Appraisal Actions &**

Dissent Rights

Delaware's legal system permits one to waive even a constitutional right and, a fortiori, one may waive a statutory right. Thus, granting stockholders a mandatory right to seek a judicial appraisal does not prohibit stockholders from alienating that entitlement in exchange for valuable consideration.

Civil Procedure > ... > Defenses, Demurrers & Objections > Affirmative Defenses > Waiver

Governments > Legislation > Interpretation

HN23[] Affirmative Defenses, Waiver

Case law supports the proposition that a party can waive a mandatory right created using the word "shall." Further, assuming that other relevant criteria are met, Delaware courts will enforce the contractual waiver of a substantive right.

Business & Corporate Law > Corporations > Articles of Incorporation & Bylaws > Interpretation of Articles of Incorporation

Mergers & Acquisitions Law > Mergers > Rights of Dissenting Shareholders

Business & Corporate Law > ... > Appraisal Actions & Dissent Rights > Right to Dissent > Procedural Matters

Business & Corporate Law > ... > Shareholder Actions > Appraisal Actions & Dissent Rights > Remedies

HN24[] Articles of Incorporation & Bylaws, Interpretation of Articles of Incorporation

The General Assembly knows how to draft language that prohibits parties from altering a mandatory provision of the Delaware General Corporation Law in a corporation's charter or bylaws. Presumably the General Assembly could draft language prohibiting stockholders from altering a mandatory provision under a stockholders agreement if it chose to do so. But *Del. Code Ann. tit. 8, § 262* does not contain any language that prohibits stockholders from waiving their appraisal rights.

Business & Corporate Law > Corporations > Shareholder Actions > Appraisal Actions & Dissent Rights

Contracts Law > Contract Interpretation

HN25[] Shareholder Actions, Appraisal Actions & Dissent Rights

The statutory right to seek a judicial appraisal may be effectively waived in the documents creating the security, provided that result is quite clearly set forth when interpreting the relevant document under generally applicable principles of construction.

Business & Corporate Law > ... > Corporate Finance > Dividends & Reacquisition of Shares > Cancellation & Redemption

Mergers & Acquisitions Law > Mergers > Rights of Dissenting Shareholders

Business & Corporate Law > ... > Corporate Finance > Initial Capitalization & Stock Subscriptions > Classes of Stock

Business & Corporate Law > ... > Appraisal Actions & Dissent Rights > Right to Dissent > Procedural Matters

Business & Corporate Law > ... > Corporate Finance > Initial Capitalization & Stock Subscriptions > Consideration

HN26[] Dividends & Reacquisition of Shares, Cancellation & Redemption

It may make good economic sense to treat preferred stock differently from common stock, but *Del. Code Ann. tit. 8, § 262* does not make such a distinction. To the contrary, *§ 262(h)* instructs the Court of Chancery to take into account all relevant factors when determining fair value. On its face, this instruction applies equally to common stock and preferred stock. Owners of both are entitled to a judicial appraisal. A stockholder can waive its appraisal rights ex ante under certain circumstances.

Contracts Law > Contract Interpretation

HN27[] **Contracts Law, Contract Interpretation**

There is no utility in defining as forbidden any term thought advantageous to informed parties, unless the term violates substantive law.

Civil Procedure > ... > Defenses, Demurrers & Objections > Affirmative Defenses > Waiver

HN28[] **Affirmative Defenses, Waiver**

Under Delaware law, a party agreeing to waive a claim must have knowledge of all material facts, including knowledge of the requirement or condition they are agreeing to waive.

Business & Corporate Law > Corporations > Articles of Incorporation & Bylaws > Amendments to Bylaws

Governments > Local Governments > Charters

Business & Corporate Law > Corporations > Articles of Incorporation & Bylaws > Interpretations of Bylaws

Business & Corporate Law > Corporations > Articles of Incorporation & Bylaws > Interpretation of Articles of Incorporation

Business & Corporate Law > ... > Directors & Officers > Terms in Office > Elections

HN29[] **Articles of Incorporation & Bylaws, Amendments to Bylaws**

Del. Code Ann. tit. 8, §§ 102(b)(1), 109(b) both provide broad authority for corporations to adopt charter provisions and bylaws that are not contrary to Delaware law.

Business & Corporate Law > ... > Appraisal Actions & Dissent Rights > Right to Dissent > Procedural Matters

Mergers & Acquisitions Law > Mergers > Rights of Dissenting Shareholders

Business & Corporate Law > ... > Shareholder Actions > Appraisal Actions & Dissent Rights > Remedies

HN30[] **Right to Dissent, Procedural Matters**

Appraisal rights allow dissenting stockholders to seek fair compensation for property taken without consent.

Business & Corporate Law > ... > Shareholder Actions > Appraisal Actions & Dissent Rights > Fair Market Value

Mergers & Acquisitions Law > Mergers > Rights of Dissenting Shareholders

Business & Corporate Law > ... > Shareholder Actions > Appraisal Actions & Dissent Rights > Remedies

Business & Corporate Law > ... > Appraisal Actions & Dissent Rights > Right to Dissent > Procedural Matters

Business & Corporate Law > ... > Shareholder Duties & Liabilities > Controlling Shareholders > Fiduciary Duties

HN31[] **Appraisal Actions & Dissent Rights, Fair Market Value**

The availability of appraisal rights might theoretically discourage attempts to pay minority stockholders less than fair value for their cancelled stock. Nonetheless, the focus of an appraisal proceeding is paying fair value for the petitioner's stock, not policing misconduct or preserving the ability of stockholders to participate in corporate governance. Granting stockholders the individual right to demand fair value does not prohibit stockholders from bargaining away that individual right in exchange for valuable consideration. And while the availability of appraisal rights may deter some unfair transactions at the margins, this does not mean that appraisal claims play a sufficiently important role in regulating the balance of power between corporate constituencies to forbid sophisticated and informed stockholders from freely agreeing to an ex ante waiver of their appraisal rights under a stockholders agreement in exchange for consideration.

Business & Corporate Law > ... > Appraisal Actions & Dissent Rights > Right to Dissent > Mergers &

Acquisitions

Mergers & Acquisitions Law > Mergers > Rights of Dissenting Shareholders

Business & Corporate Law > ... > Appraisal Actions & Dissent Rights > Right to Dissent > Procedural Matters

Business & Corporate Law > ... > Shareholder Actions > Appraisal Actions & Dissent Rights > Remedies

HN32[] Right to Dissent, Mergers & Acquisitions

Del. Code Ann. tit. 8, § 262(g) provides a de minimis exception from appraisal rights for stockholders of publicly-traded corporations.

Business & Corporate Law > ... > Meetings & Voting > Special Meetings > Fundamental Changes

Mergers & Acquisitions Law > Mergers > Duties & Liabilities of Shareholders

Mergers & Acquisitions Law > Mergers > Rights of Dissenting Shareholders

Business & Corporate Law > ... > Appraisal Actions & Dissent Rights > Right to Dissent > Mergers & Acquisitions

Business & Corporate Law > ... > Appraisal Actions & Dissent Rights > Right to Dissent > Procedural Matters

HN33[] Special Meetings, Fundamental Changes

Under Del. Code Ann. tit. 8, § 262(a), a stockholder that voted in favor of the merger or consolidation, or who provided written consent as provided for under Del. Code Ann. tit. 8, § 228, forfeits its appraisal claim. Drag-along rights often require that minority stockholders take actions that are reasonably necessary to close a merger, which would presumably include voting in favor of the merger or providing written consent. If a stockholder cannot waive its appraisal rights directly, there is no reason why a stockholder should be able to waive its appraisal rights indirectly by agreeing to a performance obligation that would require them to approve a merger.

Business & Corporate Law > ... > Appraisal Actions & Dissent Rights > Right to Dissent > Procedural Matters

Business & Corporate Law > ... > Shareholders > Meetings & Voting > Voting Shares

HN34[] Right to Dissent, Procedural Matters

Del. Code Ann. tit. 8, § 218(c) authorizes 2 or more stockholders of a Delaware corporation to form a voting agreement.

Business & Corporate Law > ... > Corporate Existence, Powers & Purpose > Powers > Contractual Agreements

Business & Corporate Law > Corporations > Articles of Incorporation & Bylaws > Interpretation of Articles of Incorporation

Business & Corporate Law > ... > Meetings & Voting > Special Meetings > Fundamental Changes

HN35[] Powers, Contractual Agreements

Nothing in the language of Del. Code Ann. tit. 8, § 218 prohibits corporations from entering into stockholders agreements. Forming contracts is a core corporate power.

Business & Corporate Law > ... > Corporate Governance > Directors & Officers > Scope of Authority

Business & Corporate Law > Corporations > Shareholder Actions

HN36[] Directors & Officers, Scope of Authority

Del. Code Ann. tit. 8, § 218 does not prohibit a Delaware corporation from enforcing a stockholders agreement.

Civil Procedure > Appeals > Standards of Review > Abuse of Discretion

Civil Procedure > Remedies > Judgment Interest > Prejudgment Interest

Civil Procedure > Judicial Officers > Judges > Discretionary Powers

HN37[] **Standards of Review, Abuse of Discretion**

The Court of Chancery's award of equitable interest is reviewed for abuse of discretion. The Court of Chancery has broad equitable authority to award pre-judgment interest, including to a party that did not prevail in the litigation. The court may grant such relief as the facts of a particular case may require even if the prevailing party has not demanded such relief in its pleadings. On at least one occasion, the Court of Chancery has suggested that a stockholder could receive equitable interest on merger consideration despite failing to perfect its appraisal claim.

Civil Procedure > Remedies > Judgment Interest > Prejudgment Interest

Civil Procedure > Preliminary Considerations > Equity > Relief

HN38[] **Judgment Interest, Prejudgment Interest**

Whether parties are entitled to equitable interest has no bearing on whether another party has a contractual right to pre-judgment interest. The former is a question of the Court of Chancery's broad equitable power to fashion an appropriate remedy. The latter is a question of the objective intent of the bargain the parties struck. These are separate issues.

Counsel: John L. Reed, Esquire (argued), Peter H. Kyle, Esquire, Kelly L. Freund, Esquire, DLA PIPER LLP (US), Wilmington, Delaware; for Appellants/Cross-Appellees Manti Holdings, LLC, Malone Mitchell, Winn Interests, Ltd., Equinox I. A Tx, Greg Pipkin, Craig Johnstone, Tri-C Authentix, Ltd., David Moxam, Lal Pearce, and Jim Rittenburg.

Samuel A. Nolen, Esquire (argued), RICHARDS, LAYTON & FINGER, P.A., Wilmington, Delaware; Andrew Hammond, Esquire, Michelle Letourneau-Belock, Esquire, Bryan Beaudoin, Esquire, WHITE & CASE LLP, New York, New York; for Appellee/Cross-Appellant Authentix Acquisition Company, Inc.

Judges: Before SEITZ, Chief Justice; VALIHURA, VAUGHN, TRAYNOR and MONTGOMERY-REEVES, Justices. VALIHURA, J., dissenting.

Opinion by: MONTGOMERY-REEVES

Opinion

[*1203] MONTGOMERY-REEVES, Justice, for the Majority:

In 2017, a third-party entity acquired Authentix Acquisition Company, Inc. ("Authentix"). The cash from the merger was distributed to the stockholders pursuant to a waterfall provision. The Authentix common stockholders received little to no consideration. A group of common stockholders filed **[**2]** a petition for appraisal in the Court of Chancery under *Section 262* of the Delaware General Corporation Law ("DGCL"). Authentix moved to dismiss the petition, arguing that the petitioners had waived their appraisal rights under a stockholders agreement that bound the corporation and all of its stockholders. The Court of Chancery granted the motion to dismiss, holding that the petitioners had agreed to a clear provision requiring that they "refrain" from exercising their appraisal rights with respect to the merger. In a separate opinion, the court awarded the petitioners equitable interest on the merger consideration and declined to award Authentix pre-judgment interest under a fee-shifting provision. All parties appealed the Court of Chancery's decisions.

The arguments in this appeal largely focus on whether *Section 262 of the DGCL* prohibits a Delaware corporation from enforcing an advance waiver of appraisal rights against its own stockholders. Pointing to Delaware's strong policy favoring private ordering, Authentix argues that stockholders are free to set the terms that will govern their corporation so long as such alteration is not prohibited by statute or otherwise contrary to the laws of this State. Authentix **[**3]** contends that a waiver of the right to seek appraisal is not prohibited by the DGCL and is not otherwise contrary to the laws of this State.

The petitioners recognize that the DGCL is flexible, but they argue that the DGCL has mandatory provisions that are fundamental features of the corporate entity's identity. These features, they contend, cannot be varied by a contract between the corporation and all its stockholders. The petitioners argue that, if one desires true "freedom of contract," Delaware provides that option through the alternative entity forms, which expressly give maximum effect to the principle of freedom of contract. The petitioners warn that, if this Court allows a waiver of any mandatory right under the DGCL, such as the right to **[*1204]** demand appraisal, then any other right could be waived. For example, they argue that a Delaware corporation and all its stockholders could also agree to a preemptive and blanket waiver of their statutory right to seek books and records under *Section 220*, their ability to challenge an election under *Section 225*, their ability to bring an action to compel a stockholders' meeting under *Section 211*, and their ability to file a breach of fiduciary duty action, among others.

HN1[] As **[**4]** a matter of public policy, there are certain fundamental features of a corporation that are essential to that entity's identity and cannot be waived. Nonetheless, it is the Court's view that the individual right of a stockholder to seek a judicial appraisal is not among those fundamental features that cannot be waived. ***HN2***[] Accordingly, we hold that *Section 262* does not prohibit sophisticated and informed stockholders, who were represented by counsel and had bargaining power, from voluntarily agreeing to waive their appraisal rights in exchange for valuable consideration.

This Court also affirms the other aspects of the Court of Chancery's decision. The petitioners agreed to a clear waiver of the appraisal rights with respect to the 2017 merger. Authentix was an intended beneficiary capable of enforcing that waiver. The waiver is not a stock restriction that had to be included in the corporation's charter, and Delaware corporations may enforce stockholders agreements. The Court of Chancery did not abuse its discretion by awarding the petitioners equitable interest on the merger consideration; nor did the court abuse its discretion by declining to award Authentix pre-judgment interest under a fee-shifting **[**5]** provision. Accordingly, the Court of Chancery's judgment is affirmed.

I. BACKGROUND

A. Parties and Relevant Non-Parties

Authentix is a Delaware corporation.[1]

Appellants and Cross-Appellees Manti Holdings, LLC; Malone Mitchell; Winn Interests, Ltd.; Equinox I. A Tx; Greg Pipkin; Craig Johnstone; Tri C Authentix, Ltd.; David Moxam; Lal Pearce; and Jim Rittenburg (collectively, the "Petitioners") were minority stockholders of Authentix before the corporation's merger with a third-party entity.[2]

The Carlyle Group and J.H. Whitney & Co. (collectively, "Carlyle") were majority stockholders of Authentix before the corporation's merger with a third-party entity.[3]

Authentix, Inc. is the predecessor entity to Authentix.[4]

B. The Petitioners Enter into the Stockholders Agreement

In 2007, Authentix, Inc. retained an investment banker and began exploring its strategic and financial options.[5] At that time, each of the Petitioners owned stock in Authentix, Inc.; and Manti Holdings, LLC held a majority of the outstanding shares.[6] Several prospective bidders made offers, including Carlyle.[7] The Carlyle offer won out, and in 2008 Authentix, Inc. entered into a transaction under which it became a wholly-owned subsidiary **[**6]** of Authentix. Carlyle gained majority control of **[*1205]** the parent corporation, Authentix.[8] The Petitioners rolled over or reinvested their stakes and became minority stockholders in the post-merger Authentix.[9]

As a condition of the 2008 merger, Carlyle required that Authentix and all of its stockholders enter into a stockholders agreement (the "Stockholders Agreement").[10] The Petitioners, Authentix, and Carlyle

---

[1] J.A. to Opening Br. 1600 (hereinafter, "J.A._").

[2] J.A. 1599-600.

[3] J.A. 1601.

[4] J.A. 1600.

[5] *Id.*

[6] J.A. 1601. Manti Resources, Inc.—a related entity to Manti Holdings, LLC—may have owned some of these shares. *See id.*

[7] *Id.*

[8] *Id.*

[9] *Id.*

[10] *Id.* This Opinion discusses the relevant provisions of the

were all represented by counsel; the Stockholders Agreement was not a contract of adhesion; and all of the parties received valuable consideration in exchange for entering into the agreement.[11] Authentix and each of the Petitioners signed the Stockholders Agreement, along with Carlyle.[12]

In 2009, Authentix sought to raise additional capital by issuing Series B preferred stock.[13] All of the existing stockholders, including the Petitioners, participated on a *pro rata* basis.[14] Carlyle and other stockholders purchased shares of the Series B preferred stock.[15] In connection with this transaction, the Stockholders Agreement was amended to add a definition of "Preferred Stock."[16]

C. Authentix Merges with a Third-Party Entity

On September 12, 2017, the Authentix **[**7]** board recommended a merger with a third-party entity.[17] On September 13, 2017, Carlyle approved the merger by written consent, and closing occurred the same day.[18] The Petitioners did not receive advance notice of the merger and were not given an opportunity to vote on the transaction.[19]

Shortly after the merger closed, the Petitioners were provided with a written notice that the corporation had executed a merger agreement by written consent.[20] The notice summarized various details of the merger agreement and "request[ed] that [the recipient] execute [an attached] Written Consent to waive any appraisal rights that [they] may have under Section 262 of the DGCL pursuant to [their] obligations set forth in the Company's Stockholder's Agreement to which [they] are a party and to which [they] are bound."[21] The notice included a one-page disclosure informing the recipient of their appraisal rights:

> **APPRAISAL RIGHTS OF STOCKHOLDERS**
>
> The Company's stockholders who do not consent in writing to the Merger may be entitled to certain appraisal rights under Section 262 of the DGCL in connection with the Merger as described below. . . . **Stockholders who executed [*1206] and delivered a written consent of stockholders to consent to the adoption of the Merger Agreement [**8] will not be entitled to these rights. [The recipient] [is] reminded that [they] have contractually agreed to refrain from exercising any appraisal rights pursuant to the Company Stockholders Agreement to which [they] are bound**.[22]

Under the merger agreement, all of the Petitioners' stock was cancelled and converted into a right to receive the merger consideration.[23] The merger consideration was to be distributed to stockholders based on a waterfall provision that gave priority to the preferred stockholders.[24] It appears that common stockholders, like the Petitioners, could expect to receive little to no compensation for their cancelled stock and that nearly all of the merger consideration would be paid to the preferred stockholders, such as Carlyle.[25]

D. The Court of Chancery Dismisses the Appraisal Petition

Stockholders Agreement in the Analysis section. *See infra* Part III.

[11] J.A. 1601-04; *see, e.g.,* *Manti Hldgs., LLC v. Authentix Acq. Co. (Manti I), 2018 Del. Ch. LEXIS 318, 2018 WL 4698255, at *4 (Del. Ch. Oct. 1, 2018)*.

[12] J.A. 93-123.

[13] J.A. 1604.

[14] *Id.*

[15] *Id.*

[16] J.A. 58-59, 1604.

[17] *Manti Hldgs., LLC v. Authentix Acq. Co. (Manti III), 2020 Del. Ch. LEXIS 262, 2020 WL 4596838, at *2 (Del. Ch. Aug. 11, 2020)*.

[18] J.A. 164-168 (written consent); J.A. 170-257 (merger agreement).

[19] *See* J.A. 459-60 (Confidential Information Statement and Notice of Action by Written Consent and Approval of Merger).

[20] *Id.*

[21] J.A. 459.

[22] J.A. 469.

[23] J.A. 193-200, at § 3.1.

[24] J.A. 195-97, at § 3.1(f).

[25] J.A. 464.

In September and October of 2017, the Petitioners sent timely appraisal demands to Authentix.[26] In response, Authentix requested that the Petitioners withdraw their appraisal demands and agree to exchange their shares for the merger consideration.[27] The Petitioners refused and filed a petition (the "Appraisal Petition") in the Court of Chancery seeking to exercise their statutory appraisal **[**9]** rights under *Section 262 of the DGCL*.[28] Authentix filed counterclaims and moved for summary judgment on the appraisal claim.[29] The Petitioners moved to dismiss the counterclaims.[30]

On October 1, 2018, the Court of Chancery issued a letter opinion granting Authentix's motion for partial summary judgment and denying the Petitioners' motion to dismiss the counterclaims.[31] The court held that the Petitioners had waived their appraisal rights under the Stockholders Agreement and that the appraisal waiver was not a stock restriction that must be included in the corporation's charter under *Section 151(a)*.[32]

On August 14, 2019, the Court of Chancery issued a memorandum opinion denying the Petitioners' motion for reargument.[33] Among other things, the Petitioners argued that the court's October 2018 opinion erred because a Delaware corporation's stockholders cannot agree to a blanket and advance waiver of a mandatory statutory right, such as the right to demand a judicial appraisal under *Section 262*.[34] The court disagreed and held that the Petitioners agreed to a clear and enforceable waiver of their appraisal rights.[35]

On August 11, 2020, the Court of Chancery issued its final memorandum opinion, which addressed whether Authentix could **[*1207]** enforce **[**10]** a fee-shifting provision and whether the Petitioners were entitled to interest on the merger consideration.[36] The court held that Authentix could enforce the fee-shifting provision but was not entitled to pre-judgment interest.[37] The court also awarded the Petitioners equitable interest on their portion of the merger consideration.[38]

Both sides have appealed. The Petitioners challenge the Court of Chancery's dismissal of their appraisal petition.[39] Authentix challenges the court's holdings granting the Petitioners equitable interest on the merger consideration and denying Authentix pre-judgment interest under the fee-shifting provision.[40]

II. STANDARD OF REVIEW

HN3[] This Court reviews *de novo* the Court of Chancery's grant of summary judgment.[41] Summary judgment is appropriate if, viewing the facts in the light most favorable to the nonmoving party, there are no disputed issues of material fact, and the moving party has demonstrated that it is entitled to judgment as a matter of law.[42]

The parties agree that there are no disputed issues of material fact.[43] Accordingly, the bulk of this appeal

---

[26] *Manti III, 2020 Del. Ch. LEXIS 262, 2020 WL 4596838, at *3*.

[27] *Id.*

[28] *Id.*

[29] *Id.*

[30] *Id.*

[31] *Manti I*, 2018 Del. Ch. LEXIS 318, 2018 WL 4698255, at *1-2.

[32] *2020 Del. Ch. LEXIS 262, [WL] at *3-5*.

[33] *Manti Hldgs., LLC v. Authentix Acq. Co. (Manti II), 2019 Del. Ch. LEXIS 307, 2019 WL 3814453 (Del. Ch. Aug. 14, 2019)*.

[34] *2019 Del. Ch. LEXIS 307, [WL] at *3*.

[35] *2019 Del. Ch. LEXIS 307, [WL] at *3-4*.

[36] *Manti III, 2020 Del. Ch. LEXIS 262, 2020 WL 4596838, at *4-11*.

[37] *2020 Del. Ch. LEXIS 262, [WL] at *4-10*.

[38] *2020 Del. Ch. LEXIS 262, [WL] at *10-11*.

[39] Opening Br. 6-10.

[40] Answering Br. 5-11.

[41] ***Monzo v. Nationwide Prop. & Cas. Ins. Co., 249 A.3d 106, 117 (Del. 2021)***.

[42] *Id.* (citing *Sherman v. Ellis, 246 A.3d 1126, 1131 (Del. 2021)*).

[43] *See, e.g.*, Opening Br. 2 ("The facts are undisputed; it remains only to apply the law and the language of the [Stockholders Agreement] to the facts."); Answering Br. 46

addresses whether the Court of Chancery committed errors of law in granting summary judgment against the Petitioners. **[**11]** The final two issues on appeal, however, add a second standard of review: whether the Court of Chancery abused its discretion by ordering improper relief.[44]

III. ANALYSIS

This appeal presents four issues. First, whether the Petitioners agreed to a clear waiver of their appraisal rights with respect to the 2017 merger. Second, whether a Delaware corporation can enforce a waiver of appraisal rights against its own stockholders. Third, whether the Court of Chancery abused its discretion by awarding the Petitioners equitable interest on the merger consideration. And fourth, whether the Court of Chancery erred by refusing to award Authentix pre-judgment interest on its attorneys' fees.

A. The Petitioners Agreed to a Clear Waiver of their Appraisal Rights

The first question on appeal is whether the Petitioners waived their statutory appraisal rights by agreeing, under Section 3(e) of the Stockholders Agreement, to "refrain" from exercising their appraisal rights with respect to a "Company Sale" if the board and Carlyle approve the transaction (the "Refrain Obligation"):

> [I]n the event that . . . a Company Sale is approved by the Board and . . . the Carlyle Majority, each Other **[**12]** Holder shall consent to and raise no objections against such transaction . . ., and . . . **[*1208]** [shall] refrain from the exercise of appraisal rights with respect to such transaction.[45]

The Petitioners argue that the Refrain Obligation did not waive their appraisal rights with respect to the 2017 merger for three reasons. First, the Petitioners argue that the Refrain Obligation was never triggered because, under the 2017 merger agreement, the preferred stock held by Carlyle was not acquired on the "Same Terms and Conditions" as the common stock held by the Petitioners.[46] Second, the Petitioners argue that the Stockholders Agreement did not impose a clear *post-termination* duty to refrain from exercising appraisal rights because the contract's termination provision can be reasonably construed to extinguish all obligations, including the Refrain Obligation, "upon" the consummation of a Company Sale.[47] Third, the Petitioners argue that the post-merger Authentix could not enforce the Stockholders Agreement because it was not an intended beneficiary.[48] For the reasons provided below, this Court rejects each of these arguments.

1. Principles of contract interpretation

HN4[] The principles of contract interpretation **[**13]** under Delaware law are well-established. When interpreting a contract, Delaware courts read the agreement as a whole and enforce the plain meaning of clear and unambiguous language.[49] Contracts will be interpreted to "give each provision and term effect" and not render any terms "meaningless or illusory."[50] "When a contract is clear and unambiguous, the court will give effect to the plain meaning of the contract's terms and provisions."[51] Language is ambiguous if it is susceptible to more than one reasonable interpretation.[52] An

---

("This Court . . . can . . . limit its holding to the undisputed facts of this case.").

[44] *See, e.g., Boush v. Hodges, 705 A.2d 242* [published in full-text format at *1998 Del. LEXIS 25*], 1998 WL 40220, at *2 (Del. Jan. 15, 1998) (TABLE).

[45] J.A. 73-74, at § 3(e).

[46] Opening Br. 24-27.

[47] *Id.* at 18-23.

[48] *Id.* at 20-21.

[49] *Osborn ex rel. Osborn v. Kemp, 991 A.2d 1153, 1159-60 (Del. 2010)* (first citing *Kuhn Constr., Inc. v. Diamond State Port Corp., 990 A.2d 393, 396-97 (Del. 2010)*; and then citing *Rhone-Poulenc Basic Chem. Co. v. Am. Motorists Ins. Co., 616 A.2d 1192, 1195 (Del. 1992)*).

[50] *Id. at 1159* (quoting *Kuhn, 990 A.2d at 396-97*; *Sonitrol Hldg. Co. v. Marceau Investissements, 607 A.2d 1177, 1183 (Del. 1992)*).

[51] *Id. at 1159-60* (citing *Rhone-Poulenc, 616 A.2d at 1195*).

[52] *Id. at 1160* (first citing *Twin City Fire Ins. Co. v. Del. Racing Ass'n, 840 A.2d 624, 628 (Del. 2003)*; and then citing *Rhone-Poulenc, 616 A.2d at 1195*); *see also* ***Sunline Com. Carriers, Inc. v. CITGO Petroleum Corp., 206 A.3d 836, 847 (Del. 2019)*** ("If, after applying these canons of interpretation, the contract is nonetheless 'reasonably susceptible [to] two or more interpretations or may have two or more different meanings,' then the contract is ambiguous . . . ." (quoting

interpretation is unreasonable if it "produces an absurd result" or a result "that no reasonable person would have accepted when entering the contract."[53] "The parties' steadfast disagreement over interpretation will not, alone, render the contract ambiguous."[54]

2. The "Same Terms and Conditions" provision did not apply to the 2017 merger

The Petitioners argue that the 2017 merger did not trigger the Refrain Obligation **[*1209]** because Carlyle received more compensation for its preferred stock than the Petitioners received for their common stock.[55] This argument rests on the premise that the 2017 merger was "structured as a sale of Equity Securities" because it involved **[**14]** the acquisition of control and not the acquisition of assets. Under Section 3(e) of the Stockholders Agreement, a "sale of Equity Securities" only triggers the Refrain Obligation if Carlyle's stock is acquired "on the Same Terms and Conditions" as stock held by Authentix's other stockholders. According to Petitioners, because the merger agreement paid more compensation for preferred stock than common stock, Carlyle's shares of preferred stock were not acquired "on the Same Terms and Conditions" as the Petitioners' shares of common stock. Thus, the 2017 merger did not trigger the Refrain Obligation.[56]

Under Section 3(e) of the Stockholders Agreement, Carlyle can exercise certain drag-along rights if a "Company Sale . . . is structured as a sale of Equity Securities."[57] These rights are contingent, however, on the condition that stock held by the "Other Holders," like the Petitioners, is acquired "on the Same Terms and Conditions" as Carlyle's stock (the "Same-Terms Requirement").[58] The Stockholders Agreement defines "Same Terms and Conditions" to mean "the same price and otherwise on the same terms and conditions . . . ."[59]

The first question that the Court must address is whether the **[**15]** 2017 merger triggered the Same-Terms Requirement because it was a Company Sale, "structured as a sale of Equity Securities," that involved the "acquisition of the Equity Securities" held by Carlyle.[60] The Stockholders Agreement's definition of Equity Securities encompasses common stock, preferred stock, stock options, and other convertible securities.[61] The Stockholders Agreement divides the definition of a Company Sale into two types of transactions: equity transactions "(whether such transaction is effected by merger, consolidation, recapitalization, sale or transfer of the Company's capital stock or otherwise)" and asset transactions.[62]

Petitioners are correct that the definition of Company Sale lumps mergers in the same *category* as stock transactions. That fact does not support Petitioners' position that all mergers are "structured as a sale of Equity Securities," however, because mergers and stock sales are two different types of transactions, even if they achieve a similar result. Carlyle structured the 2017 merger to allow an outsider to gain control of Authentix without acquiring any of the stock held by Carlyle or the Petitioners. Indeed, the merger agreement cancelled all **[**16]** outstanding stock in exchange for the right to receive the merger consideration.[63] Thus, the 2017 merger was not "structured as a sale of Equity Securities;"[64] none of Carlyle's stock was "acqui[red]" **[*1210]** under the 2017 merger agreement;[65] the 2017 merger did not trigger Same-Terms Requirement; and it is irrelevant that Carlyle received more compensation for its preferred stock than the Petitioners received for their common stock.

Kaiser Alum. Corp. v. Matheson, 681 A.2d 392, 395 (Del. 1996))).

[53] *Osborn, 991 A.2d at 1160* (citations omitted).

[54] *Id.* (citing *Rhone-Poulenc, 616 A.2d at 1195*).

[55] Opening Br. 24-27.

[56] *See id.*

[57] J.A. 73-74.

[58] *Id.*

[59] J.A. 69.

[60] *See* J.A. 74-74, at § 3(e).

[61] J.A. 67 ("'Equity Securities' means the Shares, any options to purchase shares of Common Stock and any Convertible Securities."); J.A. 69 ("'Shares' means the shares of Preferred Stock and Common Stock currently issued and outstanding or that are hereafter issued to the Holders.").

[62] J.A. 65 (formatting added); *see* Opening Br. 25-27.

[63] J.A. 193-94, at § 3.1(a)-(b).

[64] J.A. 74, at § 3(e).

[65] *Id.*

The Petitioners other arguments do not change our analysis. Holding that the 2017 merger was not "structured as a sale of Equity Securities" does not render surplusage the requirement under Section 3(e) that minority stockholders "execute any purchase agreement, *merger agreement* or other agreement" in connection with a Company Sale that is structured as a sale of Equity Securities."[66] That provision leaves flexibility for transaction planners if other transactions are being undertaken with the equity purchase.

Similarly, federal opinions holding that mergers involve an offer or purchase of securities under the securities laws are inapposite.[67] ***HN5***[] Whether a merger meets the statutory definition for a sale of securities under federal or state securities law has no bearing **[**17]** on whether a merger is "structured as a sale of Equity Securities" under the Stockholders Agreement.[68] There is no suggestion that the parties looked to the securities laws to construe these terms. Accordingly, this Court affirms the Court of Chancery's holding that the Same-Terms Requirement did not apply to the 2017 merger.

3. The Refrain Obligation clearly waived the Petitioners' appraisal rights with respect to the 2017 merger

The Petitioners argue that they did not agree to a clear waiver of their appraisal rights with respect to the 2017 merger. According to the Petitioners, Section 12 of the Stockholders Agreement provides that all obligations created under the contract cease when a Company Sale is consummated (the "Termination Provision").[69] Noting that there is no dispute the Refrain Obligation is an "obligation,"[70] the Petitioners conclude that they were not subject to a clear *post-termination* duty to refrain from filing the Appraisal Petition.[71] The Petitioners also claim that the Refrain Obligation's use of the word "refrain" rather than "waive" cements that they did not agree to permanently relinquish their appraisal rights.[72]

In addition to the **[**18]** ordinary principles of contract interpretation, we consider the law regarding contractual waivers of statutory rights. ***HN6***[] Under Delaware law, "[w]aiver is the intentional relinquishment of a known right."[73] "A waiver may be **[*1211]** either express or implied, but either way, it must be unequivocal."[74] The contractual waiver of a statutory right must be clear to be enforceable.[75] "[T]he standards

---

[66] *Id.*

[67] Opening Br. 26 n.5 (first citing *Mader v. Armel, 402 F.2d 158, 160 (6th Cir. 1968)*; and then citing *Murphy v. Stargate Def. Sys. Corp., 498 F.3d 386, 391 (6th Cir. 2007)*).

[68] J.A. 73.

[69] J.A. 89. ("Section 12. Termination. This Agreement, and the respective rights and obligations of the Parties, shall terminate upon the earlier of the: (a) consummation of a Company Sale; and [sic](b) execution of a written agreement of each Party (other than the Management Holders who are not also Rollover Stockholders or Reinvesting Stockholders) to terminate this Agreement; provided, however, that Section 2, 3, 4, 6, 7, 8, and 9 hereof shall terminate upon the closing of an IPO.").

[70] *See, e.g.*, Opening Br. 6 (referring to the Refrain Obligation as an "obligation"); Answering Br. 5 ("The Court of Chancery correctly interpreted the Stockholders Agreement, holding that the Agreement *obligated* Petitioners to refrain from exercising appraisal rights and that Authentix could enforce *this obligation* post-merger." (emphasis added)).

[71] Opening Br. 19.

[72] *Id.* ("One does not have to 'refrain' from exercising a right they already 'waived.'").

[73] *Minna v. Energy Coal S.p.A., 984 A.2d 1210, 1214 (Del. 2009)* (citing *AeroGlob. Cap. Mgmt., LLC v. Cirrus Indus., Inc., 871 A.2d 428, 444 (Del. 2005)*).

[74] *Dirienzo v. Steel P'rs Hldgs. LP., 2009 Del. Ch. LEXIS 205, 2009 WL 4652944, at *4 (Del. Ch. Dec. 8, 2009)* (citing *Rose v. Cadillac Fairview Shopping Ctr. Props. (Del.), Inc., 668 A.2d 782, 786 n. 1 (Del. Super. Ct. 1995)*).

[75] *See, e.g., Halpin v. Riverstone Nat'l, Inc., 2015 Del. Ch. LEXIS 49, 2015 WL 854724, at *8 (Del Ch. Feb. 26, 2015)* (first citing *In re Appraisal of Ford Hldgs., Inc. Preferred Stock, 698 A.2d 973, 977 (Del. Ch. 1997)* ("Since *Section 262* represents a statutorily conferred right, it may be effectively waived in the documents creating the security only when that result is quite clearly set forth when interpreting the relevant document . . . ."); and then citing *Libeau v. Fox, 880 A.2d 1049, 1057 (Del. Ch. 2005)* ("To ensure that the statutory right to partition is not arbitrarily lost, Delaware requires that any contractual relinquishment of the partition right be by clear affirmative words or actions . . . ."), *aff'd in part and rev'd in part on other grounds*, *892 A.2d 1068 (Del. 2006)*); *see also Dirienzo*, 2009 Del. Ch. LEXIS 205, 2009 WL 4652944, at *4 ("An express waiver exists where it is clear from the language used that the party is intentionally renouncing a right that it is aware of."); *Kortum v. Webasto Sunroofs, Inc., 769 A.2d 113, 125 (Del. Ch. 2000)* ("There can be no waiver of a statutory

for proving waiver under Delaware law are 'quite exacting,'"[76] and "[t]he facts relied upon to prove waiver must be unequivocal."[77]

Turning to the Stockholders Agreement, this Court agrees with the Court of Chancery that the Refrain Obligation imposed a clear post-termination duty on the Petitioners to refrain from exercising their appraisal rights with respect to the 2017 merger.[78] The only reasonable interpretation of the Refrain Obligation is that the Petitioners agreed to not seek a judicial appraisal if Carlyle and the board approved a Company Sale. ***HN7***[] This obligation was designed to apply after a Company Sale is consummated, as a stockholder may only "commence an appraisal proceeding" "within 120 days *after* the effective date of the merger or **[**19]** consolidation . . . ."[79] And regardless of whether a stockholder begins to exercise its appraisal rights before a merger has closed by providing notice of its intent to seek a judicial appraisal,[80] the clear purpose of the Refrain Obligation was to assure Carlyle and future acquirers that the minority stockholders would not be able to obtain a judicial appraisal *after* a Company Sale had closed.

The Petitioners try to muddy this analysis by arguing that the Termination Provision extinguished the Refrain Obligation when the 2017 merger closed.[81] If the Termination Provision is read in isolation, the Court might be inclined to agree with this analysis. ***HN8***[] But Delaware courts read contracts as a whole, and interpretations that are commercially unreasonable or that produce absurd results must be rejected.[82] The Petitioners' interpretation is commercially unreasonable. It is difficult to imagine that reasonable parties would draft a contractual provision that would require stockholders to "refrain" from exercising a right that would **[*1212]** never be ripe to exercise. And it is incredible that the parties included the Refrain Obligation to block appraisal rights only in a roundabout fashion by **[**20]** stopping stockholders from taking the preliminary steps needed to perfect their appraisal claims.[83]

Finally, we are not persuaded by the distinction that the Petitioners make between agreeing to "refrain" from exercising appraisal rights and agreeing to "waive" appraisal rights.[84] The Refrain Obligation only bars the Petitioners from exercising their appraisal rights if certain conditions are satisfied.[85] It therefore makes

right unless that waiver is clearly and affirmatively expressed in the relevant document." (citing Hintmann v. Fred Weber, Inc., 1998 Del. Ch. LEXIS 26, 1998 WL 83052 (Del. Ch. Feb. 17, 1998))).

[76] Bantum v. New Castle Cnty. Vo-Tech Educ. Ass'n, 21 A.3d 44, 50 (Del. 2011) (quoting AeroGlobal Cap. Mgmt., LLC v. Cirrus Indus., Inc., 871 A.2d 428, 444 (Del. 2005)).

[77] *Id.* (alteration in original) (quoting AeroGlobal, 871 A.2d at 444).

[78] *See, e.g., Manti I*, 2018 Del. Ch. LEXIS 318, 2018 WL 4698255, at *3.

[79] 8 Del. C. § 262(e).

[80] *See* Opening Br. 22-23.

[81] Opening Br. 17-27.

[82] Osborn, 991 A.2d at 1159-60.

[83] The Petitioners claim that this case is "analogous" to *Halpin v. Riverstone National, Inc.*, where the Court of Chancery held that the respondent in an appraisal proceeding could not enforce drag-along rights after a merger had closed. 2015 Del. Ch. LEXIS 49, 2015 WL 854724, at *2-4 (Del. Ch. Feb. 26, 2015). In *Halpin*, the respondent sought to enforce drag-along rights that it failed to trigger while the stockholders agreement was in force. *See* 2015 Del. Ch. LEXIS 49, [WL] at *8-10. Contrastingly, in this case the Refrain Obligation was triggered when the board and Carlyle approved the merger. *See* J.A. 73-74, at § 3(e) (providing that the Refrain Obligation is triggered if, *inter alia*, "a Company Sale is approved by the Board and either . . . the holders of at least fifty percent (50%) of the then-outstanding Shares or . . . the Carlyle Majority . . . ."). Accordingly, *Halpin* is distinguishable because Authentix seeks to enforce a waiver that was triggered before the Stockholders Agreement terminated.

[84] *See, e.g.,* Bantum v. New Castle C'ty Vo-Tech Educ. Ass'n, 21 A.3d 44, 50 (Del. 2011) ("Waiver is the voluntary and intentional relinquishment of a known right. It implies knowledge of all material facts and an intent to waive, together with a *willingness to refrain* from enforcing those [] rights." (quoting AeroGlobal Capital Mgmt., LLC v. Cirrus Indus., Inc., 871 A.2d 428, 444 (Del. 2005))).

[85] For example, the Refrain Obligation would only be triggered if Authentix was sold to an outsider. J.A. 88 ("'Company Sale' means the consummation of any transaction or series of transactions pursuant to which one or more Persons or group of Persons (*other than* any Initial Carlyle Stockholder, Manti, Whitney or any of the respective Affiliates" acquires control of Authentix. (emphasis added)); J.A. 73-74 (tying the Refrain

sense that the parties used the word "refrain" rather than "waive" when drafting the Refrain Obligation. The Petitioners did not "relinquish" their appraisal rights.[86] The Petitioners agreed "to keep [themselves] from" exercising their appraisal rights if certain criteria were met.[87] Thus, the structure of the Refrain Obligation explains why the parties used the word "refrain" when agreeing to a contingent waiver of appraisal rights.

As the Court of Chancery correctly concluded, "No contracting party, agreeing to the quoted language, would consider itself free to exercise appraisal rights in light of Board approval of a contractually compliant **[**21]** Company Sale."[88] Accordingly, the only reasonable interpretation of the Stockholders Agreement is that the Refrain Obligation imposed a post-termination duty on the Petitioners to "refrain" from filing the Appraisal Petition. To hold otherwise would undermine the objective intent of the bargain the parties struck and lead to the absurd result that a contractual provision included to stop the Petitioners from exercising their appraisal rights would never impose a burden on the Petitioners to refrain from filing an appraisal petition.[89]

[*1213] 4. Authentix is the intended beneficiary of the Refrain Obligation

The Petitioners' final contractual argument is that post-merger Authentix was not an intended beneficiary capable of enforcing the Stockholders Agreement.[90] The Petitioners seem to reason that because the 2017 merger agreement resulted in a complete change in ownership, post-merger Authentix is not a party to the Stockholders Agreement even though it was the surviving entity under the merger agreement. In other words, the Petitioners complain that they "did not enter into the [Stockholders Agreement] with the buyer . . . ."[91]

This argument misses the mark for several reasons. *HN9*[] First, **[**22]** it is a fundamental principle of Delaware law that a corporation is an entity, capable of forming a contract,[92] with an identity *separate* from its stockholders.[93] Thus, the change in control did not alter *Authentix's* status as a party to the Stockholders Agreement.

Because Authentix is a party to the Stockholders Agreement, it need not rely on its status as an intended beneficiary to enforce the agreement.[94] Nonetheless, if

---

Obligation to a Company Sale).

[86] *See* Opening Br. 19 (citing *Waive*, Meriam-Webster Online Dictionary (last visited Sept. 7, 2021) ("waive" means "to relinquish (something such as a legal right) voluntarily"), https://www.merriam-webster.com/dictionary/waive).

[87] *Id.* (citing *Refrain*, Meriam-Webster Online Dictionary (last visited Sept. 7, 2021) ("refrain" means "to keep oneself from doing"), https://www.merriam-webster.com/dictionary/refrain).

[88] *Manti I*, 2018 Del. Ch. LEXIS 318, 2018 WL 4698255, at *3.

[89] The Petitioners and the Dissent suggest several changes the parties could have made to make it clearer that the Refrain Obligation was intended to survive termination, such as using the word "waive" instead of "refrain," including a savings clause, or stating that the Petitioners agreed to refrain from exercising their appraisal rights "at any time." With the benefit of hindsight, these changes might have headed off the current dispute. Even without these changes, however, the Refrain Obligation in present form clearly waives the Petitioners' appraisal rights with respect to the 2017 merger.

[90] Opening Br. 20-21.

[91] *Id.* The Petitioners also seem to argue that post-merger Authentix—along with all of the other parties to the Stockholders Agreement—cannot enforce the Refrain Obligation because that obligation was extinguished when the 2017 merger closed. *See, e.g., id.* The Court rejects this argument for the reasons provided above.

[92] *See, e.g.*, 8 Del. C. § 122(13) ("Every corporation created under this chapter shall have the power to . . . (13) Make contracts . . . .").

[93] *See, e.g.,* Cargill, Inc. v. JWH Special Circumstance LLC, 959 A.2d 1096, 1109 (Del. Ch. 2008) ("Even though every stockholder of a corporation may change, the corporation maintains its own identity in perpetuity, because it is a separate and distinct legal entity from its shareholders." (first citing 8 Del. C. § 102(b)(5); and then citing Orzeck v. Englehart, 41 Del. Ch. 361, 195 A.2d 375, 377 (Del. 1963))).

[94] NAF Hldgs., LLC v. Li & Fung (Trading) Ltd., 118 A.3d 175, 180-81 (Del. 2015) ("It is a fundamental principle of contract law that *HN10*[] *the parties* to a contract are bound by its terms and have a corresponding right to enforce them." (emphasis added) (citations omitted)); *cf.* ***Restatement (Second) of Contracts § 302*** (Am. L. Inst. 1981) ("Unless otherwise agreed *between promisor and promisee*, a beneficiary of a promise is an intended beneficiary if recognition of a right to performance in the beneficiary is appropriate to effectuate the intention of the parties and . . . the circumstances indicate that the promise intends to give the beneficiary the benefit of the promised performance.").

anyone is an intended beneficiary of the Refrain Obligation it is Authentix. The "surviving or resulting corporation" is the respondent in an appraisal proceeding that would be liable for paying the petitioner fair value for its cancelled stock.[95] Thus, the parties must have recognized when they formed the Stockholders Agreement that the Refrain Obligation was intended to benefit Authentix—or the "resulting corporation" under different circumstances—by providing a defense to an appraisal petition. Accordingly, Authentix could rely on its status as an intended beneficiary of the Refrain Obligation to enforce the Stockholders Agreement, though Authentix need not do so because it was a party to the contract.

[*1214] B. [**23] Neither Statutory Law Nor Public Policy Prohibits Authentix from Enforcing the Refrain Obligation Against the Petitioners

The Petitioners argue that, even if they agreed to a clear waiver of appraisal rights, three provisions of the DGCL prevent Authentix from enforcing the waiver. First, the Petitioners argue that the Refrain Obligation is a stock restriction that had to be included in the corporation's charter under *Section 151(a)*.[96] Second, the Petitioners argue that *Section 262* prohibits stockholders from agreeing to an *ex ante* waiver of their appraisal rights under a stockholders agreement.[97] Third, the Petitioners argue that *Section 218* prohibits Delaware corporations from enforcing a stockholders agreement with their own stockholders.[98] The Court addresses each issue below.

1. Principles of statutory interpretation

The principles of statutory interpretation are well-settled. **HN11**[] "Statutory interpretation is a question of law, which we review *de novo*."[99] "The 'most important consideration for a court in interpreting a statute is [the language] the General Assembly used in writing [the statute].'"[100] The first step in this analysis is to "determine whether or not the statute is ambiguous."[101] "[A] statute is ambiguous only if **[**24]** it is reasonably susceptible to different interpretations, or 'if a literal reading of the statute would lead to an unreasonable or absurd result not contemplated by the legislature.'"[102] "The fact that the parties disagree about the meaning of the statute does not create ambiguity."[103] "If the statute is found to be clear and unambiguous, then the plain meaning of the statutory language controls."[104] On the other hand, if the statute is ambiguous it will be construed "'in a way that will promote its apparent purpose and harmonize [it] with other statutes' within the statutory scheme."[105]

2. The Refrain Obligation is not a stock restriction that must be included in the certificate of incorporation

At the time of adoption, the Stockholders Agreement, including the Refrain Obligation, bound all of Authentix's stockholders and contained a clause purporting to bind their successors, assigns, and transferees.[106] The

---

[95] *See* *8 Del. C. § 262(i)*.

[96] Opening Br. 28-29.

[97] *Id.* at 29-41.

[98] *Id.* at 41-45.

[99] ***Salzberg v. Sciabacucchi, 227 A.3d 102, 112 (Del. 2020)*** (citing *Corvel Corp. v. Homeland Ins. Co. of N.Y., 112 A.3d 863, 868 (Del. 2015)*).

[100] ***Id. at 113*** (quoting *Boilermakers Loc. 154 Ret. Fund v. Chevron Corp., 73 A.3d 934, 950 (Del. Ch. 2013)*).

[101] *Ins. Comm'r of Del. v. Sun Life Ins. Co. of Can. (U.S.), 21 A.3d 15, 20 (Del. 2011)* (citing *Chase Alexa, LLC v. Kent Cnty. Levy Ct., 991 A.2d 1148, 1151 (Del. 2010)*).

[102] *Id.* (first citing *Chase Alexa, 991 A.2d at 1151*; and then quoting *Dir. of Rev. v. CAN Hldgs., Inc., 818 A.2d 953, 957 (Del. 2003)*).

[103] *Id.* (quoting *Chase Alexa, 991 A.2d at 1151*).

[104] *Id.* (citing *Dir. of Rev., 818 A.2d at 957*); *see also* ***Salzberg, 227 A.3d at 112*** ("The court must 'give the statutory words their commonly understood meanings.'" (quoting *Kofron v. Amoco Chems. Corp., 441 A.2d 226, 230 (Del. 1982)*)).

[105] *Sun Life Ins., 21 A.3d at 20* (quoting *Eliason v. Englehart, 733 A.2d 944, 946 (Del. 1999)*).

[106] *See, e.g., Manti I*, 2018 Del. Ch. LEXIS 318, 2018 WL 4698255, at *4 ("Here, the corporation determined it was in the corporate interest to entice investment. It, and its stockholders individually, *all* entered an agreement with the Carlyle Group that was presumably to the benefit of all parties." (emphasis added)).

Petitioners argue that because the Refrain Obligation applied to all of the outstanding stock in Authentix, it **[*1215]** was ***HN12***[] a "limitation[] or restriction[]" on a class or series of stock that, under *DGCL Section 151(a)*, "shall be stated and expressed in [the corporation's] certificate of incorporation" **[**25]** or in the authorizing board resolutions. Noting that the Refrain Obligation was not so disclosed, the Petitioners claim that the Refrain Obligation is unenforceable because it does not comply with the disclosure requirements of *Section 151(a)*.[107] The Petitioners also argue that allowing Authentix to enforce the Refrain Obligation would render *Section 151(a)* a nullity because stock restrictions will generally be codified in a written agreement and therefore would not need to be disclosed in the charter or qualifying board resolution.[108]

As the Court of Chancery properly held, the Refrain Obligation is not a stock restriction because the Stockholders Agreement imposed *personal* obligations on the stockholders rather than encumbrances on the property rights that run with the stock. "The parties, including the Company, did not transform the Petitioners' shares of stock into a new restricted class via the S[tockholders] A[greement]; instead, individual stockholders took on contractual responsibilities in return for consideration."[109] Stated differently, the Stockholders Agreement "did not restrict the appraisal rights of the classes of stock held by the Petitioners; instead, the Petitioners, by entering the **[**26]** S[tockholders] A[greement], agreed to forbear from exercising that right."[110] Thus, "enforcing the S[tockholders] A[greement] is not the equivalent of imposing limitations on a class of stock under *Section 151(a)*."[111]

Additionally, enforcing the Refrain Obligation against the Petitioners does not implicate the notice-giving public policy concern animating *Section 151(a)*. This is not a case where a corporation seeks to enforce the Refrain Obligation against a party that did not sign the Stockholders Agreement. Authentix is only seeking to enforce the Refrain Obligation against sophisticated parties that negotiated and signed the Stockholders Agreement. The Petitioners can hardly complain about a lack of notice given the facts in this case. And while the clause purporting to bind successors, assigns, and transferees may be unenforceable,[112] the Stockholders Agreement has a severability clause,[113] and Authentix is not attempting to enforce the Refrain Obligation against any stockholders that did not sign the Stockholders Agreement in exchange for consideration.

Further, the Petitioners' interpretation of *Section 151(a)* leads to the conclusion **[*1216]** that any performance duties imposed under a **[**27]** stockholders agreement binding all of a corporation's stockholders is a stock restriction, provided that such performance obligations place a burden on the rights that come with owning stock. ***HN13***[] This result is inconsistent with the language of *Section 218(a)*, which authorizes "[o]ne stockholder or 2 *or more* stockholders" to form a stockholders agreement and does not impose any limitations on the number or percentage of a corporation's stockholders that can form a stockholders agreement.[114] Given Delaware's public policy favoring private ordering,[115] the Court is unwilling to add a total-percentage-of-stockholders limitation to *Section 218* where none exists. Accordingly, the Court rejects the Petitioners' argument that any performance duty imposed under a bilateral agreement binding all of a

---

[107] Opening Br. at 28 (citing *Ellingwood v. Wolf's Head Oil Refining Co., 38 A.2d 743, 747, 27 Del. Ch. 356 (Del Ch. 1944)*).

[108] *Id.* at 29 ("If special rights or limitations . . . related to stock are not set forth in the charter . . . can nonetheless be enforced . . . as long as they are in a separate agreement, there could never be a violation of *Section 151(a)* because such rights or limitations will always be set forth in writing somewhere . . . .").

[109] *Manti I*, 2018 Del. Ch. LEXIS 318, 2018 WL 4698255, at *4.

[110] *Id.*

[111] *Id.*

[112] J.A. 89, at § 13(b) ("Successors, Assigns, and Transferees. This Agreement shall be binding upon and inure to the benefit of the Parties and their respective legal representatives, heirs, legatees, successors and assigns and any other transferee and shall also apply to any securities acquired by a Holder after the date hereof.").

[113] J.A. 91, at § 13(j) ("Severability. In the event that any one or more of the provisions contained herein, or the application thereof in any circumstance, is held invalid, illegal or unenforceable in any respect for any reason, the validity, legality and enforceability of any such provision in every other respect and of the remaining provisions contained herein shall not be in any way impaired thereby.").

[114] (emphasis added).

[115] *See, e.g.,* ***Salzberg, 227 A.3d at 116***.

corporation's stockholders is a stock restriction.

Finally, allowing Authentix to enforce the Refrain Obligation against the Petitioners does not render *Section 151(a)* a nullity. ***HN14***[] A corporation must still make the necessary disclosures in order to issue stock with restrictions.[116] And holding that the Refrain Obligation is not a stock restriction does not mean that corporations can use stockholders agreements to circumvent the requirements **[**28]** applicable to an actual stock restriction. Accordingly, this Court affirms the Court of Chancery's holding that the Refrain Obligation is not a stock restriction that had to be disclosed in the corporation's charter or the authorizing board resolutions under *Section 151(a)*.

3. Sophisticated and informed stockholders can voluntarily agree to waive their appraisal rights in exchange for valuable consideration

HN15[] *Section 262(a) of the DGCL* provides that "[a]ny stockholder of a corporation of this State" that meets the predicate requirements for filing an appraisal petition "*shall* be entitled to an appraisal by the Court of Chancery of the fair value of the stockholder's shares of stock."[117] The Petitioners argue that because the General Assembly used the word "shall,"[118] common stockholders have a mandatory right to seek a judicial appraisal that cannot be abrogated in a corporate charter.[119] The Petitioners note that "when evaluating corporate action for legal compliance, a court examines whether the action contravenes the hierarchical components of the entity-specific corporate contract," which includes from top to bottom, "(i) the [DGCL], (ii) the corporation's charter, (iii) its bylaws, and (iv) other entity-specific contractual agreements, **[**29]** such as . . . a stockholder agreement."[120] Because the charter is higher up in the corporate hierarchy than a stockholders agreement, the Petitioners conclude that Authentix cannot use the Stockholders Agreement to impose a limitation that could not be included in the corporation's charter.[121] The Petitioners also warn that allowing Authentix to enforce the Refrain Obligation will invite corporations to use stockholders agreements to alter other mandatory provisions of the **[*1217]** DGCL, upsetting the hierarchy of corporate law and blurring the distinctions between corporations and alternative entities.[122]

The Court's discussion of this issue is divided into three parts. The first part discusses how the DGCL reflects Delaware's public policy favoring private ordering. The second part holds that the plain language of *Section 262* does not prohibit stockholders from agreeing to an *ex ante* waiver of their appraisal rights. The third part holds that the public policy concerns underlying *Section 262* do not prohibit sophisticated and informed stockholders from voluntarily waiving their appraisal rights in exchange for valuable consideration.

a) The DGCL is a broad enabling act that allows immense freedom for private ordering [**30]

HN16[] "At its core, the [DGCL] is a broad enabling act" that "allows immense freedom for businesses to adopt the most appropriate terms for the organization, finance, and governance of their enterprise" "provided the statutory parameters and judicially imposed principles of fiduciary duty are honored."[123] "In fact, 'Delaware's corporate statute is widely regarded as the most flexible in the nation because it leaves parties to the corporate contract (managers and stockholders) with great leeway to structure their relationships, subject to relatively loose statutory constraints and to the policing of director misconduct through equitable review.'"[124]

---

[116] To avoid any doubt, the Court does not hold that a Delaware corporation can issue stock that lacks appraisal rights. Rather, the Court holds more narrowly that the Refrain Obligation is not a stock restriction because it imposed personal obligations on the Petitioners.

[117] (emphasis added).

[118] *8 Del C. § 262(a)*.

[119] Opening Br. 29-41.

[120] Opening Br. 35-36 (quoting *Quadrant Structured Prods. Co., Ltd. v. Vertin, 2014 Del. Ch. LEXIS 214, 2014 WL 5465535, at *3 (Del. Ch. Oct. 28, 2014)*.

[121] *Id.* at 35-36.

[122] *Id.* at 35-41.

[123] ***Salzberg, 227 A.3d at 116*** (alteration in original) (italics added) (first quoting *Williams v. Geier, 671 A.2d 1368, 1381 (Del. 1996)*; and then citing Edward P. Welch & Robert S. Saunders, *Freedom and Its Limits in the Delaware General Corporation Law*, *33 Del. J. Corp. L. 845, 856-60 (2008)*).

[124] *Id.* (quoting *Jones Apparel Grp., Inc. v. Maxwell Shoe Co., Inc., 883 A.2d 837, 845 (Del. Ch. 2004)*).

HN17[] This public policy favoring private ordering is reflected in *Section 102(b)(1)*, which allows a corporate charter to contain virtually any provision that is related to the corporation's governance and not "contrary to the laws of this State":

> In addition to the matters required to be set forth in the certificate of incorporation by *subsection (a)* of this section, the certificate of incorporation may also contain any or all of the following matters: (1) Any provision for the management of the business and for the conduct **[**31]** of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, *and the stockholders*, or any class of stockholders . . .; if such provisions *are not contrary to the laws of this State*.[125]

Section 109(b) provides similarly broad authorization for bylaws that are "not inconsistent with law or with the certificate of incorporation," and which "relat[e] to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers, or employees."

HN18[] Although the DGCL is a broad and enabling statute, "[i]t is not . . . bereft of mandatory terms."[126] For example, "[t]he certificate of incorporation may not contain any provision that would impose liability on a stockholder for the attorneys' fees or expenses of the corporation or any other party in connection with an internal corporate claim . . . ."[127] Similarly, while a corporate charter may include "[a] provision **[*1218]** eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director," the charter may not "eliminate or limit **[**32]** the liability of a director" for breaches of the duty of loyalty, acts of bad faith, or "any transaction from which the director derived an improper personal benefit."[128] In addition to these express prohibitions, corporate charters and bylaws may not contain provisions that are "contrary" to,[129] or "inconsistent" with,[130] Delaware law because they "transgress . . . a public policy settled by the common law or implicit in the General Corporation itself."[131]

b) *Section 262* does not prohibit stockholders from agreeing to an *ex ante* waiver of their appraisal rights

The Petitioners argue that because the General Assembly provided that stockholders "shall" have the right to demand a judicial appraisal, *Section 262* prohibits common stockholders from agreeing to an *ex ante* waiver of their appraisal rights.[132] The Court rejects this argument. *HN19*[] The plain language of *Section 262* does not prohibit stockholders from agreeing to waive their appraisal rights.

HN20[] The General Assembly's use of the word "shall" appears to grant stockholders a mandatory right to seek a judicial appraisal.[133] *HN21*[] "[W]hen construing [a] statute, 'shall' generally signals [a] mandatory requirement **[**33]** while 'may' is permissive."[134] Further, "[t]he mandatory 'shall' . . . normally creates an obligation impervious to judicial discretion."[135] Nonetheless, the use of "shall" does not end our analysis because parties can agree to waive mandatory rights. For example, in *Graham v. State Farm Mutual Automobile Insurance Co.*, policyholders

---

[125] (emphasis added).

[126] *In re Appraisal of Ford Hldgs., Inc. Preferred Stock, 698 A.2d 973, 976 (Del. Ch. 1997)*.

[127] *8 Del. C. § 102(f)*; *see also id. § 109(b)* (imposing the same restriction on bylaws).

[128] *Id. § 102(b)(7)*.

[129] *Id. § 102(b)(1)*.

[130] *Id. § 109(b)*.

[131] ***Salzberg, 227 A.3d at 115-16*** (quoting *Sterling v. Mayflower Hotel, 33 Del. Ch. 293, 93 A.2d 107, 118 (Del. 1952)*) (citing Edward P. Welch & Robert S. Saunders, *Freedom and Its Limits in the Delaware Corporation Law*, *33 Del. J. Corp. L. 845, 856-60 (2008)*; *see also Jones Apparel Grp., Inc. v. Maxwell Shoe Co., 883 A.2d 837, 843 (Del. Ch. 2004)* (same).

[132] Opening Br. 29-41.

[133] *See 8 Del. C. § 262(a)*.

[134] *GMG Cap. Invs., LLC v. Athenian Venture P'rs I, 36 A.3d 776, 782 n.20 (Del. 2012)* (citing *Miller v. Spicer, 602 A.2d 65, 67 (Del. 1991)* ("The use of the verb 'shall' in legislation generally connotes a mandatory requirement while the verb 'may' is deemed permissive.").

[135] *Arnold v. State, 49 A.3d 1180, 1183 (Del. 2012)*.

argued that an insurance company could not enforce an arbitration clause because *Article 1, Section 4 of the Delaware Constitution* provides that "[t]rial by jury *shall* be as heretofore" and therefore creates a mandatory right that cannot be waived.[136] The Court rejected this argument and held that the right to a jury trial "is not absolute" and can be "waive[d] if the parties so intend."[137] Similarly, in *Baio v. Commercial Union Insurance Co.*, the Court held that a party could waive its statutory right to subrogation, explaining that ***HN22***[] "our legal system permits one to waive even a constitutional right and, *[a] fortiori*, one may waive a statutory right."[138] Thus, granting stockholders a **[*1219]** mandatory right to seek a judicial appraisal does not prohibit stockholders from alienating that entitlement in exchange for valuable consideration.[139]

HN24[] Further, the General Assembly knows how to **[**34]** draft language that prohibits parties from altering a mandatory provision of the DGCL in a corporation's charter or bylaws.[140] For example, *Section 115* states that "no provision of the certificate of incorporation or the bylaws may prohibit bringing" "internal corporate claims" "in the Courts of this State." Similarly, *Section 102(f)* prohibits charter provisions that attempt to shift fees onto stockholders litigating internal corporate claims.[141] Presumably the General Assembly could draft language prohibiting stockholders from altering a mandatory provision under a stockholders agreement if it chose to do so. But *Section 262* does not contain any language that prohibits stockholders from waiving their appraisal rights.[142]

Finally, the Petitioners point us to the Court of Chancery's decision in *Ford Holdings*.[143] In *Ford Holdings*, the corporation issued preferred stock that would have a predetermined value in an appraisal proceeding, effectively preventing a holder from getting the Court of Chancery to determine the stock's fair value.[144] The stockholders argued that these provisions were invalid because "appraisal rights are mandated by statute and cannot be eliminated by provisions in the corporate charter **[**35]** or the Designations."[145] In framing the legal issues, the court stated that appraisal rights were among the "mandatory provisions" **[*1220]** of the DGCL that "may not be varied by terms of the

[136] *565 A.2d 908, 911-12 (Del. 1989)* (quoting *Del. Const. art. 1, § 4* (emphasis added)).

[137] *Id. at 912*.

[138] *410 A.2d 502, 508 (Del. 1979)* (first citing *Mize v. Crouse, 399 F.2d 593 (10th Cir. 1968)*; then citing *Davis v. Dunbar, 394 F.2d 754 (9th Cir. 1968)*; and then citing *Components, Inc. v. W. Elec. Co., 267 A.2d 579, 582 (Del. 1970)*; *see generally Juul Labs, Inc. v. Grove, 238 A.3d 904, 919 n.15 (Del. Ch. 2020)* (collecting cases).

[139] The Petitioners claim that *Graham* is distinguishable because an arbitration clause still allows a party to pursue its cause of action in an adversarial proceeding, whereas the Refrain Obligation completely extinguished the Petitioners' appraisal claims. Opening Br. 40. This argument conflates the right that was waived in *Graham*—the right to demand a jury trial—with the underlying cause of action, which was a separate right. ***HN23***[] *Graham* supports the proposition that a party can waive a mandatory right created using the word "shall." Further, assuming that the other relevant criteria are met, Delaware courts will enforce the contractual waiver of a substantive right. *See, e.g., Baio, 410 A.2d at 502*.

[140] *See, e.g.*, *8 Del. C. §§ 102(b)(7)*, *102(f)*, *109(b)*.

[141] *8 Del. C. § 102(f)* ("The certificate of incorporation may not contain any provision that would impose liability on a stockholder for the attorneys' fees or expenses of the corporation or any other party in connection with an internal corporate claim, as defined in *§ 115* of this title.").

[142] Notably, even *Sections 115* and *102(f)* allow alteration through a stockholders agreement. The synopsis of the bill adopting *Section 115* states that "*Section 115* is *not intended* . . . to prevent the application of any such provision in a stockholders agreement or other writing signed by the stockholder against whom the provision is to be enforced." *See, e.g., Bonanno v. VTP Hldgs., Inc., 2016 Del. Ch. LEXIS 24, 2016 WL 614412, at *15 (Del. Ch. Feb. 8, 2016)* (quoting Del. S.B. 75 syn., 148th Gen. Assem. (2015)). Similarly, the synopsis to the bill adopting *102(f)* provides that "[n]ew *subsection (f)* is not intended . . . to prevent the application of such [fee-shifting] provisions pursuant to a stockholders agreement or other writing signed by the stockholder against whom the provision is to be enforced." J.A. 2364, at 111. And the General Assembly did not provide that clarification in the statutory text to preserve the rights of stockholders to agree to such restrictions under a bilateral agreement. Thus, the General Assembly appears to have rejected the Petitioners' bright-line rule that a stockholders agreement may not impose any restrictions on stockholders that could not be included in the charter.

[143] Opening Br. 32-34.

[144] *698 A.2d at 978-79*.

[145] *Id. at 975*.

certificate of incorporate or otherwise."[146] HN25[] Nonetheless, the court held that the statutory right to seek a judicial appraisal "may be effectively waived in the documents creating the security," provided "that result is quite clearly set forth when interpreting the relevant document under generally applicable principles of construction."[147]

The Petitioners argue that the Court of Chancery's analysis in *Ford Holdings* was limited to preferred stock and that common stockholders have a mandatory right to seek a judicial appraisal that cannot be waived *ex ante* under a corporation's charter, bylaws, a stockholders agreement, "or otherwise."[148] As a preliminary matter, the Petitioners rely on *dicta* to support their argument. *Ford Holdings* addressed whether a corporation could issue *preferred* stock that would have a fixed value in an appraisal proceeding.[149] This did not ask the court to decide whether common stock could be subject to a similar restriction. The court's focus on the "essentially contractual nature of preferred **[**36]** stock" did not foreclose the possibility that sophisticated and informed common stockholders, with bargaining power, could agree to waive their appraisal rights in exchange for valuable consideration.[150]

Regardless, the Petitioners' reliance on Ford Holdings is misplaced. HN26[] It may make good economic sense to treat preferred stock differently from common stock, but Section 262 does not make such a distinction. To the contrary, Section 262(h) instructs the "Court [of Chancery] [to] take into account *all relevant factors*" when determining fair value.[151] On its face, this instruction applies equally to common stock and preferred stock. Owners of both are entitled to a judicial appraisal. This statutory language casts doubt on whether it was the contractual nature of preferred stock that made the fixed-value provisions valid, as factors other than the contractual language could have been relevant to determining the preferred stock's fair value. Thus, we read *Ford Holdings* for the more general principle that a *stockholder* can waive its appraisal rights *ex ante* under certain circumstances.

Additionally, allowing Authentix to enforce the Refrain Obligation against the Petitioners does not raise the concerns about "asymmetrical **[**37]** information and rational apathy on the part of widely disaggregated shareholders of public companies" that *Ford Holdings* identified as possible "explanations" for treating a right as an essential feature of the corporate form that cannot be waived.[152] The Petitioners were sophisticated and informed investors, represented by counsel, that used their bargaining power to negotiate for funding from Carlyle in exchange for waiving their appraisal rights.[153] They also comprised all of the stockholders in the closely-held predecessor entity Authentix, Inc.,[154] removing any concerns about rational apathy that might appear in the context of a public company. And the Refrain Obligation was not a "midstream amendment" that was forced upon the Petitioners **[*1221]** without their express consent.[155] Thus, despite being common stockholders, the Petitioners have much in common with the preferred stockholders in *Ford Holdings*.[156]

In short, the Petitioners have failed to identify anything in either Section 262 or *Ford Holdings* that provides a convincing explanation of why preferred stockholders should be able to agree to *ex ante* determination **[**38]** of fair value, which effectively operates as a waiver of their appraisal rights, while sophisticated common stockholders, represented by counsel, that agreed to a clear waiver of appraisal rights for their common stock in

146 Id. at 976.

147 Id. at 977 (citing Red Clay Educ. Ass'n v. Bd. of Educ., 1992 Del. Ch. LEXIS 9, 1992 WL 14965, at *7 (Del. Ch. Jan. 16, 1992)).

148 Id. at 976; Opening Br. 32-34.

149 *See* Ford Holdings, 698 A.2d at 977-79.

150 Id. at 977.

151 (emphasis added).

152 Ford Holdings, 698 A.2d at 977 n.8 (citing Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 Harv. L. Rev. 1820 (1989)).

153 *Manti II*, 2019 Del. Ch. LEXIS 307, 2019 WL 3814453, at *2.

154 J.A. 1601-04.

155 Ford Holdings, 698 A.2d at 977 n.8.

156 *Id.* (opining that the arguments in favor of making terms mandatory to avoid problems of information asymmetry and rational apathy "would have little bite here where, at the formation stage, the preferred have in effect a bargaining agent in the underwriter and no-midstream amendment is implicated.").

exchange for valuable consideration cannot. HN27[] As the court noted in *Ford Holdings*, "[t]here is no utility in defining as forbidden any term thought advantageous to informed parties, unless the term violates substantive law."[157]

Accordingly, this Court agrees with the Court of Chancery that the plain language of Section 262 does not prohibit Authentix from enforcing the Refrain Obligation.

c) Public policy concerns do not prohibit sophisticated and informed stockholders from waiving their appraisal rights in exchange for valuable consideration

The question remains, however, whether the Petitioners have identified any other public policy concerns that prevent Authentix from enforcing an appraisal waiver against its own stockholders. The Petitioners claim that allowing Authentix to enforce the Refrain Obligation is against public policy for two main reasons: (1) a stockholder cannot knowingly waive its appraisal rights without knowing the details of the transaction that purportedly pays **[**39]** them less than fair compensation and (2) allowing Authentix to enforce the Refrain Obligation will dilute the corporate "brand" and allow corporations to use stockholders agreements to change all other provisions of the DGCL. We disagree and conclude that allowing Authentix to enforce the Refrain Obligation against the Petitioners does not raise public policy concerns that justify excusing the Petitioners from the bargain that they struck.

First, the Petitioners seem to argue that *ex ante* waivers of appraisal rights are invalid because stockholders cannot *knowingly* waive their appraisal rights without knowing the details of the transaction that purportedly pays them less than fair value.[158] HN28[] Under Delaware law, a party agreeing to waive a claim must have "knowledge of all material facts," including knowledge of "the requirement or condition" they are agreeing to waive.[159] The Refrain Obligation satisfied these criteria. The Petitioners were sophisticated investors, represented by counsel, that agreed to a clear waiver of their appraisal rights in exchange for valuable consideration.[160] The Stockholders Agreement was not a contract of adhesion;[161] and the Petitioners have not argued that they were **[**40]** ignorant of the Refrain Obligation when they signed the contract or that the inclusion of the Refrain Obligation was a mistake. It also would **[*1222]** have been easy for the Petitioners to predict the circumstances in which the Refrain Obligation would be invoked, namely, Carlyle and the board might approve a merger agreement that the Petitioners think pays them unfair compensation for their cancelled stock.

Further, this framing of the knowledge requirement would render nearly all arbitration clauses invalid or useless. If a party needs full knowledge of a claim to agree to a knowing waiver, then *ex ante* waivers of the right to demand a jury trial are invalid. This result conflicts with how Delaware courts treat arbitration clauses.[162] Accordingly, we reject the Petitioners' suggestion that they lacked sufficient knowledge to waive their appraisal rights.

Second, the Petitioners argue that "[t]here is no policy need to permit alteration of the DGCL's mandatory rights to ensure maximum freedom of contract for corporations because there are other Delaware entities," such as LLCs, "that already permit such freedom."[163] "By branding itself a Delaware corporation, a firm signals **[**41]** that it 'has certain core characteristics that provide basic protections to investors.' One of those characteristics is the right to appraisal; but if these core characteristics can be eliminated *ex ante* . . ., the value of the brand is lost."[164] It is important to preserve the fundamental characteristics of the corporate form.

---

[157] Id. at 977.

[158] *See, e.g.*, Opening Br. 41; Reply Br. 28.

[159] Bantum, 21 A.3d at 50-51.

[160] *Manti II*, 2019 Del. Ch. LEXIS 307, 2019 WL 3814453, at *2.

[161] *See* J.A. 1601-04.

[162] *See, e.g.*, Graham, 565 A.2d at 911-12 (holding that insurance policyholders could waive their right to a jury trial under an arbitration clause before the policyholders had knowledge of a ripe claim to bring against their insurer).

[163] Opening Br. 41 (citing 6 Del. C. § 18-1101(b) ("It is the policy of this chapter to give the maximum effect to the principles of freedom of contract . . . .").

[164] *Id.* (quoting Edward P. Welch & Robert S. Saunders, *Freedom and Its Limits in the Delaware General Corporation Law*, 33 Del. J. Corp. L. 845, 865-67 (2008)).

Parties wishing to deviate from those characteristics can choose to form an alternative entity, which prioritizes the freedom of contract over mandatory provisions.[165] Additionally, prohibiting the waiver or alteration of a provision of the DGCL has the benefit of promoting transparency and standardization, as prospective investors will not need to investigate whether that provision has been altered and can rely on existing case law to predict how Delaware courts will treat a corporation's actions.

The trouble with this argument, however, is that it provides an incomplete framework for determining whether stockholders can waive a right. In fact, if the goal is to remove any doubt about the features of the corporate form, all provisions of the DGCL should be mandatory. The best way to save investors **[**42]** the trouble of determining whether a corporation departed from a default rule would be to make that rule mandatory, or to make that rule mandatory unless the General Assembly expressly allows alteration. But this result would conflict with the flexibility that the General Assembly provided under *Sections 102(b)(1)* and *109(b)*, both of which provide broad authority for corporations to adopt charter provisions and bylaws that are not contrary to Delaware law.[166] ***HN29***[] If all provisions **[*1223]** are mandatory unless expressly stated, the discretion-granting language in *Sections 102* and *109* would serve no purpose, as it would be the language of the statutory section being altered that would allow for alteration, not the more general *Sections 102* and *109*.[167] This result is contrary to the Court's recognition that "[a]t its core, the [DGCL] is a broad enabling act."[168]

This brings us to the real crux of Petitioners' argument. Appraisal rights are core characteristics of the corporate entity that provide basic protections to investors; as such they cannot be waived—at least *ex ante*—under a bilateral agreement. Thus, we look to the fundamental nature of appraisal rights to determine whether stockholders can agree to an *ex ante* waiver.

As the Dissent recognizes, "before **[**43]** the Delaware appraisal statute was enacted, no consolidation or merger of corporations could be effected except with the consent of all the stockholders."[169] This unanimity "scheme proved unworkable 'since one or more minority stockholders, if he or they desired to do so, could impede the action of all the other stockholders.'"[170] Thus, the Delaware General Assembly amended the law "to allow the sale of a corporation upon the consent of a majority of its stockholders."[171] "Given that a single shareholder could no longer hold up the sale of a company, the General Assembly devised appraisal in service of the notion that 'the stockholder is entitled to be paid for that which has been taken from him.'"[172] ***HN30***[] Appraisal rights therefore allow dissenting stockholders to seek fair compensation for property taken without consent.[173]

The Dissent states that in addition to providing fair compensation, appraisal claims impose a check on corporate transactions at an unfair price. Thus, the right to demand a judicial appraisal is a fundamental feature of the corporate form because appraisal claims regulate the balance of power between Delaware corporations and their constituencies.[174] We acknowledge **[**44]** that ***HN31***[] the availability of appraisal rights might

---

[165] *See* *6 Del. C. § 18-1101(b)*.

[166] *8 Del. C. § 102(b)(1)* (allowing the charter to contain "[a]ny provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders, or any class of stockholders . . . if such provisions are not contrary to the laws of this State."); *id.* *§ 109(b)* ("The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees.").

[167] *Maxwell, 883 A.2d at 848*.

[168] ***Salzberg, 227 A.3d at 116*** (citation omitted).

[169] ***In re Solera Ins. Coverage Appeals, 240 A.3d 1121, 1133 (Del. 2020)***.

[170] *Id.* (quoting *Schenley Indus., Inc. v. Curtis, 38 Del. Ch. 370, 152 A.2d 300, 301 (Del. 1959)*.

[171] *Id.*

[172] *Id.* (quoting *Dell, Inc. v. Magnetar Glob. Event Driven Master Fund Ltd., 177 A.3d 1, 19 (Del. 2017)*).

[173] *See, e.g.,* *Francis I. DuPont & Co. v. Universal City Studios, Inc., 343 A.2d 629, 634 (Del. Ch. 1975)* ("The power of a stockholder majority to override minority dissenters and remit them to the cash appraisal remedy is 'analogous to the right of eminent domain.'" (citations omitted)).

[174] *Id.* at 20.

theoretically discourage attempts to pay minority stockholders less than fair value for their cancelled stock.[175] Nonetheless, the focus of an appraisal proceeding is paying fair value for the petitioner's stock,[176] not policing misconduct or **[*1224]** preserving the ability of stockholders to participate in corporate governance.[177] Granting stockholders the individual right to demand fair value does not prohibit stockholders from bargaining away that individual right in exchange for valuable consideration. And while the availability of appraisal rights may deter some unfair transactions at the margins, we are unconvinced that appraisal claims play a sufficiently important role in regulating the balance of power between corporate constituencies to forbid sophisticated and informed stockholders from freely agreeing to an *ex ante* waiver of their appraisal rights under a stockholders agreement in exchange for consideration.

HN32[] Further, *Section 262(g)* provides a *de minimis* exception from **[**45]** appraisal rights for stockholders of publicly-traded corporations. If appraisal rights are sacrosanct to the corporate form, it would make little sense for the General Assembly to adopt this exception, which "removed appraisal rights for the most disempowered shareholders."[178] And if adopted, the Petitioners' position would also cast doubt on whether drag-along rights are enforceable. ***HN33***[] Under *Section 262(a)*, a stockholder that "voted in favor of the merger or consolidation," or who provided written consent as provided for under *Section 228*, forfeits its appraisal claim. Drag-along rights often require that minority stockholders take actions that are reasonably necessary to close a merger, which would presumably include voting in favor of the merger or providing written consent.[179] If a stockholder cannot waive its appraisal rights directly, there is no reason why a stockholder should be able to **[*1225]** waive its appraisal rights indirectly by agreeing to a performance obligation that would require them to approve a merger.

Additionally, allowing Authentix to enforce the Refrain

---

[175] *See, e.g.*, Reply Br. 23 ("The public policy behind inviolate appraisal rights has even greater significance for stockholders of private companies—like Petitioners—who lack a robust market for their shares." (citing Cornerstone Research, *Appraisal Litigation in Delaware: Trends in Petitioners and Opinions 2016-2018*, at 9 (2019), https://www.cornerstone.com/publications/reports)).

[176] *See, e.g.*, *8 Del. C. § 262(a)* (providing that a stockholder meeting certain criteria "shall be entitled to an appraisal by the Court of Chancery *of the fair value* of the stockholder's shares of stock . . . ." (emphasis added)); ***In re Solera, 240 A.3d at 1133*** ("[A]ppraisal 'is a limited legislative remedy developed initially as a means to compensate shareholders of Delaware corporations for the loss of their common law right to prevent a merger or consolidation by refusal to consent to such transactions.' As such, we have said that '[t]here is one issue in an appraisal trial: "the value of the dissenting stockholder's stock."'" (second alteration in original) (first quoting *Ala. By-Prods. Corp. v. Cede & Co., 657 A.2d 254, 258 (Del. 1995)*; and then quoting *Dell, 177 A.3d at 19*) (citing *Applebaum v. Avaya, 812 A.2d 880, 893 (Del. 2002)*)); *Cede & Co. v. Technicolor, Inc., 542 A.2d 1182, 1186 (Del. 1988)* (The purpose of appraisal rights is to "provide shareholders dissenting from a merger on grounds of inadequacy of the offering price with a judicial determination of the intrinsic word (fair value) of their shareholders.").

[177] Some scholars argue that appraisal rights indirectly police misconduct by deterring offers that would pay minority stockholders unfair compensation for their stock, particularly for private firms. *See, e.g.*, Jill E. Fisch, *Stealth Governance: Shareholder Agreements and Private Ordering*, Faculty Scholarship at Penn Law 2199, at (Mar. 1, 2021) ("The problem with analyzing shareholder agreements as personal waivers, as the *Manti* court did, is that a shareholder's corporate governance rights affect the interests of other shareholders as well as the rights and responsibilities of the corporation's officers, directors and non-shareholder stakeholders. . . . An agreement to forsake appraisal rights affects the terms of future transactions."), https://scholarship.law.upenn.edu/faculty_scholarship/2199. Nonetheless, the Court views such indirect policing as an ancillary benefit and not the focus of *Section 262*.

[178] *See, e.g.*, Jill E. Fisch, *A Lesson from Startups: Contracting Out of Shareholder Appraisal*, Faculty Scholarship at Penn Law 2198, at 45 (Mar. 1, 2021) ("Delaware amended its appraisal statute in 2016 to require that a minimum of 1% of the outstanding shares petition for appraisal. This de minimis exception removed appraisal rights for the most disempowered shareholders, undercutting the argument that appraisal rights are a critical source of minority shareholder protection." (citations omitted)), https://scholarship.law.upenn.edu/faculty_scholarship/2198.

[179] *See generally* *SV Inv. P'rs, LLC v. ThoughtWorks Inc., 7 A.3d 973, 991-92 (Del. Ch. 2010)* ("Another alternative, common in stockholders' agreements, allows a preferred stockholder to sell its security and 'drag along' the remaining stockholders. 'Drag along' rights, which effectively allow a preferred stockholder to sell the entire company to a third party without board involvement, are quite common. A similar but stronger provision requires the forced sale of the company to the preferred stockholder.").

Obligation against the Petitioners does not implicate other **[**46]** public policy concerns that might be present in different bargaining contexts. For example, if Authentix attempted to enforce the Refrain Obligation against a retail investor that was not involved in negotiating the Stockholders Agreement—or against outsiders that lack material knowledge of Authentix's corporate governance dynamics—concerns about information asymmetry might justify excusing enforcement. But that is not this case. The Petitioners were sophisticated and informed investors, represented by counsel, that used their bargaining power to negotiate a waiver of their appraisal rights in exchange for valuable consideration.[180] The Petitioners were also the sole stockholders of the predecessor entity—Authentix, Inc.—before Carlyle entered the picture and were therefore insiders for the purpose of negotiating the Stockholders Agreement.[181] There is no suggestion that Carlyle coerced the Petitioners into waiving their appraisal rights, that the Petitioners did not know that the Stockholders Agreement contained the Refrain Obligation, or that Carlyle had any secret knowledge when it negotiated the Stockholders Agreement. Stated differently, the Petitioners were sophisticated insiders with **[**47]** access to all the information that they could need to understand the Refrain Obligation's value and cost. These capable investors do not need protection of the courts to escape a bad bargain.

Similarly, allowing Authentix to enforce the Refrain Obligation against the Petitioners does not raise the concerns about a lack of consent that might be present had the board or a subset of stockholders adopted the Refrain Obligation, or if Authentix was trying to enforce a contract of adhesion against a stockholder that lacked bargaining power. Authentix is seeking to enforce the Refrain Obligation against stockholders that specifically assented to the Stockholders Agreement. Those stockholders were represented by counsel and had negotiating leverage. There is no basis to question that the Petitioners freely and knowingly consented to waive their appraisal rights in exchange for valuable consideration.

Finally, throughout their papers, the Petitioners frame the Refrain Obligation as something that Authentix imposed upon its stockholders.[182] This framing is inaccurate. The Refrain Obligation is not a performance obligation that Authentix unilaterally foisted upon the Petitioners. The Refrain Obligation **[**48]** is a concession that the Petitioners voluntarily agreed to make in exchange for obtaining valuable funding from Carlyle. Thus, this case is about whether sophisticated and informed parties, represented by counsel and with the benefit of bargaining power, can freely agree to alienate their appraisal rights *ex ante* in **[*1226]** exchange for valuable consideration. The answer to that question is yes.

The Petitioners warn that this holding will have broad and negative implications, effectively rendering all provisions of the DGCL permissive and endorsing waivers of other stockholder rights that may be fundamental to the corporate form.[183] Allowing Authentix to enforce this Refrain Obligation against these Petitioners does not mean that all *ex ante* waivers of appraisal rights are enforceable or that the waiver of any other stockholder right would be enforceable. To the contrary, there are other contexts where an *ex ante* waiver of appraisal rights would be unenforceable for public policy reasons.

Similarly, there may be other stockholder rights that are so fundamental to the corporate form that they cannot be waived *ex ante*, such as certain rights designed to police corporate misconduct **[**49]** or to preserve the

---

[180] *Manti II*, 2019 Del. Ch. LEXIS 307, 2019 WL 3814453, at *2.

[181] J.A. 1601-04.

[182] *See, e.g.*, Opening Br. 4 ("This is not a question of a knowing waiver in the face of a live transaction, nor a question of what stockholders can do to each other by private agreement; it is a question of corporate authority and what corporations can do to their own stockholders."); *id.* at 36 ("There is no authority in the DGCL or case law for a corporation to modify stockholder rights . . . simply by putting the modification in a stockholders agreement . . . and not denominating it a 'certificate' . . . in order to circumvent the Delaware corporate hierarchy."); *id.* at 45 ("There is no authority for a Delaware corporation to enter into and enforce a stockholders agreement for its own benefit and against its own stockholders . . . .").

[183] *See, e.g.*, Opening Br. 37 ("Under the trial court's approach, whether a provision of the DGCL is mandatory or permissive is irrelevant so long as the corporation acts by separate agreement. By that logic, a corporation could enter into an agreement with all stockholders entitled 'Governing Agreement (Charter Disclaimed) Among Corporation and Stockholders' and each stockholder signatory would be bound to abide by its terms, even if it disclaimed all mandatory provisions of the DGCL.").

ability of stockholders to participate in corporate governance. Allowing Authentix to enforce the Refrain Obligation against the Petitioners does not mean that the *ex ante* waiver of all other stockholder rights would be enforceable.

The Petitioners have failed to identify policy concerns that would justify stopping Authentix from enforcing the Refrain Obligation against the Petitioners under the facts of this case.

4. Delaware corporations can enforce stockholders agreements

HN34[] *Section 218(c)* authorizes "2 or more stockholders" of a Delaware corporation to form a voting agreement:

> An agreement between 2 or more stockholders, if in writing and signed by the parties thereto, may provide that in exercising any voting rights, the shares held by them shall be voted as provided by the agreement, or as the parties may agree, or as determined in accordance with a procedure agreed upon by them.

The Petitioners argue that because *Section 218(c)* only mentions "stockholders," it does not authorize *corporations* to enter into a voting agreement.[184] Noting that there was uncertainty about whether stockholders agreements were enforceable under common law, the Petitioners claim that Authentix cannot enforce the Stockholders **[**50]** Agreement because the General Assembly did not authorize *corporations* to enforce such agreements.[185]

This argument misses the mark for several reasons. First, the uncertainty under the common law was about whether *voting trusts* were illegal because they separated ownership from voting rights.[186] The Stockholders Agreement does not assign voting rights to someone other than the stock's owner. Rather, it is an agreement between stockholders to vote *their shares* consistent with terms to which the parties mutually agreed.[187] Thus, the Stockholders **[*1227]** Agreement lacks the fundamental characteristic that raised doubts about whether voting trusts were enforceable under common law.

HN35[] Additionally, nothing in the language of *Section 218* prohibits corporations from entering into stockholders agreements. Forming contracts is a core corporate power.[188] Thus, given Delaware's public policy respecting private ordering,[189] the Petitioners have failed to provide a strong reason for this Court to construe *Section 218* to prohibit corporations from entering into a stockholders agreement drafted and negotiated by sophisticated stockholders represented by counsel. Things might be different if, for example, a **[**51]** corporation's board or officers used a stockholders agreement to perpetuate themselves in office. But that concern is not present here.[190]

---

[184] Opening Br. 41-45.

[185] *Id.*

[186] *See, e.g., Oceanic Expl. Co. v. Grynberg, 428 A.2d 1, 6-7* (noting that the separation of ownership from voting rights is both the defining feature of a voting trust and the characteristic that cast doubt on whether such agreements are enforceable).

[187] *See, e.g.*, J.A. 73-74, at § 3(e) (imposing restrictions on the minority stockholders to vote *their own shares* consistent with the terms of the Stockholders Agreement).

[188] *See, e.g.*, *8 Del. C. § 122(13)* (authorizing corporations to "[m]ake contracts").

[189] *See, e.g.*, ***Salzberg, 227 A.3d at 116*** ("At its core, the [DGCL] is a broad enabling act which leaves latitude for substantial private ordering, provided the statutory parameters and judicially imposed principles of fiduciary duty are honored." (quoting *Williams, 671 A.2d at 1381*)).

[190] For the same reasons, the Court of Chancery's opinion in *Insituform of North America v. Chandler* is inapposite. *534 A.2d 257 (Del. Ch. 1987)*. In *Insituform*, the court suggested that corporations might not have standing to contest an election under *DGCL Section 225* because the statute—as it was written at that time—did not expressly grant corporations standing. *Id. at 270, n.11*; *see* Del. S.B. 244, 144th Gen. Assem., 2008 Delaware Laws Ch. 252 (amending *Section 225* to expressly confer standing upon corporations). The court's concern seems to have been based, however, on the public policy concerns underlying *DGCL Section 160(c)*, which prohibits a corporation from voting its own stock in an effort to "prevent those in control of a corporation from using corporate resources to perpetuate themselves in office." *Insituform, 534 A.2d at 270, n.12* (citing *Speiser v. Baker, 525 A.2d 1001 (Del. Ch. 1987)*). That concern is not present here because enforcing the Refrain Obligation did not allow any directors to perpetuate themselves in office. To the contrary, the merger agreement allowed an outsider to gain control of Authentix. *See, e.g., Manti II, 2020 Del. Ch. LEXIS 262, 2020 WL 4596838, at *1* (noting that the 2017 merger sold Authentix to a third-party). Additionally, the General Assembly did not need

HN36[] Accordingly, this Court affirms the Court of Chancery's holding that *Section 218* does not prohibit a Delaware corporation from enforcing a stockholders agreement.

C. The Court of Chancery Did Not Abuse Its Discretion by Awarding the Petitioners Equitable Interest on the Merger Consideration

The Court of Chancery awarded the Petitioners equitable interest on their portion of the merger consideration.[191] The court explained that because the Appraisal Petition raised several novel questions of corporate law, Authentix was able to hold onto funds belonging to the Petitioners for a long period of time while the court resolved the dispute.[192] Thus, the court found that equity required awarding the Petitioners interest at the statutory rate, but based on the court's *equitable* power to fashion an appropriate remedy:

> The Petitioners were stockholders in an entity. Through the 2017 Merger, the merger consideration became available to the Petitioners. Nonetheless, they had significant questions regarding **[**52]** their contractual and statutory rights, and in good faith tested those rights by filing an appraisal petition. The litigation required the resolution of several novel **[*1228]** issues at the intersection of contract and corporate law and has been lengthy.
>
> The equities of the situation are this: the Petitioners were stripped of their stock and entitled to consideration therefore from the time of the 2017 Merger. These funds of the Petitioners have been held by [Authentix] for the duration of this now-lengthy action. It would, to my mind, be inequitable not to award interest on that amount. It is within this Court's discretion to award such interest. Therefore, and regardless of whether *8 Del. C. § 262(h)* applies, I find that interest at the legal rate applies to the 2017 merger consideration from the date of the merger.[193]

Authentix argues that the Court of Chancery erred by awarding the Petitioners interest on the merger consideration because they "did not assert a claim to the merger consideration in any pleading."[194] Authentix claims that "[w]ithout the benefit of legal pleadings . . . [it] had no notice as to whether [the] Petitioners were seeking an award of the merger consideration on legal or equitable grounds." **[**53]** [195] Further, Authentix argues that the award of interest was contrary to the provision of the merger agreement stating that the cancelled stock "shall be . . . converted . . . into . . . the merger consideration . . . *without any interest* thereon . . . ."[196] Finally, Authentix argues that there was no equitable basis to award interest because the Petitioners caused their own misfortune by filing the Appraisal Petition instead of accepting the merger consideration, and that Authentix did not benefit from holding the funds belonging to the Petitioners because those funds were deposited in a non-interest-bearing account.

The Petitioners raise several arguments in defense of the Court of Chancery's analysis. For example, the Petitioners claim that they did not need to plead a claim for the merger consideration to provide adequate notice because *Authentix* asked the court to "direct [the] Petitioners to . . . accept the Merger consideration for [their] shares . . . ."[197] The Petitioners also argue that they were entitled to interest as a matter of right because they were entitled to receive the merger consideration, and that Delaware courts have used their equitable powers to award interest under **[**54]** similar circumstances where a stockholder failed to perfect its appraisal claim and was therefore forced to settle for the amount of the merger consideration.

HN37[] This Court reviews for abuse of discretion the Court of Chancery's award of equitable interest.[198] The

---

to list corporations in *Section 218* to grant corporations the authority to enforce a stockholders agreement. *DGCL Section 122(13)* already grants corporations with the power to form and enforce contracts.

[191] *Manti III, 2020 Del. Ch. LEXIS 262, 2020 WL 4596838, at *10*

[192] *Id.*

[193] *Id.* (citations omitted) (formatting altered).

[194] Answering Br. 53.

[195] *Id.* at 54.

[196] J.A. 506, at § 3.8.

[197] J.A. 154.

[198] *See, e.g.*, *Boush, 1998 Del. LEXIS 25, 1998 WL 40220, at *2* ("[W]e review the [Court of Chancery's] decision to award . . . equitable interest . . . for abuse of discretion." (citing *Shell Petroleum, Inc. v. Smith, 606 A.2d 112, 117 (Del. 1992)*)).

Court of Chancery has broad equitable authority to award pre-judgment interest, including to a party that did not prevail in the litigation.[199] The "court may grant such relief as **[*1229]** the facts of a particular case may require even if the prevailing party has not demanded such relief in its pleadings."[200] On at least one occasion, the Court of Chancery has suggested that a stockholder could receive equitable interest on merger consideration despite failing to perfect its appraisal claim.[201]

Although we might reach a different result on *de novo* review, this Court holds that the Court of Chancery did not abuse its discretion by awarding the Petitioners equitable interest on the merger consideration. As noted above, the Court of Chancery has broad discretion to fashion an appropriate remedy. Regardless of whether the Petitioners pled a claim for the merger consideration **[**55]** in the alternative, *Authentix* recommended that the Court resolve the Appraisal Petition by ordering the Petitioners to accept the merger consideration. This suggestion raised the question of whether the Petitioners should receive interest on their portion of the merger consideration. And the Petitioners could not accept the merger consideration until the court decided the many novel issues of corporate and contractual law the Appraisal Petition raised. Finally, although the merger consideration was deposited in a non-interest-bearing account, the fact remains that the Petitioners were deprived of the beneficial use of their property for an extended period of time to resolve a dispute regarding a merger agreement to which they did not agree, and that Authentix—along with Carlyle and the acquirer—had the power to choose and control where the funds belonging to the Petitioners were deposited. Given the totality of these circumstances, the Court of Chancery did not abuse its discretion by holding that fairness required awarding the Petitioners interest on their portion of the merger consideration.

D. The Court of Chancery Properly Denied Authentix's Request for Pre-Judgment Interest on [**56] Attorneys' Fees

Under Section 13(i) of the Stockholders Agreement, the prevailing party in litigation "involving the . . . enforcement of the rights or obligations of the Parties" has the right to recover reasonable attorneys' fees and expenses (the "Fee-Shifting Provision"):

> (i) Attorney's Fees. In the event of any litigation or other legal proceeding involving the interpretation of this Agreement or enforcement of the rights or obligations of the Parties, the prevailing Party or Parties shall be entitled to recover reasonable attorney's fees and expenses in addition to any other available remedy.[202]

[*1230] The Court of Chancery held that Authentix could recover fees under the Fee-Shifting Provision but was not entitled to pre-judgment interest.[203] Authentix argues that this holding was erroneous because it was wrongfully deprived of the beneficial use of the funds it spent to defend against the Appraisal Petition before the Court of Chancery granted summary judgment against

---

[199] *See, e.g.,* Hayward v. Green, 32 Del. Ch. 576, 88 A.2d 806, 810-13 (Del. 1952) (affirming the Court of Chancery's equitable award of interest to the defendant, who was not the prevailing party at trial and did not have a contractual right to interest); ReCor Med., Inc. v. Warnking, 2015 Del. Ch. LEXIS 32, 2015 WL 535626, at *1 (Del. Ch. Jan. 30, 2015) ("The Court [of Chancery] 'has broad discretion, subject to principles of fairness' in awarding interest." (quoting Valeant Pharms. Int'l v. Jerney, 921 A.2d 732, 756 (Del. Ch. 2007))).

[200] ***Boush v. Hodges, 705 A.2d 243*** [published in full-text format at 1998 Del. LEXIS 25], 1998 WL 40220, at *2 (Del. Jan. 15, 1998) (TABLE) (first citing Ch. Ct. R. 54(c); and then citing Weinberger v. UOP, Inc., 457 A.2d 701, 714 (1983)).

[201] *See* Mehta v. Smurfit-Stone Container Corp., 2014 Del. Ch. LEXIS 211, 2014 WL 5438534, at *6 (Del. Ch. Oct. 20, 2014) (opining that despite the stockholders' failure to perfect their appraisal claim, "[t]he remedy for [the defendant's] failure to pay the cash portion [of the merger consideration] is relatively straightforward: damages equal to the amount of the cash portion *plus an award of pre- and post-judgment interest* running from . . ., the day after the 120-day [appraisal petition] filing period ran, until the date of payment." (emphasis added)); *see also* Brandywine Smyrna, Inc. v. Millennium Builders, LLC, 34 A.3d 482, 485 (Del. 2011) ("[I]nterest is awarded in Delaware as a matter of right and not of judicial discretion." (quoting Moskowitz v. Mayor and Council of Wilm., 391 A.2d 209, 210 (Del. 1978)); ***Boush v. Hodges, 705 A.2d 243*** [published in full-text format at 1998 Del. LEXIS 25, 1998 WL 40220, at *2 (Del. Jan. 15, 1998) ("The law is that where a court of equity in its sound discretion finds that justice requires interest, it is the duty of that court to allow interest." (quoting Hayward v. Green, 32 Del. Ch. 576, 88 A.2d 806, 810 (1952)).

[202] J.A. 91, at § 13(i).

[203] Manti III, 2020 Del. Ch. LEXIS 262, 2020 WL 4596838, at *5-9.

the Petitioners.[204] Authentix also argues that it was inappropriate to award the losing party interest on the merger consideration while denying the prevailing party interest on the attorneys' fees owed under the Fee-Shifting Provision. **[**57]** [205]

The Court of Chancery properly rejected Authentix's request for pre-judgment interest. Under the plain language of the Fee-Shifting Provision, the Petitioners were not liable for attorneys' fees unless and until Authentix became the prevailing party.[206] Authentix became the prevailing party when the Court of Chancery granted summary judgment against the Petitioners, and nothing in the Fee-Shifting Provision allowed for pre-judgment interest. Thus, Authentix is asking for an award of pre-judgment interest under a contractual provision that does not provide that remedy.

The language in the Fee-Shifting Provision preserving "any other available remedy" does not change the analysis.[207] Apart from enforcing the Fee-Shifting Provision, Authentix does not claim that it has another path to recovering its attorneys' fees. And for the reasons provided above, the Petitioners could not have breached the Fee-Shifting Provision before the Court of Chancery dismissed the Appraisal Petition. The case law Authentix cites is inapposite for the same reason. In each of those cases, pre-judgment interest was owed because the obligation to indemnify arose *before* the party seeking fees became the prevailing **[**58]** party,[208] or the court awarded pre-judgment interest to a party that prevailed on its affirmative claim.[209] This is not true of the Fee-Shifting Provision, and the Court is unwilling to add language to which the parties did not agree.

Finally, the Court rejects Authentix's disparate treatment argument. *HN38*[] Whether the Petitioners were entitled to equitable interest on their portion of the merger consideration has no bearing on whether Authentix had a *contractual* right to pre-judgment interest under the Fee-Shifting Provision. The former is a question of the Court of Chancery's broad equitable power to fashion an appropriate remedy. The latter is a question of the objective intent of the bargain the parties struck. These are separate issues. Accordingly, this Court affirms the Court of Chancery's holding that the plain meaning of the Fee-Shifting Provision did not grant Authentix pre-judgment interest on its attorneys' fees.

[*1231] IV. CONCLUSION

For the reasons provided above, the Court affirms the Court of Chancery's judgment.

Dissent by: VALIHURA

Dissent

VALIHURA, J., dissenting:

Appellants/Cross-Appellees Manti Holdings, LLC, and other common stockholders (collectively, "Petitioners") **[**59]** in the predecessor entity to Appellee/Cross-Appellant Authentix Acquisition Co. ("Authentix") sought appraisal. The parties do not dispute that the merger is one that would give rise to statutory appraisal rights, nor that Petitioners took those actions necessary to perfect appraisal rights. Instead, the Court of Chancery found that the appraisal remedy was unavailable because a stockholders agreement (the "Stockholders Agreement") obligated Petitioners to refrain from seeking it. From that conclusion, the trial court held that the contractual obligation barred the appraisal remedy.

To reach this holding, the trial court necessarily had to find that pursuing the appraisal remedy would breach a provision of the Stockholders Agreement and that the provision at issue is enforceable. The second of these inquiries -- whether a stockholders agreement preemptively waiving appraisal rights *ex ante* and which binds all of its stockholders and governs all of its stock is enforceable under the DGCL -- is a difficult and

[204] Answering Br. 57-59.

[205] *Id.*

[206] *See* J.A. 91, at § 13(i).

[207] *See id.*

[208] *See, e.g.,* Underbrink v. Warrior Energy Servs. Corp., 2008 Del. Ch. LEXIS 65, 2008 WL 2262316, at *19 (Del. Ch. May 30, 2008) ("A party seeking advancement is entitled to interest from the date on which the party 'specified the amount of reimbursement demanded and produced his written promise to pay.'" (quoting Citadel Hldg. Corp. v. Roven, 603 A.2d 818, 826 n. 10 (Del. 1992)).

[209] *See, e.g.,* Trans World Airlines Inc. v. Summa Corp., 1987 Del. Ch. LEXIS 373, 1987 WL 5778, at *1 (Del. Ch. Jan. 21, 1987), *aff'd*, 540 A.2d 403 (Del. 1988) (awarding the *plaintiff* pre-judgment interest after the plaintiff prevailed at trial).

important question of Delaware corporate law.[1] Recognizing the importance of the inquiry, the Court of Chancery issued a second opinion in response to Petitioners' Motion for Reargument **[**60]** expounding on that single question. The Court of Chancery's holding is significant because it is the first time a Delaware court has held that a contractual provision in a *stockholders agreement* barring *common* stockholders from exercising their statutory appraisal rights under 8 Del. C. § 262 is enforceable as a matter of law.[2]

The Court of Chancery held in *In re Appraisal of Ford Holdings, Inc. Preferred Stock*[3] that the appraisal right set forth in Section 262 is "mandatory."[4] Nevertheless, it also held that the *fair value* of preferred stock could be set by contract.[5] But Chancellor Allen was careful to caution that "preferred stock is a very special case."[6] The Court of Chancery specifically addressed only "whether purchasers of preferred stock can, in effect, contract away their rights to seek judicial determination of the fair value of their stock, by accepting a security that explicitly provides either a stated amount or a formula by which an amount to be received in the event of a merger is set forth."[7] I submit **[*1232]** that the setting of the value in a certificate of designations is not truly a waiver of Section 262 rights, but rather, "the amount so fixed or determined constitutes the 'fair value' of the stock for **[**61]** the purposes of dissenters' rights under Section 262."[8]

The Majority opinion affirming the Court of Chancery's decision in this case allowing for modification of statutory governance rights *ex ante* in a stockholders agreement gives me pause. I will set forth three reasons for my concern.

I. The Stockholders Agreement Fails to Clearly and Unambiguously Indicate the Refrain Objection Survives Termination.

First, I do not think the Stockholders Agreement has the requisite clarity to effectuate such a waiver. I leave aside for the moment the question of whether an *ex ante* waiver of appraisal rights via a stockholders agreement is enforceable as a matter of Delaware statutory law and public policy. Even if such a provision were legally permissible and not violative of public policy, such a waiver would need to be unequivocally and unquestionably clear.[9] Waivers of statutory

---

[1] Petitioners point out that "whether a stockholder can waive a mandatory right in connection with a specific transaction -- *i.e.*, a 'knowing' waiver or relinquishment -- is not the issue here. The issue is whether such rights can be eliminated *ex ante*." Op. Br. at 32. They emphasize that "[t]his is not a question of a knowing waiver in the face of a live transaction; nor a question of what stockholders can do to each other by private agreement; it is a question of corporate authority and what corporations can do to their own stockholders." Op. Br. at 4. I agree.

[2] *Manti Holdings, LLC v. Authentix Acq. Co. (Manti I), 2018 Del. Ch. LEXIS 318, 2018 WL 4698255, at *1-2 (Del. Ch. Oct. 1, 2018)*.

[3] *698 A.2d 973 (Del. Ch. 1997)*.

[4] *Id. at 976*.

[5] *Id. at 977* ("All of the characteristics of the preferred are open for negotiation; that is the nature of the security.").

[6] *Id.* ("[P]referred stock is a very special case . . .. To the extent it possesses any special rights or powers and to the extent it is restricted or limited in any way, the relation between the holder of the preferred and the corporation is contractual.").

[7] *Id. at 976*.

[8] *Id. at 974*. *See also* *Shiftan v. Morgan Joseph Holdings, Inc., 57 A.3d 928, 942 (Del. Ch. 2012)* ("As a general rule, preferred stock has the same appraisal rights as common stock, but '[u]nlike common stock, the value of preferred stock is determined solely from the contract rights conferred upon it in the certificate of designation.' Therefore, when determining the fair value of preferred stock, the court must consider the contract upon which the preferred stock's value was based.") (alteration in original) (footnote omitted) (quoting *In re Appraisal of Metromedia Int'l Grp., 971 A.2d 893, 900 (Del. Ch. 2009)*, *modified on other grounds after rearg.*, *2009 Del. Ch. LEXIS 92, 2009 WL 1509182 (Del. Ch. May 28, 2009)*); *id. at 932* ("In the case of an appraisal of preferred stock, therefore, the court must look at the contract rights granted to the shares being appraised under the relevant certificate of incorporation or designation in determining fair value.").

[9] *See, e.g.*, *Dirienzo v. Steel P'rs Holdgs. L.P., 2009 Del. Ch. LEXIS 205, 2009 WL 4652944, at *4 (Del. Ch. Dec. 8, 2009)* ("A waiver may be express or implied, but either way, it must be unequivocal.") (citing *Rose v. Cadillac Fairview Shopping Ctr. Props. (Del.) Inc., 668 A.2d 782, 786 n.1 (Del. Super. 1995)*); *see also* *Bantum v. New Castle Cty. Vo-Tech Educ. Ass'n, 21 A.3d 44, 50 (Del. 2011)* ("'the facts relied upon to prove waiver must be unequivocal'") (alteration omitted) (quoting *AeroGlobal Cap. Mgmt., LLC v. Cirrus Indus. Inc., 871 A.2d 428, 444 (Del. 2005)*). In *Ford* ***[**62]*** *Holdings*,

provisions must also be unambiguous.[10] If language is susceptible to more than one reasonable interpretation, then it is ambiguous.[11] It follows that our interpretive canons require that waivers of statutory rights, if they are valid at all, be strictly construed.[12]

[*1233] The Refrain Obligation does not satisfy these high bars. For one thing, the Refrain Obligation conflicts with the Termination Provision. Section 3(e) of the Stockholders Agreement sets forth the Refrain Obligation. That section reads, in relevant part:

> [I]n the event that . . . a Company Sale is approved by the Board and . . . the Carlyle Majority, each Other Holder shall consent to and raise no objections against such transaction, and if any such transaction is structured as a sale of Equity Securities, each Other Holder shall take all actions that the Board and/or the applicable Carlyle Stockholders reasonably deem necessary or desirable in connection with the consummation of such transaction. . . [w]ithout limiting the generality of the foregoing, each Other Holder agrees that he, she or it shall (i) consent to and raise no objections against such transaction; . . . and (iv) refrain from the exercise of appraisal rights with respect to such transaction. . ..[13]

However, Section 12 of the Agreement sets forth a Termination provision. Pursuant to this provision, all rights and obligations (including Section 3) terminate if and when a Company Sale is consummated. **[**63]** The Termination Provision states:

> This Agreement, and the respective rights and obligations of the Parties, shall terminate upon the earlier of the[:]
>
> > (a) consummation of a Company Sale[;] and
> >
> > (b) execution of a written agreement of each Party (other than the Management Holders who are not also Rollover Stockholders or Reinvesting Stockholders) to terminate this Agreement;
> >
> > [P]rovided, however, that Section 2, 3, 4, 6, 7, 8 and 9 hereof shall terminate upon the closing of an IPO.[14]

It is not disputed that the merger at issue was a Company Sale. The threshold requirements for invoking the Refrain Obligation were met. In this case, Authentix chose to proceed with a merger by consent in lieu of a stockholder vote. The Board vote and shareholder consent approving and consummating the merger both occurred on September 13, 2017. That consummation triggered Section 12's termination provision. In this scenario, pursuant to *8 Del. C. § 262(d)(2)*, every action Petitioners took to seek and perfect their appraisal rights occurred *after* the closing of the merger. The question is not whether the Stockholders Agreement unequivocally and unambiguously bound Petitioners not to file an appraisal petition. The question is whether that obligation **[**64]** survived termination upon consummation of the Company Sale.

Notably, the parties here chose not to include a savings clause that would have allowed for survival of the Refrain Obligation. Such savings clauses are common. In fact, the NVCA Model Agreement, provided to this Court by the parties in their Joint Appendix, contains such a provision. It states:

> Term. This Agreement shall be effective as of the date hereof and shall continue in effect until and shall terminate upon the earliest to occur of (a) the consummation of the Company's first underwritten public offering of its Common Stock (other than a

---

Chancellor Allen recognized that, absent "[c]lear and direct drafting," in a case involving appraisal rights for preferred shareholders, "the court may not cut stockholders off from a statutory right." *698 A.2d at 979*.

[10] *See, e.g.,* *Halpin v. Riverstone Nat'l. Inc., 2015 Del. Ch. LEXIS 49, 2015 WL 854724, at *8 (Del. Ch. Feb. 26, 2015)* ("A contractual waiver of a statutory right, where permitted, is effective only to the extent clearly set forth in the parties' contract.").

[11] ***Sunline Com. Carriers, Inc. v. CITGO Petroleum Corp., 206 A.3d 836, 847 (Del. 2019)*** (citing *Kaiser Alum. Corp. v. Matheson, 681 A.2d 392, 395 (Del. 1996)*).

[12] *See, e.g.,* *Juul Labs, Inc. v. Grove, 238 A.3d 904, 911 (Del. Ch. 2020)* (a putative waiver of inspection rights, if ambiguous, "would be ineffective because it would not be expressed clearly and affirmatively, which is the standard for waiver of a statutory right"); *Metromedia, 971 A.2d at 900* ("in the case of unclear or indirect drafting, [the Court of Chancery] will not cut stockholders off from a statutory right to judicial appraisal of their preferred shares") (quotation omitted); *Kortum v. Webasto Sunroofs Inc., 769 A.2d 113, 125 (Del. Ch. 2000)* ("There can be no waiver of a statutory right unless that waiver is clearly and affirmatively expressed in the relevant document.").

[13] JA73-74 (Stockholders Agreement § 3(e)).

[14] JA89 (Stockholders Agreement § 12) (formatting added).

registration statement relating either to the sale of securities to employees of the Company pursuant to its stock option, stock purchase or similar plan or an SEC Rule 145 transaction); (b) the consummation of a **[*1234]** Sale of the Company and distribution of proceeds to or escrow for the benefit of the Stockholders in accordance with the Restated Certificate, *provided that the provisions of Section 3 hereof will continue after the closing of any Sale of the Company to the extent necessary to enforce the provisions of Section 3 with respect to such Sale of the Company; (c) termination of this* ***[**65]*** *Agreement in accordance with Section 7.8 below* [; and (d) __ __, 20__].[15]

Section 3(e) in the Stockholders Agreement likewise contrasts with the language in the Model Agreement. In the Model Agreement, that section provides that "each Stockholder and the Company hereby agree:. . . to refrain from (i) exercising any dissenters' rights or rights of appraisal under applicable law ***at any time*** with respect to such Sale of the Company. . . ."[16] The Model Agreement specifically calls attention to the *Riverstone* decision and explains how the controlling stockholder's decision in that case to approve the merger by consent terminated the agreement and thereby enabled the minority shareholders to pursue appraisal rights.[17] It explicitly advises parties to include express language closing this window.[18]

Nor was the Termination Provision the only place where such a savings clause **[**67]** could have occurred. Elsewhere in the Stockholders Agreement, the parties inserted language into contractual clauses specifying that certain provisions would survive termination.[19] They did not include any such language in Section 3(e).

The Court of Chancery made much of the fact that the parties to the Stockholders Agreement were sophisticated.[20] The **[*1235]** parties were obviously familiar with such savings clauses. Authentix, simply put, did not negotiate for an express term specifying that the Refrain Obligation survived termination despite the parties demonstrating a clear understanding of how to craft such a provision.[21]

Nor does the language of Section 3(e) render such a

---

[15] JA1322-1323 (NCVA Model Agreement § 6).

[16] JA1315-16 (NCVA Model Agreement § 3.2(e)) (emphasis added).

[17] JA1316 (NCVA Model Agreement n.16); *see Riverstone*, 2015 Del. Ch. LEXIS 49, 2015 WL 854724, at *8-10.

[18] This footnote in the Model Agreement submitted by the parties in the Joint Appendix bears quoting in full:

> An express waiver of appraisal rights is particularly important in light of the Delaware Chancery Court's ruling in *Riverstone National Inc. v. Caplan et.al*, Case No. C.A. 9796-NVCG (Del. Ch. Ct. Feb. 26, 2015). In *Riverstone*, a corporation's 91% controlling stockholder approved a merger of the corporation by written consent. When a group of minority stockholders sought statutory appraisal rights, **[**66]** the controlling stockholder purported to exercise drag-along rights contained in a stockholders agreement signed by the minority stockholders that contained an agreement to vote their shares in favor of the merger, but not an express waiver of appraisal rights. The Court ruled that because the drag-along in question was limited to a voting agreement (which if enforced would have resulted in a waiver of appraisal rights), the drag along was only operative and enforceable prior to the merger's becoming effective. *Once the merger was effective, the voting agreement had terminated, the minority stockholders who had not voted in favor of the merger were no longer obligated to vote and thus could exercise their appraisal rights*. Importantly, the Court did not decide whether common stockholders can waive statutory appraisal rights in advance through a contractual drag-along provision so *the efficacy of this provision is not certain*. Including it, however, provides *an argument* that appraisal rights have been extinguished even if the drag-along and related voting agreement are not implemented in connection with a merger.

JA1316 1316 (NCVA Model Agreement n.16) (emphasis added).

[19] JA88 (Stockholders Agreement § 10(h)) (dealing with contribution and indemnification provisions, "The obligations of the Company and the Registering Stockholders under this Section 10 shall survive the completion of any offering of Registrable Common Stock in a registration statement, including the termination of this Agreement.") (underline in original).

[20] Manti Holdings, LLC v. Authentix Acq. Co. (Manti III), 2020 Del. Ch. LEXIS 262, 2020 WL 4596838, at *2 (Del. Ch. Aug. 11, 2020) ("there is no record evidence that the Petitioners were not fully informed; to the contrary, there is evidence that the Petitioners are sophisticated investors who were fully informed and represented by counsel when they signed the [Stockholders Agreement], under which they obtained some rights and relinquished others.").

[21] Metromedia, 971 A.2d at 900 ("[I]n the case of unclear or indirect drafting, this Court will not cut stockholders off from a statutory right to judicial appraisal of their preferred shares.").

continuing obligation implicit. Words should be given their "plain, ordinary meaning."[22] *Refrain* is not a technical word of the legal profession.[23] As a question of ordinary language, to *refrain* from an act tends to imply a forbearance that is temporary or conditional rather than permanent.[24] Indeed, the Court of Chancery noted an example of *refrain* used lyrically in precisely this transitory sense in popular music.[25] "Refrain" in that sense implies continuation of the right and its later availability when the requirement to refrain **[**68]** has passed.

"Waive," by contrast, is a word implying greater permanence.[26] This distinction is especially true in the legal profession, where practitioners well-recognize the longstanding technical definition of waiver, "an intentional relinquishment or abandonment of a known right or privilege."[27] That **[*1236]** definition is so well-established[28] as to be recognized in lay dictionaries.[29] Nor must the Court rely on inference to know that the sophisticated parties in this case parsed the distinction between "waive" versus other words of forbearance since they used "waive" elsewhere in the Stockholders Agreement.[30] The meaning of *waive* has some overlap with *refrain*,[31] but where sophisticated parties use both

[22] Alta Berkeley VI C.V. v. Omneon Inc., 41 A.3d 381, 385 (Del. 2012).

[23] There is no entry for "refrain" in BLACK'S LAW DICTIONARY (11th ed. 2019); nor BALLENTINE'S LAW DICTIONARY (3d ed. 1969); nor BOUVIER LAW DICTIONARY DESK EDITION (2012).

[24] *See Refrain*, WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE, 1909 (2002) (distinguishing refrain from its synonyms by explaining "REFRAIN is more suitable than ABSTAIN or FORBEAR to indicate checking or inhibiting an inclination or impulse, especially a momentary or passing one"); *see also* "*Refrain*," MERRIAM-WEBSTER ONLINE DICTIONARY, ("to keep oneself from doing, feeling, or indulging in something and *especially from following a passing impulse*") (emphasis added), https://www.merriam-webster.com/dictionary/refrain.

[25] *See Manti I*, 2018 Del. Ch. LEXIS 318, 2018 WL 4698255, at *3 n.16 (citing Arlo Guthrie, *City of New Orleans* (Reprise Records 1972) and remarking that "[t]he Petitioners make a valiant attempt to freight the term 'refrain' with more ambiguity than anyone since Arlo Guthrie."). Steve Goodman wrote the song, later popularized by Guthrie, about and while aboard the eponymous Chicago-to-New Orleans passenger rail route. *See generally*, Craig Sanders, *Writing of City of New Orleans*, TRAINS, Sept. 2017, at 34-39 (describing the history of the song and its many covers by other musicians), https://www.trains.com/trn/magazine/archive-access/trains-september-2017/. The relevant lyric, "the passengers will please refrain" references signage on passenger rail lavatories which commonly instructed passengers to "refrain from flushing toilets *while the train is standing in the station*." Jack Smith, *Train Sign Fits an Old Song in a Fine Meter*, LOS ANGELES TIMES, Sept. 10, 1987 (emphasis added), https://www.latimes.com/archives/la-xpm-1987-09-10-vw-6928-story.html. Far from being an ambiguous lyric, *refrain* in this context only makes sense as a transitory obligation that lapses once the circumstance giving rise to the obligation ceases to apply. In other words, once the merger closed, the train had left the station so to speak, and the obligation to refrain no longer applied.

[26] *See Waiver*, 2 BOUVIER LAW DICTIONARY DESK EDITION, 2970 (2012) ("Waiver is an act by which a person or entity holding a right, privilege, claim, or any other interest in law or equity that may be asserted or defended in any forum elects not to assert it or defend it, *electing not to do so in some manner that makes the election final*.") (emphasis added).

[27] Johnson v. Zerbst, 304 U.S. 458, 464, 58 S. Ct. 1019, 82 L. Ed. 1461 (1938).

[28] *E.g.*, College Sav. Bank v. Fl. Prepaid Postsecondary Educ. Expense Bd., 527 U.S. 666, 682, 119 S. Ct. 2219, 144 L. Ed. 2d 605 (1999) (quoting Johnson, 304 U.S. at 464); Minnick v. Mississippi, 498 U.S. 146, 159, 111 S. Ct. 486, 112 L. Ed. 2d 489 (1990) (same); Pellaton v. Bank of New York, 592 A.2d 473, 476 (Del. 1991) (same); Lewis v. State, 757 A.2d 709, 714 (Del. 2000) (same).

[29] *See Waiver*, WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE, at 2570 ("the act of waiving or intentionally relinquishing or abandoning a known right, claim, or privilege"). Other dictionaries do the same, *e.g., Waive*, MERRIAM-WEBSTER ONLINE DICTIONARY ("to relinquish (something, such as a legal right) voluntarily"), https://www.merriam-webster.com/dictionary/waive.

[30] For example, Section 13(d) provides that "[e]ach Party *waives* any right to a trial by jury in any such suit or proceedings." A90 (emphasis added); *see also id.* at A81 § 10(a) ("the Carlyle Majority may waive, on behalf of all holders of Registrable Common Stock, any right to participate in or receive notice of any registration of Common Stock. . .") and A88 § 10 (i) ("Waiver of Registration Rights").

[31] *See Waive*, Black's Law Dictionary (11th ed. 2019) (giving a second definition, "To refrain from insisting on (a strict rule, formality, etc.); to forgo."); *Waive*, New Oxford American Dictionary, 1943 (3d ed. 2010) ("refrain from insisting on or using (a right or claim): *he will waive all rights to the money*."). We have likewise held that waiver "implies knowledge of all material facts and an intent to waive, together with a

terms in a single document we should assume that the usage of distinct terms was **[**69]** intended by the parties and we should give that distinct usage meaning.[32] Understanding the Refrain Obligation to use *refrain* as a narrower restriction than *waive* is consistent with both Section 3(e) and the Termination Provision, gives effect to both provisions, and defers to the parties' own choice of contractual language.

Finally, Authentix argues that applying the Termination Provision as written renders the Refrain Obligation "a nullity" or at least "commercially unreasonable."[33] I disagree. When a merger is subject to a vote at a meeting of stockholders, those owners who wish to seek appraisal in lieu of merger consideration must take steps to perfect their appraisal rights before the meeting and vote.[34] Proceeding in that **[*1237]** fashion would have forced Stockholders **[**70]** either to breach their obligations *prior to termination* or forfeit the opportunity to perfect their appraisal rights. Carlyle freely chose to proceed differently.[35]

In sum, for the Stockholders Agreement to cut off Petitioners' statutory appraisal rights Authentix needs to show at the very least it provides for such a derogation in unambiguous terms and in language that is unquestionably and unequivocally clear. *This* Stockholders Agreement, which unambiguously terminated before any of the complained-of conduct, and with a savings clause for other sections but pointedly *not* for the Refrain Obligation, does not do so.[36] Given that there is a reasonable reading of these provisions in Petitioners' favor, I would find the Stockholders Agreement's unclear drafting renders it at least ambiguous, and so not sufficiently clear to divest Petitioners of their statutory right to appraisal. Reversal is justified on that ground alone.

But there are two more bases for reversal.

II. Appraisal Rights Are Fundamental Features of Corporate Governance, and Modifications Should Be Permitted Only in the Corporate Charter.

The second reason to reverse the Court of Chancery is that even if the "waiver" **[**71]** were sufficiently clear and unambiguous, permitting waiver of fundamental corporate governance rights in a *stockholders agreement* as opposed to in the corporation's constitutive documents,[37] is problematic. Here the issue is: to what extent can a waiver of statutory rights be effectuated via a *stockholders agreement*, and what are the limiting principles on such private ordering for

willingness to refrain from enforcing those rights." Bantum, 21 A.3d at 50 (emphasis added). That is, waiver *includes* the obligation to refrain *but goes further*, requiring a showing that the party specifically intended to pledge permanent rather than temporary forbearance. The *Bantum* Court likewise cited the traditional definition of waiver, "the voluntary and intentional relinquishment of a known right." The word "relinquishment" carries with it this same connotation of definitiveness or permanence. *See Relinquishment*, Webster's Third New International Dictionary of the English Language, at 1919 ("the act of relinquishing : a giving up : surrender, renunciation."); *see also id.* at 1918 (listing the synonyms for "relinquish" as "LEAVE, ABANDON, WAIVE, RESIGN, CEDE, YIELD, SURRENDER.").

[32] *Davis Broad. of Atlanta LLC v. Charlotte Broad., LLC*, 134 A.3d 759, 2016 WL 837367, at *1 (Del. 2016) (TABLE) (when a contract used "date of filing" instead of the defined term "Filing Date" used elsewhere in the contract, "[a]lthough not dispositive, that intentional choice must incline the interpretative process toward giving the distinct usage meaning.").

[33] Ans. Br. at 25-26.

[34] *E.g.*, 8 Del. C. § 262(d)(1) ("If a proposed merger or consolidation for which appraisal rights are provided under this section is to be submitted for approval at a meeting of stockholders. . . [e]ach stockholder electing to demand the appraisal of such stockholder's shares shall deliver to the corporation, before the taking of the vote on the merger or consolidation, a written demand for appraisal of such stockholder's shares. . .").

[35] *See e.g., Riverstone*, 2015 Del. Ch. LEXIS 49, 2015 WL 854724, at * 10 ("Both Riverstone and the Minority Stockholders are sophisticated parties, and both are charged with knowledge as to the various ways Riverstone could have carried out a merger under Delaware law, including by written consent pursuant to Section 228. Yet, with full awareness that it could consummate a merger by written consent, without the Minority Stockholders' knowledge or involvement, Riverstone agreed to a drag-along rights that by their unambiguous terms did not apply to this retrospective scenario.").

[36] *See* O'Brien v. Progressive N. Ins. Co., 785 A.2d 281, 288 (Del. 2001) (defining an ambiguous contract as one where "the provisions in controversy are reasonably or fairly susceptible to different interpretations or may have two or more different meanings.") (citing Rhone-Poulenc Basic Chems. Co. v. Am. Motorists Ins. Co., 616 A.2d 1192, 1196 (Del. 1992)).

[37] That is, the bylaws or, preferably, the charter.

Delaware corporations?

As this Court recognized in *Salzberg v. Sciabacucchi*,[38] the DGCL allows for substantial private ordering. We said:

> [T]he DGCL allows immense freedom for businesses to adopt the most appropriate terms for the organization, finance, and governance of their enterprise. "At its core, the [DGCL] is a broad enabling act which leaves latitude for substantial private ordering, provided the statutory parameters and judicially imposed principles of fiduciary duty are honored." In fact, "Delaware's corporate statute is widely regarded as the most flexible in the nation because it leaves the parties to the corporate contract (managers and stockholders) with great leeway to structure their relations, subject to relatively loose statutory constraints and to the policing of director misconduct through **[**72]** equitable review."[39]

[*1238] In *Salzberg*, we considered the validity of a provision in a Delaware *certificate of incorporation* requiring actions arising under the federal Securities Act of 1933 to be filed in a federal court. We held that such a charter provision was facially valid and within the parameters of *Section 102(b)(1)*. But we also observed that *Section 102(b)*'s broad authorization was constrained by the phrase, "if such provisions are not contrary to the *laws of this State*."[40] We held that federal forum provisions "do not violate the policies or laws of this State."[41]

We further observed that although "*Section 102(b)(1)*'s scope was broadly enabling," additional limits are imposed by *public policy*:

> First, *Section 102(b)(1)*'s scope is broadly enabling. For example, in *Sterling v. Mayflower Hotel Corp.*, this Court held that *Section 102(b)(1)* bars only charter provisions that would "achieve a result forbidden by settled rules of public policy." Accordingly, "the stockholders of a Delaware corporation may by contract embody in the certificate of incorporation a provision departing from the rules of common law, provided that it does not transgress a statutory enactment *or a public policy settled by the common law or implicit in the General Corporation Law itself*."[42]

Salzberg ***[**73]*** addressed private ordering through a charter provision. By contrast, the phenomenon we address here has largely evolved in the private company realm by start-up companies and venture capital firms who have developed a practice of using *stockholder agreements* to structure significant aspects of their corporation's corporate governance. This practice apparently has become fairly commonplace in that sector. In fact, commentators have observed that private equity transactions for years have been including drag-along rights that include waivers of statutory rights such as appraisal.[43] The Majority is, no doubt, concerned about upsetting what has, or is becoming, an established practice in that sector.

I appreciate that "our DGCL was intended to provide directors and stockholders with flexibility and wide discretion for private ordering and adaption to new situations."[44] The use of stockholder agreements to (purportedly) effectuate waivers of *Section 262* rights is evidence that such waivers, at least in that sector of the capital markets, may be achieving efficiencies beneficial to the parties. **[**74]** But the question that this Court must answer is whether that is a practice that is consistent with the DGCL and relevant public policy.

Why should the use of stockholder agreements, as opposed to the corporation's constitutive documents, as the vehicle for effectuating such waivers matter? After all, this Court recently has reiterated its view that private ordering through binding contracts ought to be respected. For example, in *ev3, Inc. v. Lesh*, we stated that "[w]hen parties have ordered their affairs voluntarily

---

[38] ***227 A.3d 102 (Del. 2020)***.

[39] ***Id. at 116*** (citations omitted).

[40] ***Id. at 115*** (citing *8 Del. C. § 102(b)(1)*).

[41] *Id.*

[42] ***Id. at 115-16*** (emphasis added) (alteration omitted).

[43] *See, e.g., Drag-along Rights and Appraisal Remedies in Stockholders Agreements*, PRACTICAL LAW CORPORATE & SECURITIES (Mar. 26, 2015) ("The ability to contractually waive the appraisal remedy has not typically been thought of as controversial. . .."), https://1.next.westlaw.com/4-523-5341.

[44] ***Salzberg, 227 A.3d at 137 n.169*** ("[Delaware corporations have] the broadest grant of power in the English-speaking world to establish the most appropriate internal organization and structure for the enterprise.") (alteration in original) (quoting *Jones Apparel Grp. v. Maxwell Shoe Co., Inc., 883 A.2d 837, 845 (Del. Ch. 2004)*).

through a binding contract, **[*1239]** Delaware law is strongly inclined to respect their agreement and will only interfere upon a strong showing that dishonoring the contract is required to vindicate a public policy interest even stronger than freedom of contract."[45] And in *Salzberg*, we agreed that freedom of contract is a public policy of paramount importance in Delaware.[46] But again, as in *ev3, Inc.* and *Salzberg*, we have acknowledged public policy and statutory limitations.

I believe the use of stockholder agreements to effect *ex ante* waivers of governance rights of common stockholders is problematic. The Petitioners challenge **[**75]** the use of stockholder agreements for effectuating such waivers and argue that the Stockholders Agreement "operates as a *de facto* charter that supersedes Delaware's hierarchical corporate contract."[47] It is undisputed that the Stockholders Agreement bound all outstanding shares of Authentix stock.[48] Further, Section 13(b) provides that it "shall be binding upon . . . assigns and any other transferee and shall also apply to any securities acquired by a Holder after the date hereof."[49] Section 2 likewise purports to require that all future transferees must execute and join the Stockholders Agreement.[50] Because of this, Petitioners argue that this arrangement is akin to a *de facto* charter.[51] It is also **[*1240]** undisputed that none of the Stockholders Agreement's restrictions and obligations at issue is in the Company's charter. They further argue that the decision to permit this use of a stockholders agreement violates this hierarchy. Specifically, they contend that a stockholder agreement (to which the corporation is a party) sits at the bottom of the hierarchy. To the extent stockholder agreements are being utilized to effectuate what would be restricted in charters and bylaws, this point has merit.[52]

This Court has long observed that the certificate of incorporation, together with bylaws and the DGCL form part of a flexible contract between a corporation and its stockholders. "The components of [the corporate] contract form a hierarchy, comprising from top to bottom

---

[45] *114 A.3d 527, 529 n.3 (2014)* (quoting *Libeau v. Fox, 880 A.2d 1049, 1056-57 (Del. Ch. 2005)*, *aff'd in relevant part* *892 A.2d 1068 (Del. 2006)*). In *ev3*, former shareholders of an acquired corporation sued for breach of an earn-out milestone provision, arguing that the buyer violated its obligation to adequately fund pursuit of the milestones. *Id. at 529*. The contract provided that funding would be in the buyer's sole discretion, exercised in good faith. *Id.* Although the contract also partially incorporated a letter of intent from the negotiation phase which specified that the buyer should provide funding to pursue the milestones, the final contract included an express clause by which the final agreement overrode contrary provisions as to funding. *Id. at 529-30*. Where two contractual clauses appear to be in conflict, another clause specifying which takes priority provides a simple mechanism for resolving the tension without resort to questions of public policy. That circumstance contrasts with cases where a contractual clause conflicts with a *statutory* right, as with the *Libeau* case which *ev3* cited and which addressed whether a contract had waived the statutory right to partition of real property. *Libeau, 880 A.2d at 1058* (requiring waiver "'by clear affirmative words or actions'" for a contract to eliminate a right conferred by statute) (citing *Ford Holdings, 698 A.2d at 979*).

[46] *See, e.g.,* ***Salzberg, 227 A.3d at 116*** ("Delaware's corporate statute . . . leaves the parties to the corporate contract (managers and stockholders) with great leeway to structure their relations, subject to relatively loose statutory constraints. . .."); *NAF Hldgs., LLC v. Li & Fung (Trading) Ltd., 118 A.3d 175, 180 n.14 (Del. 2015)* ("Delaware upholds the freedom of contract and enforces as a matter of fundamental public policy the voluntary agreements of sophisticated parties.") (quoting *NACCO Indus. v. Applica Inc., 997 A.2d 1, 35 (Del. Ch. 2009)*).

[47] Op. Br. at 4. They expound further on this point:

> ***[**76]*** *[I]f* such an agreement is enforceable stockholder-to-stockholder, permitting creation and enforcement by the corporation itself against its own stockholders would mean that no principled barrier would prevent a Delaware corporation from using a separate agreement to create *for itself* second-class stockholders with rights not set forth in the charter (because it would be illegal to put them in the charter).

Id. at 5 (alteration added) (emphasis in original).

[48] It was binding upon all the Company's then-stockholders at the time of its execution in 2008.

[49] JA89 (Stockholders Agreement § 13(b)).

[50] JA72 (Stockholders Agreement § 2).

[51] Op. Br. at 4 ("If affirmed, [the Court of Chancery's decision] would mean that a prospective investor/controller could be offered by a corporation as an incentive -- or could demand (like here) that a corporation obtain -- an agreement from all of the corporation's stockholders (enforceable by the corporation) that waives *ex ante* mandatory provisions of the DGCL and operates as a *de facto* charter that supersedes Delaware's hierarchical corporate contract.") (alteration added) (emphasis in original).

[52] *See, e.g.,* *Ford Holdings, 698 A.2d at 976* ("Generally, these mandatory provisions may not be varied by terms of the certificate of incorporation *or otherwise*.") (emphasis added).

(i) the [DGCL], (ii) the certificate of incorporation, and (iii) the bylaws."[53] "Each of the lower components of the contractual hierarchy must conform to the higher components."[54] And "[a] bylaw that conflicts with the charter is void, as is a bylaw or charter provision that conflicts with the DGCL."[55]

Petitioners argue that ancillary agreements to which the corporation is a party **[**77]** are not exempt from having to conform to this hierarchy. Support exists for that proposition. For example, the Court of Chancery has observed that:

> When evaluating corporate action for legal compliance, a court examines whether the action contravenes the hierarchical components of the entity-specific corporate contract, comprising (i) the Delaware General Corporation Law, (ii) the corporation's charter, (iii) its bylaws, and (iv) other entity-specific contractual agreements, such as a stock option plan, other equity compensation plan, or, as to the parties to it, a stockholder agreement.[56]

[*1241] In addition to case law support, I note that the General Assembly has expressly indicated when certain actions not permitted to be taken in charters may be effectuated in stockholders agreements. For example, Section 115 of the DGCL deals with forum selection clauses for internal corporate claims, and specifies that "no provision of the certificate of incorporation or the bylaws may prohibit bringing such claims in the courts of this State."[57] The synopsis of the bill enacting Section 115 expressly provides that "Section 115 is not intended . . . to prevent any such provision in a stockholders agreement . . . signed by the stockholder against **[**78]** whom the provision is to be enacted."[58]

There are some valid policy concerns with using stockholder agreements to effect *ex ante* waivers of appraisal rights for common stockholders. For example, some commentators have pointed out the dangers of "stealth governance" and have argued that "using shareholder agreements for corporate governance . . . sacrifices critical corporate law values."[59] The scope of these stockholder agreements now includes (putative) restrictions or waivers of inspection rights, appraisal rights and fiduciary duties of directors.[60]

---

[53] Sinchareonkul v. Fahnemann, 2015 Del. Ch. LEXIS 17, 2015 WL 292314, at *6 (Del. Ch. Jan. 22, 2015).

[54] *Id.* Thus, for example, a corporate charter can confer onto the board of directors the power to alter the bylaws beneath it (8 Del. C. § 109(a)), but the bylaws cannot derogate the corporate charter that sits above it (8 Del. C. § 109(b)). *See, e.g.,* Centaur Partners IV v. Nat'l Intergroup, Inc., 582 A.2d 923, 929 (Del. 1990) ("Where a by-law provision is in conflict with a provision of the charter, the by-law provision is a 'nullity.'") (quoting Burr v. Burr Corp., 291 A.2d 409, 410 (Del. Ch. 1972)); 8 Del. C. § 109(b) ("The bylaws may contain any provision, *not inconsistent with law or with the certificate of incorporation*, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees.") (emphasis added). Likewise, the DGCL and all of its amendments "shall be a part of the charter or certificate of every corporation," and thus the General Assembly through its power to amend the DGCL sits at the top of the hierarchy. 8 Del. C. § 394.

[55] *Sinchareonkul*, 2015 Del. Ch. LEXIS 17, 2015 WL 292314, at *6.

[56] Quadrant Structured Prods. Co. v. Vertin, 2014 Del. Ch. LEXIS 214, 2014 WL 5465535, at *3 (Del. Ch. Oct. 28, 2014); *see also* Marmon v. Arbinet-Thexchange, Inc., 2004 Del. Ch. LEXIS 44, 2004 WL 936512, at *5 (Del. Ch. Apr. 29, 2004) (holding that the company's directors "were not free to contract away disclosure obligations that they had a fiduciary duty to observe," and that "[n]or could they rely upon a certificate provision prohibiting disclosure to avoid a shareholder's inspection right conferred by statute," and by doing so, the "directors and management made the corporation complicit in their violations of fiduciary, as well as statutory, law.").

[57] 8 Del. C. § 115.

[58] Del. S.B. 75 syn.

[59] *See generally*, Fisch, Jill E., *Stealth Governance: Shareholder Agreements and Private Ordering*, FACULTY SCHOLARSHIP AT PENN LAW (2021) (arguing that "stealth governance is inappropriate for corporations and instead advocates a uniform structural approach to corporate law that would limit private ordering to the charter and bylaws."), https://scholarship.law.upenn.edu/faculty_scholarship/2199.
As Professor Fisch notes, shareholder agreements purporting to derogate critical rights afforded to shareholders under the DGCL are apparently common among startup companies that have not gone public. *Id.* at 5. Precisely because they are not part of the incorporating documents filed with the Secretary of State, the public can become aware of them only when they are litigated.

[60] *See* Fisch at 5 n.15 ("Both appraisal waivers and inspection rights waivers are part of the most recent versions of the National Venture Capital Association's model documents.") (citing NVCA, *Voting Agreement*, at 7 (July 2020),

No doubt, the sophisticated parties entering into these agreements have found them to be beneficial. Stockholder agreements may offer venture capital funded start-ups flexibility versus complying with the formalities of charters and bylaws. And unlike charters, they are not public documents filed with the Secretary of State. But restriction or elimination of important stockholder rights such as inspection, appraisal, election rights and fiduciary duties may minimize accountability of **[*1242]** the Board and upset the delicate balance of power that the General Assembly and courts have attempted to maintain among a Delaware corporation's constituencies.[61]

The ordinary place for private ordering provisions that alter this balance is in the charter or bylaws.[62] Principles of corporate democracy support this preference.[63] If a

---

https://nvca.org/recommends/nvca-2020-voting-agreement-2/; NVCA, *Investors' Rights Agreement*, at 24-25 (September 2020), https://nvca.org/ recommends/nvca-2020-investors-rights-agreement-2/). As Professor Fisch notes, the NVCA model documents also purport to waive the right to assert post-merger claims for breaches of fiduciary duties. *Id.* Further in this regard, I note that a footnote to Section 3(e) of the Model Agreement submitted by the parties states that:

> Even if appraisal rights are waived, common and subordinate preferred stockholders are increasingly filing breach of fiduciary duty claims seeking quasi-appraisal - i.e., damages that mirror the recovery available in an appraisal suit - in transactions subject to drag along provisions where the junior preferred or common shareholders are to receive no consideration for their shares. Because the directors are often representatives of the senior preferred holders, these suits are difficult **[**79]** to dismiss at an early stage. *Accordingly consideration should be given to expanding the agreement to include an agreement not to file appraisal actions to cover breach of fiduciary suits in transactions subject to the drag along*.

JA1316-17 (NCVA Model Agreement § 3.2(e) n.17) (emphasis added).

[61] For example, while the DGCL authorizes mergers approved by a majority vote of the outstanding shares, 8 Del. C. § 251(c), it permits a corporation to impose a supermajority provision if it does so *in the certificate of incorporation. See* Berlin v. Emerald Partners, 552 A.2d 482, 488-89 n.8 (Del. 1988) ("The approval of a merger, under the Delaware General Corporation Law, requires the affirmative vote of a majority of the outstanding common stock of the corporations unless the certificate of incorporation provides for a higher percentage.").

[62] *In Centaur Partners IV v. Nat'l Intergroup, Inc.*, this Court stated:

> In *Standard Power*, this Court held that the rules of corporate democracy are based in large part upon the principle that a majority of the votes cast at a stockholders meeting is sufficient to elect directors. Although by statute a simple plurality provision now suffices, the result is the same: a charter or bylaw provision which purports to alter this principle must be positive, explicit, clear and readily understandable. This presumption is overcome only by a clear, unambiguous and unequivocal statement, *in the charter or by-laws of a corporation*, expressing the stockholders' desire that a specific percentage of votes be required.

582 A.2d at 927 (emphasis added) (citations and alterations omitted) (citing Std. Power & Light Corp. v. Invest. Assocs., Inc., 29 Del. Ch. 593, 51 A.2d 572, 576 (Del. 1947)).

[63] *See* 8 Del. C. § 141(d) (addressing classified boards). This section allows for a departure from the default rule of annual elections of the *full* board in favor of election instead of at most three classes of director "by the certificate of incorporation or by an initial bylaw, or by a bylaw adopted by a vote of the stockholders." *Id.; see also* Boilermakers Local 154 Ret. Fund v. Chevron Corp., 73 A.3d 934, 939 (Del. Ch. 2013) (observing that "the certificate of incorporation may authorize the board to amend the bylaws' terms and that stockholders who invest in such corporations assent to be bound by board-adopted bylaws when they buy stock in those corporations"); id. at 958 ("Where, as here, the certificate of incorporation has conferred on the board the power to adopt bylaws, and the board has adopted a bylaw consistent with 8 Del. C. § 109(b), the stockholders have assented to that new bylaw being contractually binding."). In *Williams v. Geier*, this Court observed for example, that:

> At its core, the Delaware General Corporation Law is a broad enabling act which leaves latitude for substantial **[**81]** private ordering, provided the statutory parameters and judicially imposed principles of fiduciary duty are honored. Although directors are given much discretion in managing the business and affairs of the corporation, some fundamental measures require stockholder action. For example, when the statutory framework was altered in 1986 to permit some exemptions from personal liability for directors in 8 Del. C. § 102 (b)(7), it was (and is) the legislative policy of this State that such exemptions could be enjoyed by directors only if the stockholders approved such a provision in the certificate of incorporation. Further, all amendments to certifications of incorporation and mergers require stockholder action. Thus, Delaware's legislative policy is to look to the will of the stockholders in these areas.

[*1243] private contract by and between all stockholders could override the charter and bylaws, that agreement would transform **[**80]** the corporate governance documents into gap-filling defaults and collapse the distinction between a corporation and alternative entities. Thus, assuming *arguendo* the validity of *ex ante* waivers of important statutory governance rights like appraisal rights (the question next addressed), they should be in a corporation's charter and not in a stockholders agreement.[64]

III. Based Upon Statutory Language, the Structure of the Various Entity Statutory Schemes, and Public Policy, the Better View is That Appraisal Rights Are Mandatory.

My third concern, which would also be a basis for reversal, is that I do not believe that such an *ex ante* waiver of appraisal rights for common stockholders is presently permissible. I start with the proposition that there are at least *some* provisions of the DGCL that are mandatory. This proposition is not all that controversial.[65] A consensus has emerged that at least some provisions of the DGCL are mandatory and simply cannot be **[**83]** waived.[66] In *Ford Holdings*, Chancellor Allen listed a number of mandatory provisions:

> Thus, unlike the corporation law of the nineteenth century, modern corporation law contains few mandatory terms; it is largely enabling in character. It is not, however, bereft of mandatory terms. Under Delaware law, for example, a corporation is required to have an annual meeting for the election of directors; is required to have shareholder approval for amendments to the certificate of incorporation; must have appropriate shareholder concurrence in the authorization of a merger; and is required to have shareholder approval in order to dissolve. Generally, these mandatory provisions may not be varied by the terms of the certificate of incorporation **[*1244]** or otherwise. *Among these mandatory provisions of Delaware law is Section*

---

671 A.2d 1368, 1381 (Del. 1996). As we further explained, the process of amending certificates of incorporation enjoys a favored place within that statutory framework because of its procedural safeguards:

> Like the statutory scheme relating to mergers under 8 Del. C. § 251, it is significant that two discrete corporate events must occur, in precise sequence, to amend the certificate of incorporation under 8 Del. C. § 242: First, the board of directors must adopt a resolution declaring the advisability of the amendment and calling for a stockholder vote. Second, a majority of the outstanding stock entitled to vote must vote in favor. The stockholders **[**82]** may not act without prior board action. Likewise, the board may not act unilaterally without stockholder approval. Therefore, the stockholders control their own destiny through informed voting. *This is the highest and best form of corporate democracy*.

Id. (emphasis added).

[64] I note that the Maryland Legislature has authorized such waivers but only in a corporation's *charter. See, e.g.*, MD CODE, CORP & ASS'NS, § 3-202(c)(4) ("Unless the transaction is governed by § 3-602 of this title or is exempted by ***§ 3-603(b)*** of this title, a stockholder may not demand the fair value of the stockholder's stock and is bound by the terms of the transaction if. . . [t]he *charter* provides that the holders of the stock are not entitled to exercise the rights of an objecting stockholder under this subtitle; . . .") (emphasis added). Similarly, the Model Business Corporation Act authorizes waiver of appraisal rights but only for preferred stock and only in charter provisions. MBCA § 13.02(c) (Dec. 2020), https://www.americanbar.org/content/dam/aba/administrative/business_law/corplaws/2020_mbca.pdf. The Official Comment explains:

> Section 13.02(c) permits the corporation to eliminate or limit appraisal rights that would otherwise be available for the holders of one or more series or classes of preferred shares provided that the standards in that section are met. Chapter 13 does not permit the corporation to eliminate or limit the appraisal rights of common shares.

MBCA § 13.02, cmt. 3.

[65] I recognize that there has been an ongoing debate as to whether any mandatory provisions are desirable. *See, e.g., Ford Holdings, 698 A.2d at 976-77* ("This question is a specification of the general question -- which has received a great deal of scholarly attention -- whether, as a matter of sound policy, mandatory provisions are ever desirable in corporation law.").

[66] *See, e.g.*, Edward P. Welch & Robert S. Saunders, *Freedom and its Limits in the Delaware General Corporation Law*, 33 Del. J. Corp. L. 845 (2008) (arguing that there are a few statutory provisions that cannot be limited in a certificate of incorporation and identifying, among them, rights of stockholders to periodically elect directors, to inspect books and records, and directors' duty of loyalty); *see also Rainbow Nav., Inc. v. Pan Ocean Nav., Inc., 535 A.2d 1357, 1359 (Del. 1987)* (holding that Section 220 creates mandatory inspection rights that "can only be taken away by statutory enactment.").

262, the appraisal remedy.[67]

But moving from that starting point, there is considerable debate as to *which* provisions are mandatory. Resolving that debate is a difficult task.

I submit that the analysis must begin with the text of the statute -- in this case, *Section 262*.[68] "The 'most important consideration for a court **[**84]** in interpreting a statute is the words the General Assembly used in writing it.'"[69] "The court must 'give the statutory words their commonly understood meanings.'"[70] The General Assembly's use of the word "shall" in *Section 262(a)* is significant.[71] It suggests that the statutory remedy of appraisal is mandatory if a stockholder petitions for it.[72] Also, *Section 262(a)*, unlike dozens of other provisions of the DGCL, does not use the phrase "unless otherwise provided in the certification of incorporation."

But the text of the statute and the use of the word "shall" may not be determinative. Further, Petitioners accept that in the DGCL, the lack of a prefatory clause such as "unless otherwise provided in the certificate of incorporation" is not always determinative of what is modifiable.[73] Indeed, our courts have found certain statutory **[*1245]** provisions to be modifiable even absent these words. For example, in *Jones Apparel Group, Inc. v. Maxwell Shoe Co.*, the Court of Chancery held that for *Section 102(b)(1)*[74] to have meaning, it must not be limited to modifying **[**85]** default provisions of the DGCL that contain "magic words" permitting contrary provisions.[75] Otherwise, "there is no

[67] *698 A.2d at 976* (emphasis added) (footnotes omitted).

[68] ***Salzberg, 227 A.3d at 113***.

[69] *Id.* (quoting *Boilermakers, 73 A.3d at 950*).

[70] *Id.* (quoting *Kofron v. Amoco Chems. Corp., 441 A.2d 226, 230 (Del. 1982)*).

[71] *See* *8 Del. C. § 262(a)*: Any stockholder of a corporation of this State who holds shares of stock on the date of the making of a demand pursuant to *subsection (d)* of this section with respect to such shares, who continuously holds such shares through the effective date of the merger or consolidation, who has otherwise complied with *subsection (d)* of this section and who has neither voted in favor of the merger or consolidation nor consented thereto in writing pursuant to *§ 228* of this title *shall be entitled to an appraisal by the Court of Chancery of the fair value of the stockholder's shares of stock under the circumstances described in subsections (b) and (c) of this section*.

[72] *See, e.g.*, *Arnold v. State, 49 A.3d 1180, 1183 (Del. 2012)* ("The mandatory 'shall' normally creates an obligation impervious to judicial discretion.") (alterations omitted) (quoting *Lexecon Inc. v. Milberg Weiss Bershad Hynes & Lerach, 523 U.S. 26, 35, 118 S. Ct. 956, 140 L. Ed. 2d 62 (1998)*); *H-M Wexford LLC v. Encorp, Inc., 832 A.2d 129, 152 (Del. Ch. 2003)* (the requirements of *Section 228(c)* are mandatory because "the word 'shall' is a mandatory term.").

[73] Reply Br. at 22. For example, the General Assembly has made some DGCL provisions explicitly default. *E.g.*, *8 Del. C. § 212(a)* ("Unless otherwise provided in the certificate of incorporation and subject to *§ 213* of [the DGCL], each stockholder shall be entitled to 1 vote for each share of capital stock held by such stockholder.") (alteration added); *8 Del. C. § 223(a)* (providing rules for filling vacancies on the board of directors which apply "[u]nless otherwise provided in the certificate of incorporation or bylaws"); *8 Del. C. § 273(a)* (allowing either stockholder of a corporation owned by exactly two owners in equal shares to petition for dissolution "unless otherwise provided in the certificate of incorporation of the corporation or in a written agreement between the stockholders"). One might argue that inclusion of such clauses implies that some provisions of the DGCL not so designated cannot be so derogated, because "[w]here the General Assembly prescribes a form of conduct, the manner of its performance and operation, and the *persons and things to which it refers are affirmatively or negatively designated, there is an inference that all omissions were intended by the legislature*." *Leatherbury v. Greenspun, 939 A.2d 1284, 1291 (Del. 2007)* (quoting and adding emphasis to Norman J. Singer, SUTHERLAND STATUTES AND STATUTORY CONSTRUCTION, § 4915 (3d Ed.)). But *Jones Apparel*, discussed next, provides an effective rebuttal that these "magic words" are not dispositive.

[74] Section 102(b)(1) provides:

> In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters:. . . [a]ny provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders, or any class of the stockholders, or the governing body, members, or any class or group of members of a nonstock corporation; if such provisions are not contrary to the laws of this State.

8 Del. C. s 102(b)(1).

[75] *883 A.2d at 847-48*; *see* *id. at 845* ("Currently, our corporate code contains 48 separate provisions expressly referring to

independent utility to [section] 102(b)(1)."[76] Rather, a court must determine, based upon a careful and specific review, whether a particular certificate provision contravenes Delaware public policy in the form of statutory or common law.[77]

Adding to the difficulty here is that our courts have not yet established a clear analytical framework to discern where the dividing line is. I offer the view that certain key statutory provisions that establish the balance of powers and checks and balances between and among stockholders, directors, and officers, may qualify as mandatory, particularly when the General Assembly uses mandatory language in the provisions.[78]

[*1246] That certain mandatory provisions in the DGCL are not waivable by contract is also suggested by comparing the DGCL with Delaware's alternative entity statutes. Despite the broad freedom of contract afforded to Delaware corporations, unlike the alternative entity statutes the DGCL does *not* contain a provision endorsing freedom of contract to "maximum effect." As this Court recently noted in *United States v. Sanofi-Aventis U.S. LLC*, the function of the 'maximum effect' clause as it appears in the DRUPA is that a partnership agreement "controls in most circumstances," and the DRUPA itself "consist[s] largely of default 'gap-filler' provisions that govern when a partnership agreement is silent on an issue."[79] Although the DGCL is broadly an

---

the variation of a statutory rule by charter. Those provisions generally lay out various statutory rules, but include prefatory language such as 'unless otherwise provided in the certificate of incorporation.'") (footnote omitted).

[76] Id. at 848.

[77] *Id.* As then-Vice Chancellor Strine noted, while Section 102(b)(1) and Section 141(a) are "important expressions of the wide room for private ordering authorized by the DGCL," that wide room is provided "*when such private ordering* ***[**86]*** *is reflected in the corporate charter*." Id. at 839 (emphasis added).

[78] *See* Leo E. Strine Jr., & J. Travis Laster, *The Siren Song of Unlimited Contractual Freedom*, Harvard L. School John M. Olin Center Discussion Paper No. 789, at 6 (Aug. 1, 2014) (noting that "[a]fter all, American corporate law statutes have few mandatory requirements" and that "the notion that American corporate statutes contain burdensome and non-waivable provisions that hamper managerial effectiveness is not an intuitively obvious one."), https://ssrn.com/abstract=2481039; *id.* ("[t]o the contrary, the DGCL and its counterparts predominantly offer default rules that can be altered through private ordering via the corporation's certificate of incorporation and bylaws."). Further, at the comprehensive reversion in 1960:

> The distinguished group of experts who carefully examined and rewrote the DGCL, section by section, had the opportunity to craft statutory language that, if followed, would conclusively resolve the competing interests of managers and investors and foreclose any judicial inquiry under equitable principles. They declined to take that approach, recognizing that a rigid set of statutory rules could not properly balance the interests of managers and investors and achieve both efficiency and . . . opted instead to maintain corporate law's two-fold tradition: first, a broadly enabling statute *that nevertheless contains important* ***[**87]*** *and fairness-enhancing mandatory rules, such as requirements for the regular election of directors, stockholder votes on major transactions like mergers and sales of substantially all assets, and a stockholder right to access corporate books and records for a proper purpose*; and second, an equitable overlay of fiduciary duties, enforced primarily by the ability of stockholders to sue directors in the courts for breach of their duty of loyalty.

Id. at 10-11 (Emphasis added).

[79] 226 A.3d 1117, 1127 (Del. 2020) (citing 6 Del. C. § 15-103(d)). This Court has also stated in the context of the Delaware Limited Liability Company Act (noting that, "the following observations relating to limited partnerships applies as well to limited liability companies"):

> The Act's basic approach is to permit partners to have the broadest possible discretion in drafting their partnership agreements and to furnish answers only in situations where the partners have not expressly made provisions in their partnership agreement. Truly, the partnership agreement is the cornerstone of a Delaware limited partnership, and effectively constitutes the entire agreement among the partners with respect to the admission of partners to, and the creation, operation and termination of, the limited partnership. Once partners exercise their contractual freedom in their partnership agreement, the partners have a great deal of certainty that their partnership agreement will be enforced in accordance with its **[**89]** terms.

Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 291 (Del. 1999) (quoting Martin I. Lubaroff & Paul Altman, *Delaware Limited Partnerships* § 1.2 (1999)). *See also* 6 Del. C. § 17-1101(c) ("It is the policy of [the Limited Partnership Act] to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements."); 6 Del. C. § 18-1101(b) ("It is the policy of [the LLC Act] to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements."); 12 Del. C. § 3825(b) ("It is the policy of [the Trust Act] to give the enabling **[**88]** act that establishes default rules,[80] by not including such a provision in the DGCL, it is logical to infer that the General Assembly was drawing at least some distinction with other statutory business entity schemes. I believe this difference in the statutory structure reflects the General Assembly's intent to create different "brands" among the entity types and signals that Delaware corporations have at least a few features imposed by the DGCL that cannot be modified.[81]

A further comparison of these statutory schemes may hint at what some of these immutable features are. For example, the DRULPA and LLC Act authorize provisions that managers or partners will not owe fiduciary duties of loyalty to members or partners.[82] The statutes expressly authorize restriction on inspection rights.[83] Those entities need not have periodic elections of managers or general partners.[84] **[*1247]** That the General Assembly saw fit to include these provisions suggest at least some support for the proposition that corresponding provisions in the DGCL are mandatory. For example, a Delaware corporation cannot eliminate the duty of loyalty or the periodic election of directors.[85]

The narrower question presented here is whether appraisal is among the mandatory provisions. The Court of Chancery rejected Petitioners' contention that *Section 262* appraisal rights are mandatory. It held that "the DGCL does not explicitly prohibit contractual modifications or waiver of appraisal rights, nor does it require a party to exercise its statutory appraisal rights."[86] But I believe that there is more support for the argument that *Section 262* appraisal rights are a mandatory feature of Delaware corporate law than against it. Aside from Chancellor Allen's statement in *Ford Holdings* that appraisal rights were "mandatory" and could not be modified in a charter *or otherwise*,[87] *Section 262*'s use of the word "shall" suggests the General Assembly's intent.

In addition to the statutory textual evidence, the public

---

maximum effect to the principle of freedom of contract and to the enforceability of governing instruments.").

[80] *E.g.*, *Shintom Co., Ltd. v. Audiovox Corp., 888 A.2d 225, 227 (Del. 2005)* ("The Delaware General Corporation Law is an enabling statute that provides great flexibility for creating the capital structure of a Delaware corporation.").

[81] *See, e.g.*, *Welch & Saunders, supra note 66, at 846-47* ("mandatory terms guarantee that certain core qualities are associated with the particular 'brand' of business entity called a 'Delaware corporation.'").

[82] *See* *6 Del. C. § 18-1101(d)*; *6 Del. C. § 17-1101(e)*.

[83] *See* *6 Del. C. § 18-305(g)*; *6 Del. C. § 17-305(j)*.

[84] *See* *6 Del. C.§ 18-402*; *6 Del. C. § 17-402*.

[85] *See* *8 Del. C. § 102(b)(7)* (allowing for a corporate charter to exculpate the personal liability of a director for some breaches of fiduciary duty, but *not* for violations of "the director's duty of loyalty to the corporation or its stockholders" or for "knowing violation of law"). This Court long ago explained the importance of the duty of loyalty as a matter of public policy:

> If an officer or director of a corporation, in violation of his duty as such, acquires gain or advantage for himself, the law charges the interest so acquired with a trust for the benefit of the corporation, at its election, while it denies to the betrayer all benefit and profit. The rule, inveterate and uncompromising in its rigidity, does not rest upon the narrow ground of injury or damage to the corporation resulting from a betrayal of confidence, **[**90]** but upon a broader foundation of a wise public policy that, for the purpose of removing all temptation, extinguishes all possibility of profit flowing from a breach of the confidence imposed by the fiduciary relation.

Guth v. Loft, Inc., 5 A.2d 503, 23 Del. Ch. 255, 270 (Del. 1939). Where it has deemed it desirable, the General Assembly has carved out areas where interested transactions implicating the duty of loyalty are permitted. *See* *8 Del. C. § 144(a)* (addressing corporate transactions involving interested directors); *8 Del. C. § 122(17)* (permitting a corporation, "in its certificate of incorporation or by action of its board of directors" to renounce interest in business opportunities that would otherwise accrue to it).

[86] *Manti Holdings, LLC v. Authentix Acq. Co. (Manti II), 2019 Del. Ch. LEXIS 307, 2019 WL 3814453, at *4 (Del. Ch. Aug. 14, 2019)*. Indeed, there are provisions of the DGCL containing express prohibitions on private ordering. *See, e.g.*, *8 Del. C. §§ 102(b)(7)*, *102(f)*. Thus, *Section 262*'s lack of an express prohibition could be viewed as some support to find *Section 262* waivers to be permissible. However, I believe the weight of the text of *Section 262* and public policy underlying *Section 262* point towards prohibition. Further, *Section 115*'s express permission of private ordering complicates the analysis and could cut against implying private ordering via stockholders agreements elsewhere. Just as in *Jones Apparel*, a "context- and statute-specific approach to police horribles" is preferable to a "sweeping rule" drawn from the presence of lack of magic words. *883 A.2d at 852* (internal quotation omitted).

[87] *698 A.2d at 976* (emphasis added).

policy underlying the purpose of Section 262 adds support to the view that its appraisal rights are mandatory. If one of the guideposts, in addition to the statutory test, is whether **[**91]** a provision is central to maintaining that delicate balance of power and checks and balances among the corporation's constituencies as I suggest, then consideration should be given to whether there is a public policy embedded in that provision that encompasses such checks and balances.[88] There is a case to **[*1248]** be made that the statutory appraisal remedy falls into this category. We recently recounted a brief history of the appraisal statute in *In re Solera Insurance Coverage Appeals, 240 A.3d 1121 (Del. 2020)*. Before its 1899 enactment, mergers required shareholder unanimity, an "unworkable" mechanism:

> At common law, before the Delaware appraisal statute was enacted, no consolidation or merger of corporations could be effected except with the consent of all the stockholders. That scheme proved unworkable since one or more minority stockholders, if he or they desired to do so, could impede the action of all the other stockholders.
>
> The Delaware General Assembly created the appraisal remedy in 1899 to allow the sale of a corporation upon the consent of a majority of its stockholders rather than upon unanimous approval. As we said in *Dell*, given that a single shareholder could no longer hold up the sale of a company, the General Assembly devised appraisal in **[**92]** service of the notion that the stockholder is entitled to be paid for that which has been taken from him. Minority shareholders who disagree with the sale or who view the sale price as inadequate can seek an independent judicial determination of the fair value of their shares rather than accept the per-share merger consideration. Accordingly, appraisal is a limited legislative remedy developed initially as a means to compensate shareholders of Delaware corporations for the loss of their common law right to prevent a merger or consolidation by refusal to consent to such transactions.[89]

Thus, the trade-off for stockholders giving up the common law right to a unanimous vote, and thus a veto over mergers, **[*1249]** was the statutory right to dissent and seek appraisal of their shares.[90] Viewed in this

---

[88] Many prior rulings from Delaware courts have taken great care to preserve these interlocking checks and balances. *See e.g.* Seinfeld v. Verizon Commc'ns., Inc., 909 A.2d 117, 122 (Del. 2006) ("The evolution of Delaware's jurisprudence in section 220 actions reflects judicial efforts to maintain a proper balance between the rights of shareholders to obtain information based upon credible allegations of corporation mismanagement and the rights of directors to manage the business of the corporation without undue interference from stockholders."). As we recently explained:

> Delaware law recognizes that the stockholder franchise is the ideological underpinning upon which the legitimacy of the directors['] managerial power rests. Keeping a proper balance in the allocation of power between the stockholders' right to elect directors and the board of directors' right to manage the corporation is dependent upon the stockholders' unimpeded right to vote effectively in an election of directors.

Coster v. UIP Cos., Inc., --- A.3d ----, 2021 Del. LEXIS 208, 2021 WL 2644094, at *7 (Del. June 28, 2021) (quotations omitted). Similarly, corporate bylaws cannot divest shares of their statutory power to remove directors, such as by imposing supermajority requirements or requiring cause. Frechter v. Zier, 2017 Del. Ch. LEXIS 14, 2017 WL 345142, at *4 (Del. Ch. Jan. 24, 2017) (citing 8 Del. C. § 141(k) and *In re Vaalco Energy, Inc. S'holder Litig.*, C.A. No. 11775-VCL (Del. Ch. Apr. 20, 2016)). Likewise, aside from interim appointments to vacancies arising between annual meetings, directors cannot remove other directors -- that is, directors hold their positions due to the vote and under the authority of the shareholders, not each other:

> For 89 years, Delaware law has barred directors from removing other directors. In 1974, when the stockholders' power to remove directors was **[**93]** confirmed and addressed through the adoption of Section 141(k), two leading authorities on the DGCL wrote that "by negative implication intended by the draftsmen, directors do not have the authority to remove other directors." I do not believe the DGCL contemplates a bylaw amendment could overturn this rule.

Kurz v. Holbrook, 989 A.2d 140, 157 (Del. Ch. 2010) (footnote omitted) (citations omitted) (quoting S. Samuel Arsht & Lewis S. Black, Analysis of the 1974 Amendments to the Delaware General Corporation Law 378 (1974)), *aff'd in part, rev'd in part sub nom.* Crown EMAK P'rs, LLC v. Kurz, 992 A.2d 377 (Del. 2010).

[89] ***Solera, 240 A.3d at 1133*** (footnotes and alterations omitted) (citing Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd., 177 A.3d 1, 19 (Del. 2017)).

[90] *Id.* Both the Court of Chancery and this Court repeatedly have explained the important historical and analytical connection between appraisal rights and the derogation of the

fashion, the appraisal remedy was a statutorily created right and remedy to compensate stockholders for the loss of a veto or blocking power over a transaction, and a check on the power to effectuate certain qualifying corporate transactions at an unfair price.

IV. Conclusion

No doubt, the question of whether *Section 262* appraisal rights are waivable, and if so, under what circumstances, is fraught with public policy issues. On the one hand, the DGCL affords immense respect for freedom of contract and private ordering.[91] On the other, there are public policy limitations imbedded in the text of the appraisal statute itself ("shall") and other public polices pertaining to appraisal rights in general, and maintaining the delicate balance of power among the Delaware corporation's constituencies. There is also the notion that a Delaware corporation is a different "brand" of entity, as compared with alternative entities, and is known to have certain key features.[92] Public policy determinations are quintessentially a legislative judgment.[93] This **[**95]** is particularly so when the determination to be made hinges on the comparative weighing of polices in tension with one another.

[*1250] Although it is a close call, I believe the better view is that appraisal rights are mandatory. If the General Assembly disagrees, it can amend *Section 262* to make clear that waivers are permissible and under what circumstances.[94] Our DGCL is routinely revised

common law unanimity requirement:

> At common law no consolidation or merger of corporations could be effected except with the consent of all the stockholders. This, at times, brought about an intolerable situation, since one or more minority stockholders, if he or they desired to do so, could impede the action of all the other stockholders. When this situation **[**94]** was changed by statute in Delaware, to permit the consolidation or merger of two or more corporations without the consent of all the stockholders, it became necessary to protect the contractual rights of such stockholders—who by reason of the statute lost their common law right to prevent a merger—by providing for the appraisement of their stock and the payment to them of the full value thereof in money

Schenley Indus., Inc. v. Curtis, 152 A.2d 300, 38 Del. Ch. 370, 372-73 (Del. 1959) (citing *Chicago Corp. v. Munds, 20 Del. Ch. 142, 172 A. 452, 455 (Del. Ch. 1934)* and 15 FLETCHER CYC. CORP. § 7165); *see also* *Salomon Bros. Inc. v. Interstate Bakeries Corp., 576 A.2d 650, 651-52 (Del. Ch. 1989)* (explaining that "[t]he judicial determination of fair value pursuant to *§ 262* is a statutory right given the shareholder as compensation for the abrogation of the common law rule that a single shareholder could block a merger" and that "appraisal rights were provided as a *quid pro quo* for the minority's loss of its veto power") (citations and alterations omitted).

[91] *See* ***Salzberg, 227 A.3d at 116*** ("At its core, the DGCL is a broad enabling act which leaves latitude for substantial private ordering, *provided the statutory parameters and judicially imposed principles of fiduciary duty are honored*.") (alteration omitted) (emphasis added) (quoting *Williams, 671 A.2d at 1381*); *Abry Partners V, L.P. v. F&W Acquisition LLC, 891 A.2d 1032, 1059-60 (Del. Ch. 2006)* ("There is . . . a strong American tradition of freedom of contract, and that tradition is especially strong in our State, which prides itself on having commercial laws that are efficient.").

[92] *See, e.g.,* *CML V, LLC v. Bax, 28 A.3d 1037, 1043 (Del. 2011)* ("[u]ltimately, LLCs and corporations are different; investors can choose to invest in an LLC, which offers one bundle of rights, or in a corporation, which offers an entirely separate bundle of rights," and that "in the LLC context specifically, the General Assembly has espoused its clear intent to allow interested parties to define the contours of their relationships with each other to the maximum extent possible.").

[93] *Sternberg v. Nanticoke Mem. Hosp., Inc., 62 A.3d 1212, 1217 (Del. 2013)* ("[q]uestions of public policy are best left to the legislature") (citing *Shea v. Matassa, 918 A.2d 1090, 1092 (Del. 2007)* and *Moss Rehab v. White, 692 A.2d 902, 909 (Del. 1997)*).

[94] The Majority cites the *de minimis* exception from appraisal rights for stockholders of public-traded corporations. They then argue that if appraisal rights are "sacrosanct to the corporate form," then it would make little sense for the General Assembly to adopt this exception. I think the 2016 *de minimis* amendment proves just the opposite. The amendment to *Section 262(g)* was designed to address the concern that certain potential appraisal petitioners were targeting corporations and demanding settlements to address threatened appraisal claims, even non-meritorious claims. Some referred to this phenomenon as "appraisal arbitrage." A settlement made economic sense if it were less than estimated defense costs. The synopsis to the 2016 amendments stated that "appraisal rights are essentially precluded unless the dispute with regard to valuation is substantial and involves little risk that the petition for appraisal will be used to achieve a settlement because of the nuisance value of discovery and other burdens of litigation." Notably, the ban on *de minimis* claims does not apply to short-form mergers effected pursuant to *Sections 253* or *267*, because there, appraisal rights may be the only remedy available to

and updated through the work of the Corporation Law Council of the Corporation Law Section of the Delaware State Bar Association and the General Assembly. I believe that if such waivers are to be permitted, that any such waiver should be in the corporation's certificate of incorporation (which is publicly filed with the Secretary of State and which requires both stockholder and board approval).[95]

The Majority tries to limit its holding to the facts presented. The Court of Chancery tried to do the same.[96] Authentix also suggests that "[t]his Court need not decide that appraisal rights can always be waived by common stockholders, or that agreement **[**96]** not to exercise appraisal rights are always permissible, but can instead limit its holding to the undisputed facts of this case."[97] Perhaps the use of a stockholders agreement is not of concern to them because of the difficulties and impracticality of using such an agreement in a public company setting. And perhaps they do not fear pressure to expand such waivers to encompass other statutory rights such as inspection rights. But the inevitable consequence of affirmance here is to create one set of rules for such private start-up companies and another for public companies. This is not a desirable outcome. Given the availability and the flexibility afforded by Delaware's alternative entity statutes, I am not ready to endorse *ex ante* waivers effectuated in stockholders agreements barring common stockholders from exercising mandatory provisions of the DGCL.

[*1251] In sum, I would hold that the Stockholders Agreement fails to set forth an obligation from Petitioners to Authentix requiring them to refrain from seeking appraisal in all future mergers *ex ante* that unambiguously and unequivocally survives termination. Even if it had, I would hold that such a term goes to the heart of corporate governance **[**97]** and can only be contained in a corporate charter, not a bylaw or stockholders agreement. Even if it had been contained in a charter amendment, I would hold that such an amendment contravenes the DGCL and cannot be valid without authorization from the General Assembly.

For these reasons, I respectfully dissent.

End of Document

stockholders in a short-form merger transaction. *See* H.371, 148th Gen. Assembly, 80 Del. Laws c. 265, § 10 (2016). My point is that it took an act of the *General Assembly* to carefully craft a restriction on appraisal rights, and it was done for the purpose of addressing an imbalance of corporate power resulting from the practice of using the appraisal statute to leverage settlements for non-meritorious claims. Consistent with this approach, I believe any restriction on appraisal rights now sanctioned by the Majority should be effected by the General Assembly, if at all, and only after careful, deliberate debate informed by input from all relevant constituencies as is our typical practice in amending the DGCL.

[95] *See, e.g.*, Jones Apparel, 883 A.2d at 846 ("Although the identification of what is a mandatory right might at times be difficult, the *Sterling* approach leaves the space for private ordering that the General Assembly's adoption of §§ 102(b)(1) and 141(a) clearly contemplated.").

[96] *Manti II*, 2019 Del. Ch. LEXIS 307, 2019 WL 3814453, at *4 ("I need not decide whether a waiver of appraisal rights would be upheld in other circumstances.").

[97] Ans. Br. at 46.

Marchand v. Barnhill

Supreme Court of Delaware

April 24, 2019, Submitted; June 18, 2019, Decided; June 20, 2019, Filed

No. 533, 2018

Reporter

212 A.3d 805 *; 2019 Del. LEXIS 310 **; 2019 WL 2509617

JACK L. MARCHAND II, Plaintiff Below, Appellant, v. JOHN W. BARNHILL, JR., GREG BRIDGES, RICHARD DICKSON, PAUL A. EHLERT, JIM E. KRUSE, PAUL W. KRUSE, W.J. RANKIN, HOWARD W. KRUSE, PATRICIA I. RYAN, DOROTHY MCLEOD MACINERNEY and BLUE BELL CREAMERIES USA, INC., Defendants Below, Appellee.

Subsequent History: Case Closed July 5, 2019.

As Corrected: June 19, 2019.

Prior History: **[**1]** Court Below: Court of Chancery of the State of Delaware. C.A. No. 2017-0586-JRS.

Marchand v. Barnhill, 2018 Del. Ch. LEXIS 316 (Del. Ch., Sept. 27, 2018)

Disposition: REVERSED and REMANDED.

Counsel: Robert J. Kriner, Jr., Esquire (Argued), and Vera G. Belger, Esquire, CHIMICLES SCHWARTZ KRINER & DONALDSON-SMITH LLP, Wilmington, Delaware; Michael Hawash, Esquire, and Jourdain Poupore, Esquire, HAWASH CICACK & GASTON LLP, Houston, Texas, Attorneys for Appellant, Jack L. Marchand II.

Paul A. Fioravanti, Jr., Esquire (Argued), and John G. Day, Esquire, PRICKETT, JONES & ELLIOT, P.A., Wilmington, Delaware, Attorneys for Appellees, John W. Barnhill, Jr., Richard Dickson, Paul A. Ehlert, Jim E. Kruse, W.J. Rankin, Howard W. Kruse, Patricia I. Ryan, Dorothy McLeod MacInerney, and nominal defendant Blue Bell Creameries USA, Inc.

Srinivas M. Raju, Esquire, and Kelly L. Freund, Esquire, RICHARDS, LAYTON & FINGER, P.A., Wilmington, Delaware, Attorneys for Appellees, Greg Bridges and Paul W. Kruse.

Judges: Before STRINE, Chief Justice; VALIHURA, VAUGHN, SEITZ, and TRAYNOR, Justices, constituting the Court en Banc.

Opinion by: STRINE

Opinion

[*807] **STRINE**, Chief Justice:

Blue Bell Creameries USA, Inc., one of the country's largest ice cream manufacturers, suffered a *listeria* outbreak in early 2015, causing the company to recall all of its products, shut **[**2]** down production at all of its plants, and lay off over a third of its workforce. Blue Bell's failure to contain *listeria*'s spread in its manufacturing plants caused *listeria* to be present in its products and had sad consequences. Three people died as a result of the *listeria* outbreak. Less consequentially, but nonetheless important for this litigation, stockholders also suffered losses because, after the operational shutdown, Blue Bell suffered a liquidity crisis that forced it to accept a dilutive private equity investment.

Based on these unfortunate events, a stockholder brought a derivative suit against two key executives and against Blue Bell's directors claiming breaches of the defendants' fiduciary duties. The complaint alleges that the executives—Paul Kruse, the President and CEO, and Greg Bridges, the Vice President of Operations—breached their duties of care and loyalty by knowingly disregarding contamination risks and failing to oversee the safety of Blue Bell's food-making operations, and that the directors breached their duty of loyalty under *Caremark*.[1]

---

[1] *In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch.1996)* (Allen, C.); *see also* App. to Opening Br. at A67-68 (Verified Stockholder Derivative Action Complaint (Aug. 14,

The defendants moved to dismiss the complaint for failure to plead demand futility.[2] **[*808]** The Court of Chancery granted **[**3]** the motion as to both claims. As to the claim against management, the Court of Chancery held that the plaintiff "failed to plead particularized facts that raise a reasonable doubt as to whether a majority of [Blue Bell's] Board could impartially consider a demand."[3] Although the complaint alleged facts sufficient to raise a reasonable doubt as to the impartiality of a number of Blue Bell's directors, the plaintiff ultimately came up one short in the Court of Chancery's judgment: the plaintiff needed eight directors for a majority, but only had seven.

As to the *Caremark* claim, the Court of Chancery held that the plaintiff did not plead any facts to support "his contention that the [Blue Bell] Board 'utterly' failed to adopt or implement any reporting and compliance systems."[4] Although the plaintiff argued that Blue Bell's board had no supervisory structure in place to oversee "health, safety and sanitation controls and compliance," the Court of Chancery reasoned that "[w]hat Plaintiff really attempts to challenge is not the existence of monitoring and reporting controls, but the effectiveness of monitoring and reporting controls in particular instances," and "[t]his is not a valid **[**4]** theory under . . . *Caremark*."[5]

In this opinion, we reverse as to both holdings.

We first hold that the complaint pleads particularized facts sufficient to create a reasonable doubt that an additional director, W.J. Rankin, could act impartially in deciding to sue Paul Kruse, Blue Bell's CEO, and his subordinate Greg Bridges, Blue Bell's Vice President of Operations, due to Rankin's longstanding business affiliation and personal relationship with the Kruse family.[6] According to the complaint, Rankin worked at Blue Bell for decades and owes his entire career to Ed Kruse, the current CEO's father, who hired Rankin as his administrative assistant in 1981 and promoted him five years later to the position of CFO, a position Rankin maintained until his retirement in 2014. In 2004, while serving as CFO, Rankin was elected to Blue Bell's board, and has served since then. Moreover, the complaint alleges that the Kruse family showed its appreciation for Rankin not only by supporting his career, but also by leading a campaign that raised over $450,000 to name a building at the local university after Rankin. Despite the defendants' contentions that Rankin's relationship with the Kruse family was **[**5]** just an ordinary business relationship from which Rankin would derive no strong feelings of loyalty toward the Kruse family, these allegations are "suggestive of the type of very close personal [or professional] relationship that, like family ties, one would expect to heavily influence a human's ability to exercise impartial judgment."[7] Rankin's apparently deep business and personal ties to the Kruse family raise a reasonable doubt as to whether Rankin could "impartially or **[*809]** objectively assess whether to bring a lawsuit against the sued party."[8]

As to the *Caremark* claim, we hold that the complaint alleges particularized facts that support a reasonable inference that the Blue Bell board failed to implement any system to monitor Blue Bell's food safety performance or compliance. Under *Caremark* and this Court's opinion in *Stone v. Ritter*,[9] directors have a duty "to exercise oversight" and to monitor the corporation's operational viability, legal compliance, and financial performance.[10] A board's "utter failure to attempt to assure a reasonable information and reporting system exists" is an act of bad faith in breach of the duty of loyalty.[11]

2017)).

[2] App. to Answering Br. at B48-134 (Defendants' Opening Br. in Support of their Joint Motion to Dismiss (Oct. 30, 2017)); *see also* Court of Chancery Rule 23.1.

[3] *Marchand v. Barnhill, 2018 Del. Ch. LEXIS 316, 2018 WL 4657159, at *16 (Del. Ch. Sept. 27, 2018)*.

[4] *2018 Del. Ch. LEXIS 316, [WL] at *18*.

[5] *Id.*

[6] Because we hold that the complaint pleads particularized facts supporting a reasonable inference that Rankin could not be impartial as to suing a member of the Kruse family, we need not, and do not, reach that issue as to the other director whose impartiality the plaintiff challenges on appeal.

[7] *Sandys v. Pincus, 152 A.3d 124, 130 (Del. 2016)*.

[8] *In re Oracle Corp. Derivative Litig., 824 A.2d 917, 942 (Del. Ch. 2003)*.

[9] *911 A.2d 362 (Del. 2006)*.

[10] *Id. at 364* (quoting *In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch.1996))*; *see also* ***In re Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 125 (Del. Ch. 2009)*** (Chandler, C.).

[11] *Caremark, 698 A.2d at 971*.

As a monoline company that makes a single product—ice **[**6]** cream—Blue Bell can only thrive if its consumers enjoyed its products and were confident that its products were safe to eat. That is, one of Blue Bell's central compliance issues is food safety. Despite this fact, the complaint alleges that Blue Bell's board had no committee overseeing food safety, no full board-level process to address food safety issues, and no protocol by which the board was expected to be advised of food safety reports and developments. Consistent with this dearth of any board-level effort at monitoring, the complaint pleads particular facts supporting an inference that during a crucial period when yellow and red flags about food safety were presented to management, there was no equivalent reporting to the board and the board was not presented with any material information about food safety. Thus, the complaint alleges specific facts that create a reasonable inference that the directors consciously failed "to attempt to assure a reasonable information and reporting system exist[ed]."[12]

I. Background[13]

A. Blue Bell's History and Operating Environment

i. History

Founded in 1907 in Brenham, Texas, Blue Bell Creameries USA, Inc. ("Blue Bell"), a Delaware corporation, produces **[**7]** and distributes ice cream under the Blue Bell banner.[14] By 1919, Blue Bell's predecessor was struggling financially. Blue **[*810]** Bell's board turned to E.F. Kruse, who took over the company that year and turned it around. Under his leadership, the company expanded and became profitable.[15]

E.F. Kruse led the company until his unexpected death in 1951.[16] Upon his death, his sons, Ed F. Kruse and Howard Kruse, took over the company's management. Rapid expansion continued under Ed and Howard's leadership.[17] In 2004, Ed Kruse's son, Paul Kruse, took over management, becoming Blue Bell's President and CEO.[18] Ten years later, in 2014, Paul Kruse also assumed the position of Chairman of the Board, taking the position from his retiring father.[19]

ii. The Regulated Nature of Blue Bell's Industry

As a U.S. food manufacturer, Blue Bell operates in a heavily regulated industry. Under federal law, the Food and Drug Administration ("FDA") may set food quality standards, require food manufacturing facilities to register with the FDA, prohibit regulated manufacturers from placing adulterated food into interstate commerce, and hold companies liable if they place any adulterated foods into interstate commerce in **[**8]** violation of FDA rules.[20] Blue Bell is "required to comply with regulations and establish controls to monitor for, avoid and remediate contamination and conditions that expose the Company and its products to the risk of contamination."[21]

Specifically, FDA regulations require food

[12] *Id.*

[13] The facts come from the plaintiff's complaint, documents incorporated by reference into the complaint, and the Court of Chancery's opinion based on these same documents.

[14] Blue Bell Creameries USA, Inc. is a holding company. Its only assets are a 69.6 percent interest in Blue Bell Creameries, L.P., which actually produces and distributes ice cream, and a 100 percent interest in Blue Bell Creameries, Inc., the general partner of Blue Bell Creameries, L.P. Because the plaintiff is a stockholder of Blue Bell Creameries USA, the Court of Chancery requested supplemental briefing regarding the fiduciary duties of dual fiduciaries—because the holding company and the general partner have the same executives—and a board's responsibilities when its only asset is a majority stake in a subsidiary. App. to Opening Br. at A275-83 (Letter from Vice Chancellor Slights to counsel requesting supplement submissions (May 11, 2018)). But in its decision, the Court of Chancery sensibly and properly collapsed the enterprise for purposes of analyzing the complaint. *Marchand v. Barnhill, 2018 Del. Ch. LEXIS 316, 2018 WL 4657159, at *3 (Del. Ch. Sept. 27, 2018)*.

[15] App. to Opening Br. at A20 (Verified Stockholder Derivative Action Complaint (Aug. 14, 2017)).

[16] *Id.* at A20-21.

[17] *Id.* at A21.

[18] *Id.* at A28-29.

[19] *Id.*

[20] *See 21 U.S.C. §§ 333, 341, 342, 350.*

[21] App. to Opening Br. at A28 (Verified Stockholder Derivative Action Complaint (Aug. 14, 2017)).

manufacturers to conduct operations "with adequate sanitation principles"[22] and, in line with that obligation, "must prepare . . . and implement a written food safety plan."[23] As part of a manufacturer's food safety plan, the manufacturer must include processes for conducting a hazard analysis that identifies possible food safety hazards, identifies and implements preventative controls to limit potential food hazards, implements process controls, implements sanitation controls, and monitors these preventative controls. Appropriate corporate officials must monitor these preventative controls.[24]

Not only is Blue Bell subject to federal regulations, but it must also adhere to various state regulations. At the time of the *listeria* outbreak, Blue Bell operated in three states, and each had issued rules and regulations regarding the proper handling and production of food to ensure food safety.[25]

B. Plaintiff's Complaint ***[**9]***

With that context out of the way, we briefly summarize the plaintiff's well-pled factual allegations and the reasonable inferences drawn from them.

The complaint starts by observing that, as a single-product food company, food safety is of obvious importance to Blue **[*811]** Bell.[26] But despite the critical nature of food safety for Blue Bell's continued success, the complaint alleges that management turned a blind eye to red and yellow flags that were waved in front of it by regulators and its own tests, and the board—by failing to implement any system to monitor the company's food safety compliance programs—was unaware of any problems until it was too late.[27]

i. The Run-Up to the Listeria *Outbreak*

According to the complaint, Blue Bell's issues began to emerge in 2009. At that time, Paul Kruse, Blue Bell's President and CEO, and his cousin, Paul Bridges, were responsible for the three plants Blue Bell operated in Texas, Oklahoma, and Alabama.[28] The complaint alleges that, despite being responsible for overseeing plant operations, Paul Kruse and Bridges failed to respond to signs of trouble in the run up to the *listeria* outbreak. From 2009 to 2013 several regulators found troubling compliance failures **[**10]** at Blue Bell's facilities:

- In July 2009, the FDA's inspection of the Texas facility revealed "two instances of condensation, one from a pipe carrying liquid caramel [that] was dripping into three gallon cartons waiting to be filled, and one dripping into ice cream sandwich wafers."[29] The FDA reported these observations directly to Paul Kruse, who assured the FDA that "condensation is treated by Blue Bell as a serious concern."[30]
- In March 2010, the Alabama Department of Health inspected the Alabama plant and "found equipment left on the floor and a ceiling in disrepair in the container forming room."[31]
- Two months later, in May 2010, the FDA returned to the Texas plant "and observed ten violations that were cited to Paul Kruse including, again, a condensation drip."[32] While the condensation drip persisted from the FDA's last inspection of the Texas plant, the FDA also observed "ripped and open containers of ingredients, inconsistent hand-washing and glove use and a spider and its web near the ingredients."[33]
- In July 2011, an inspection by "the Alabama Department of Public Health cited drips from a ceiling unit and pipelines, standing water, open tank lids and unprotected measuring cups."[34]

- **[**11]** Nine months later, in March 2012, an

[22] 21 C.F.R. § 110.80.

[23] *Id.* § 117.3.

[24] Marchand v. Barnhill, 2018 Del. Ch. LEXIS 316, 2018 WL 4657159, at *9-11 (Del. Ch. Sept. 27, 2018).

[25] *Id.*

[26] App. to Opening Br. at A9 (Verified Stockholder Derivative Action Complaint (Aug. 14, 2017))

[27] *Id.* at A9-11.

[28] *Id.* at A21.

[29] *Id.* at A25.

[30] *Id.* at A33.

[31] *Id.*

[32] *Id.*

[33] *Id.* at A34.

[34] *Id.*

inspection of the Oklahoma facility revealed the plant's "'[f]ailure to manufacture foods under conditions and controls necessary to minimize contamination' and '[f]ailure to handle and maintain equipment, containers and utensils used to hold food in [sic] manner that protects against contamination.'"[35]

• That same month, in March 2012, "[t]he Alabama Department of Public Health required five changes" to the **[*812]** Alabama facility, "including instructions to clean various rooms and items, make repairs and [sic] after fruit processing to prevent contamination."[36] A year later, "in March 2013, the Alabama Department of Public Health again ordered cleaning and repairs and observed an uncapped fruit tank."[37] The Alabama Department of Public Health made similar observations in a July 2014 inspection.[38]

Regulatory inspections during this time were not the only signal that Blue Bell faced potential health safety risks. In 2013, "the Company had five positive tests" for *listeria*,[39] and in January 2014, "the Company received a presumptive positive *[l]isteria* result reports from the third party laboratory for the [Oklahoma] facility on January **[**12]** 20, 2014 and the samples reported positive for a second time on January 24, 2014."[40]

Although management had received reports about *listeria*'s growing presence in Blue Bell's plants, the complaint alleges that the board never received any information about *listeria* or more generally about food safety issues. Minutes from the board's January 29, 2014 meeting "reflect no report or discussion of the increasingly frequent positive tests that had been occurring since 2013 or the third party lab reports received in the preceding two weeks."[41] Board meeting minutes from February and March likewise reflect no board-level discussion of *listeria*.[42]

During the rest of 2014, Blue Bell's problems accelerated, but the board remained uninformed about Blue Bell's problems. In April, "[t]he Company received further positive *[l]isteria* lab tests regarding [the Oklahoma facility]."[43] That same month, the company had three "positive coliform tests far above the known legal regulator limits."[44] Yet, minutes from the April board meeting reflected no discussion of *listeria*. Instead, the minutes note only that the Oklahoma and Alabama facilities'"plant operations were discussed briefly" and that **[**13]** Bridges also discussed "a good report from the TCEQ [Texas Commission on Environmental Quality]."[45]

Over the course of 2014, Blue Bell received ten positive tests for *listeria*. According to the complaint, these positive tests "included repeated positive results from the Company's third party laboratory in 2014, on consecutive samples, evidencing the inadequacy of the Company's remedial methods to eliminate the contamination."[46]

Despite management's knowledge of the growing problem, the complaint alleges that this information never made its way to the board, and the board continued to be uninformed about (and thus unaware of) the problem. Minutes from the board's 2014 meetings are bereft of reports on the *listeria* issues. Only during the September meeting is sanitation discussed, when **[*813]** Bridges informed the board that "[t]he recent Silliker audit [Blue Bell's third-party auditor for sanitation issues in 2014] went well."[47] This lone reference to a third-party audit is the only instance, until the *listeria* outbreak forced the recall of Blue Bell's products, of *any* board-level discussion regarding food safety.

---

[35] *Id.*

[36] *Id.*

[37] *Id.*

[38] *Id.*

[39] *Id.* at A49-50.

[40] *Id.* at A52.

[41] *Id.*

[42] *Id.* ("[T]here is no reference to *Listeria* or the lab reports in the minutes of the February or March 2014 meetings.").

[43] *Id.*

[44] *Id.* at A49-50.

[45] *Id.* at A170 (Minutes to April 29, 2014 board meeting).

[46] *Id.* at A49 (Verified Stockholder Derivative Action Complaint (Aug. 14, 2017)).

[47] *Id.* at A180 (Minutes to September 30, 2014 board meeting). *See also* *Marchand, 2018 Del. Ch. LEXIS 316, 2018 WL 4657159, at *6 n.72*.

At this stage of the case, we are bound to draw all fair inferences **[**14]** in the plaintiff's favor from the well-pled facts. Based on this chronology of events, the plaintiffs have fairly pled that:

- Blue Bell had no board committee charged with monitoring food safety;
- Blue Bell's full board did not have a process where a portion of the board's meetings each year, for example either quarterly or biannually, were specifically devoted to food safety compliance; and
- The Blue Bell board did not have a protocol requiring or have any expectation that management would deliver key food safety compliance reports or summaries of these reports to the board on a consistent and mandatory basis. In fact, it is inferable that there was no expectation of reporting to the board of any kind.

In short, the complaint pleads that the Blue Bell board had made no effort at all to implement a board-level system of mandatory reporting of any kind.

ii. The Listeria *Outbreak and the Board's Response*

Blue Bell's *listeria* problem spread in 2015. Starting in January 2015, one of Blue Bell's product tests had positive coliform levels above legal limits.[48] The same result appeared in February 2015.[49] And by this point, the problem spread to Blue Bell's products and spiraled out of control.

On February 13, 2015, "Blue Bell received notification that the Texas Department of State Health Services also had positive tests for *[l]isteria* in Blue Bell samples."[50] The Texas Department of State Health Services was alerted to these positive tests by the South Carolina Health Department.[51] Company swabs at the Texas facility on February 19 and 21, 2015 tested positive for *listeria*.[52] Yet despite these reports to management, Blue Bell's board was not informed by management about the severe problem. The board met on February 19, 2015, following Blue Bell's annual stockholders meeting, but there was no *listeria* discussion.[53]

Four days later, Blue Bell initiated a limited recall.[54] Two days after that, Blue Bell's board met, and Bridges reported that "[t]he FDA is working with Texas health inspectors regarding the Company's recent recall of products. More information is developing and should be known within the next days or weeks."[55] Despite two years of evidence that *listeria* was a growing **[*814]** problem for Blue Bell, this is the first time the board discussed the issue, according to the complaint and the incorporated board minutes. Instead of holding more frequent emergency board meetings **[**16]** to receive constant updates on the troubling fact that life-threatening bacteria was found in its products, Blue Bell's board left the company's response to management.

And the problem got worse, with awful effects. "In early March 2015, health authorities reported that they suspected a connection between human [*l*]*isteria* infections in Kansas and products made by Blue Bell's [Texas] facility."[56] The outbreak in Kansas matched a *listeria* strain found in Blue Bell's products in South Carolina. And by March 23, 2015, Blue Bell was forced to recall more products. Two days later, Blue Bell's board met and adopted a resolution "express[ing] support for Blue Bell's CEO, management, and employees and encourag[ing] them to ensure that everything Blue Bell manufacture[s] and distributes is a wholesome and good testing [sic] product that our consumers deserve and expect."[57]

Blue Bell expanded the recall two weeks later, and less than a month later, on April 20, 2015, Blue Bell "instituted a recall of all products."[58] By this point, the Center for Disease Controls and Prevention ("CDC") had begun an investigation and discovered that the source of the *listeria* outbreak in Kansas was caused by

---

[48] App. to Opening Br. at A49-50 (Verified Stockholder Derivative Action Complaint (Aug. 14, 2017)).

[49] ***[**15]*** *Id.*

[50] *Id.* at A36, A54.

[51] *Id.* at A54-55.

[52] *Id.*

[53] *Id.* at A55.

[54] *Marchand v. Barnhill, 2018 Del. Ch. LEXIS 316, 2018 WL 4657159, at *7 (Del. Ch. Sept. 27, 2018)*.

[55] App. to Opening Br. at A55 (Verified Stockholder Derivative Action Complaint (Aug. 14, 2017)).

[56] *Id.* at A36.

[57] *Id.* at A56-57.

[58] *Id.* at A37.

Blue **[**17]** Bell's Texas and Oklahoma plants.[59] Ultimately, five adults in Kansas and three adults in Texas were sickened by Blue Bell's products; three of the five Kansas adults died because of complications due to *listeria* infection.[60] The CDC issued a recall to grocers and retailers, alerting them to the contamination and warning them against selling the products.[61]

After Blue Bell's full product recall, the FDA inspected each of the company's three plants. Each was found to have major deficiencies. In the Texas plant, the FDA found a "failure to manufacture foods under conditions and controls necessary to minimize the potential for growth of microorganisms," inadequate cleaning and sanitizing procedures, "failure to maintain buildings in repair sufficient to prevent food from coming [sic] adulterated," and improper construction of the building that failed to prevent condensation from occurring.[62] Likewise, at the Oklahoma facility, "[t]he FDA found that the Company had been receiving increasingly frequent positive [*l*]*isteria* tests at [the Oklahoma facility] for over three years," failed "to manufacture and package foods under conditions and controls necessary to minimize the potential growth **[**18]** of microorganisms and contamination," failed to perform testing to ferret out microbial growth, implemented inadequate cleaning and sterilization procedures, failed to provide running water at an appropriate temperature to sanitize equipment, and failed to store food in clean and sanitized portable equipment.[63]

[*815] Although the Alabama facility fared better, the FDA still found contamination and several issues, including the "failure to perform microbial testing where necessary to identify possible food contamination," "failure to maintain food contact surfaces to protect food from contamination by any source," and inadequate construction of the facility such that condensation was likely.[64] Most of these findings, the complaint alleges, are unsurprising because similar deficiencies were found by the FDA and state regulators in the run up to the *listeria* outbreak, yet according to the FDA's inspection after the fact, it appeared that neither management nor the board made progress on remedying these deficiencies.

After the fact, various news outlets interviewed former Blue Bell employees who "claimed that Company management ignored complaints about **[**19]** factory conditions in [the Texas facility]."[65] One former employee "reported [that] spilled ice cream was left to pool on the floor, 'creating an environment where bacteria at A94-96 (Food and Drug Administration Inspection Report for Blue Bell Creameries facility in Sylacauga, Alabama (Apr. 30, 2015)). could flourish.'"[66] Another former employee described being "instructed to pour ice cream and fruit that dripped off his machine into mix to be used later."[67]

iii. The Aftermath of the Listeria *Outbreak*

With its operations shuttered, Blue Bell faced a liquidity crisis. Blue Bell initially sought a more traditional credit facility to bridge its liquidity, but after Blue Bell director W.J. Rankin informed his brother-in-law, Bill Reimann, about Blue Bell's liquidity crunch, Blue Bell ended up striking a deal with Moo Partners, a fund controlled by Sid Bass and affiliated with Reimann.[68] Moo Partners provided Blue Bell with a $125 million credit facility and purchased a $100 million warrant to acquire 42% of Blue Bell at $50,000 per share.[69] As part of Moo Partners's investment conditions, Blue Bell also amended its certificate of incorporation to grant Moo the right to appoint one member of Blue Bell's board who would be entitled to one-third of the board's voting power (or five votes based on a then-10-member board). **[**20]**

---

[59] *Id.* at A37-38.

[60] *Id.* at A37.

[61] *Id.*

[62] *Id.* at A38; *see also id.* at A77-80 (Food and Drug Administration Inspection Report for Blue Bell Creameries facility in Brenham, Texas (May 1, 2015)).

[63] *Id.* at A38-39 (Verified Stockholder Derivative Action Complaint (Aug. 14, 2017)); *see also id.* at A82-91 (Food and Drug Administration Inspection Record for Blue Bell Creameries facility in Broken Arrow, Oklahoma (Apr. 23, 2015)).

[64] *Id.* at A40-41 (Verified Stockholder Derivative Action Complaint (Aug. 14, 2017)); *see also id.*

[65] *Id.* at A35 (Verified Stockholder Derivative Action Complaint (Aug. 14, 2017)).

[66] *Id.*

[67] *Id.* at A35-36.

[68] *Id.* at A42-43.

[69] *Id.*

After investing in Blue Bell, Moo named Reimann to Blue Bell's board, expanding the board to 11 members with Reimann possessing five votes.[70] In February 2016, Reimann suggested that the board separate the roles of CEO and Chairman (both held by Paul Kruse). The board voted to follow Reimann's recommendation at its February 18th meeting, but after Paul Kruse disagreed with the recommendation and threatened to resign as President and CEO if the split occurred, the board held another vote in which all members, except Reimann and Rankin, voted to restore the position of CEO and Chairman of the board.[71]

C. The Court of Chancery Dismisses the Case

After requesting Blue Bell's books and records through a § 220 request, the plaintiff **[*816]** , a Blue Bell stockholder, sued Blue Bell's management and board derivatively, asserting two claims based on management's alleged failure to respond appropriately to the red and yellow flags about growing food safety issues and the board's violation of its duty of loyalty, under *Caremark*, by failing to implement any reporting system and therefore failing to inform itself about Blue Bell's food safety compliance. The Court of Chancery dismissed both claims, holding **[**21]** that the plaintiff failed to plead demand futility.

As to the first claim, the plaintiff alleges that Paul Kruse, Blue Bell's President and CEO, and Bridges, Blue Bell's Vice President of Operations, had breached their duties of loyalty and care by knowingly disregarding contamination risks and failing to oversee Blue Bell's operations and food safety compliance process.[72] "Because directors are empowered to manage, or direct the management of, the business and affairs of the corporation," the plaintiff's complaint must allege facts suggesting that "demand is excused because the directors are incapable of making an impartial decision regarding such litigation."[73] The plaintiff's complaint claims that "[a] demand upon the Board of the Company to pursue claims against Paul Kruse and Bridges . . . would be futile" because "the Kruse family—of which both Paul Kruse and Bridges are members—ha[s] long dominated Blue Bell" and the majority of directors are "long-time employees and/or otherwise beholden and loyal to the Kruse family."[74]

But the Court of Chancery held that the plaintiff "failed to plead particularized facts to raise a reasonable doubt that a majority of the [Blue Bell board] members **[**22]** could have impartially considered a pre-suit demand."[75] Without belaboring the details of the Court of Chancery's thorough analysis, which is somewhat complicated due to the unusual structure of Blue Bell's board, we note that the court essentially ruled that the plaintiff came up one vote short. To survive the Rule 23.1 motion to dismiss, the complaint needed to allege particularized facts raising a reasonable doubt that directors holding eight of the 15 votes could have impartially considered a demand, but the court held that the plaintiff had done so for directors holding only seven votes.

One of the directors who the trial court held could consider demand impartially was Rankin, Blue Bell's recently retired former CFO. Although Rankin worked at Blue Bell for 28 years, the court emphasized that he was no longer employed by Blue Bell, having retired in 2014. As to the allegations that donations from the Kruse family resulted in a building at Blinn College being named for Rankin, the court noted that "the Complaint provide[d] no more specifics regarding the donation (i.e., who gave how much), and ma[de] no attempt to characterize the materiality of the gesture."[76] That failure, the Court of Chancery **[**23]** concluded, fell short of Rule 23.1's particularity requirement. Further, the court noted that Rankin voted against rescinding a board initiative to split the CEO **[*817]** and Chairman positions held by Paul Kruse.[77] In the court's view, that act was evidence that Rankin was not beholden to the Kruse family. Ultimately, the Court of Chancery concluded that the plaintiff's "allegation that Rankin

[70] *Id.* at A46.

[71] *Id.* at A57-59.

[72] *Id.* at A67 (asserting a "derivative claim for breach of fiduciary duties of loyalty and care for knowingly disregard of contammination [sic] risks and failure to oversee Blue Bell's operation and compliance").

[73] Rales v. Blasband, 634 A.2d 927, 932 (Del. 1993).

[74] App. to Opening Br. at A62 (Verified Stockholder Derivative Action Complaint (Aug. 14, 2017)).

[75] Marchand v. Barnhill, 2018 Del. Ch. LEXIS 316, 2018 WL 4657159, at *2 (Del. Ch. Sept. 27, 2018).

[76] 2018 Del. Ch. LEXIS 316, [WL] at *15.

[77] *Id.*

lacks independence falls flat."[78]

The Court of Chancery also rejected the plaintiff's second claim that Blue Bell's directors breached their duty of loyalty under *Caremark* by failing to "institute a system of controls and reporting" regarding food safety.[79] In support of this claim, the plaintiff asserted, based on the facts alleged in the complaint and reasonable inferences from those facts, that: (1) the Blue Bell board had no committee overseeing food safety; (2) Blue Bell's board did not have any reporting system in place about food safety; (3) management knew about the growing *listeria* issues but did not report those issues to the board, further evidence that the board had no food safety reporting system in place; and (4) the board did not discuss food safety at its regular board meetings.

Rejecting the plaintiff's **[**24]** *Caremark* claim, the Vice Chancellor started by observing that "[d]espite the far-reaching regulatory schemes that governed Blue Bell's operations at the time of the [*l*]*isteria* contamination, the Complaint contains no allegations that Blue Bell failed to implement the monitoring and reporting systems required by the FDCA [*Federal Food, Drug, and Cosmetic Act*], FDA regulations or state statutes (or that it was ever cited for such a failure)."[80] In fact, the Court of Chancery concluded that "documents incorporated by reference in the Complaint reveal that Blue Bell distributed a sanitation manual with standard operating and reporting procedures, and promulgated written procedures for processing and reporting consumer complaints."[81] And at the board level, the Vice Chancellor noted that "[b]oth Bridges and Paul Kruse . . . provided regular reports regarding Blue Bell operations to the . . . Board," including reports about audits of Blue Bell's facilities.[82]

Based on Blue Bell's compliance with FDA regulations, ongoing third-party monitoring for contamination, and consistent reporting by senior management to Blue Bell's board on operations, the Court of Chancery concluded that there was a monitoring **[**25]** system in place. At bottom, the Court of Chancery opined that "[w]hat Plaintiff really attempts to challenge is not the *existence* of monitoring and reporting controls, but the *effectiveness* of monitoring and reporting controls in particular instances."[83] That, the Court of Chancery held, does not state a *Caremark* claim. As a result, the court held that demand was not excused as to the *Caremark* claims and dismissed the complaint.

The plaintiff timely appealed from that dismissal.

II. Analysis

We review a motion to dismiss for failure to plead demand futility *de novo*.[84]

A. Rankin's Independence

[*818] We first address the plaintiff's claim that the Court of Chancery erred by holding that the complaint did not allege particularized facts that raise a reasonable doubt as to whether directors holding a majority of the board's votes could impartially consider demand as to the management claims. The Court of Chancery concluded that four directors representing eight votes were independent and that seven directors representing seven votes were not independent. On appeal, the plaintiff challenges the Court of Chancery's conclusion as to only Rankin and one other director, Paul Ehlert. Holding that the Court **[**26]** of Chancery erred as to either director would be dispositive. Because we hold that Rankin was not independent for demand futility purposes, we reverse and need not and do not address whether Ehlert was independent.

On appeal, both parties agree that the *Rales* standard applies,[85] and we therefore use it to determine whether the Court of Chancery erred in finding that a majority of the board was independent for pleading stage purposes. "[A] lack of independence turns on 'whether the plaintiffs

[78] *Id.*

[79] App. to Opening Br. at A68-69 (Verified Stockholder Derivative Action Complaint (Aug. 14, 2017)).

[80] *Marchand, 2018 Del. Ch. LEXIS 316, 2018 WL 4657159, at *11*.

[81] *2018 Del. Ch. LEXIS 316, [WL] at *17*.

[82] *Id.*

[83] *2018 Del. Ch. LEXIS 316, [WL] at *17*. (emphasis in original)

[84] *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1048 (Del. 2004)* ("This Court reviews de novo a decision of the Court of Chancery to dismiss a derivative suit under *Rule 23.1*.").

[85] *See* *Rales v. Blasband, 634 A.2d 927, 932-34 (Del. 1993)*.

have pled facts from which the director's ability to act impartially on a matter important to the interested party can be doubted because that director may feel either subject to the interested party's dominion or beholden to that interested party."[86] When it comes to life's more intimate relationships concerning friendship and family, our law cannot "ignore the social nature of humans" or that they are motivated by things other than money, such as "love, friendship, and collegiality."[87]

The standard for conducting this inquiry at the demand futility stage is well balanced, requiring that the plaintiff plead facts with particularity, but also requiring that this Court draw all reasonable inferences **[**27]** in the plaintiff's favor.[88] That is, the plaintiff cannot just assert that a close relationship exists, but when the plaintiff pleads specific facts about the relationship—such as the length of the relationship or details about the closeness of the relationship—then this Court is charged with making all reasonable inferences from those facts in the plaintiff's favor.[89]

From the pled facts, there is reason to doubt Rankin's capacity to impartially decide whether to sue members of the Kruse family. For starters, one can reasonably infer that Rankin's successful **[*819]** career as a businessperson was in large measure due to the opportunities and mentoring given to him by Ed Kruse, Paul Kruse's father, and other members of the Kruse family. The complaint alleges that Rankin started as Ed Kruse's administrative assistant and, over the course of a 28-year career with the company, rose to the high managerial position of CFO.[90] Not only that, but Rankin was added to Blue Bell's board in 2004,[91] which one can reasonably infer was due to the support of the Kruse family. Capping things off, the Kruse family spearheaded charitable efforts that led to a $450,000 donation to a key local college, resulting in **[**28]** Rankin being honored by having Blinn College's new agricultural facility named after him.[92] On a cold complaint, these facts support a reasonable inference that there are very warm and thick personal ties of respect, loyalty, and affection between Rankin and the Kruse family, which creates a reasonable doubt that Rankin could have impartially decided whether to sue Paul Kruse and his subordinate Bridges.

Even though Rankin had ties to the Kruse family that were similar to other directors that the Court of Chancery found were sufficient at the pleading stage to support an inference that they could not act impartially in deciding whether to cause Blue Bell to sue Paul Kruse,[93] the Court of Chancery concluded that because Rankin had voted differently from Paul Kruse on a proposal to separate the CEO and Chairman position, these ties did not matter.[94] In doing so, the Court of Chancery ignored that the decision whether to sue someone is materially different and more important than the decision whether to part company with that person on a vote about corporate governance, and our law's precedent recognizes that the nature of the decision at issue must be considered in determining whether **[**29]** a director is independent.[95] As important, at the

---

86 *Sandys v. Pincus, 152 A.3d 124, 128 (Del. 2016)* (quoting ***Del. Cty. Emps. Ret. Fund v. Sanchez, 124 A.3d 1017, 1024 n.25 (Del. 2015))***.

87 *In re Oracle Corp. Derivative Litig., 824 A.2d 917, 938 (Del. Ch. 2003)* ("Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement."); *see also* ***Sanchez, 124 A.3d at 1022*** ("Close friendships of that duration are likely considered precious by many people, and are rare. People drift apart for many reasons, and when a close relationship endures for that long, a pleading stage inference arises that it is important to the parties.").

88 ***Sanchez, 124 A.3d at 1022*** ("In that consideration, it cannot be ignored that although the plaintiff is bound to plead particularized facts in pleading a derivative complaint, so too is the court bound to draw all inferences from those particularized facts in favor of the plaintiff, not the defendant, when dismissal of a derivative complaint is sought.").

89 *Id.* (holding that at the pleading stage this Court is "bound to draw all inferences from those particularized facts in favor of the plaintiff, not the defendant, when dismissal of a derivative complaint is sought").

90 App. to Opening Br. at A17-18 (Verified Stockholder Derivative Action Complaint (Aug. 14, 2017).

91 *Id.*

92 *Id.*

93 *Marchand v. Barnhill, 2018 Del. Ch. LEXIS 316, 2018 WL 4657159, at *14-15 (Del. Ch. Sept. 27, 2018)* (holding that two directors who both worked at Blue Bell for most, if not all, of their entire careers were beholden to the Kruse family and therefore not independent for demand futility).

94 *2018 Del. Ch. LEXIS 316, [WL] at *15*.

95 *See* *Sandys v. Pincus, 152 A.3d 124, 134 (Del. 2016)* ("Causing a lawsuit to be brought against another person is no

pleading stage, **[*820]** the Court of Chancery was bound to accord the plaintiff the benefit of all reasonable inferences, and the pled facts fairly support the inference that Rankin owes an important debt of gratitude and friendship to the Kruse family for giving him his first job, nurturing his progress from an entry level position to a top manager and director, and honoring him by spearheading a campaign to name a building at an important community institution after him. Although the fact that fellow directors are social acquaintances who occasionally have dinner or go to common events does not, in itself, raise a fair inference of non-independence,[96] our law has recognized that deep and long-standing friendships are meaningful to human beings and that any realistic consideration of the question of independence must give weight to these important relationships and their natural effect on the ability of the parties to act impartially toward each other. As in cases like *Sandys v. Pincus*[97] and *Delaware County Employees Retirement Fund v. Sanchez*,[98] the important personal and business relationship that Rankin and the Kruse family have shared supports **[**30]** a pleading-stage inference that Rankin cannot act independently.

Because the complaint pleads particularized facts that raise a reasonable doubt as to Rankin's independence, we reverse the Court of Chancery's dismissal of the plaintiff's claims against management for failure to adequately plead demand futility.

B. The Caremark *Claim*

The plaintiff also challenges the Court of Chancery's dismissal of his *Caremark* claim. Although *Caremark* claims are difficult to plead and ultimately to prove out,[99] we nonetheless disagree with the Court of Chancery's decision to dismiss the plaintiff's claim against the Blue Bell board.

Under *Caremark* and *Stone v. Ritter*, a director must make a good faith effort to oversee the company's operations.[100] Failing to make that good faith effort breaches the duty of loyalty and can expose a director to liability. In other words, for a plaintiff to prevail on a *Caremark* claim, the plaintiff must show that a fiduciary acted in bad faith—"the state of mind traditionally used

---

small matter, and is the sort of thing that might plausibly endanger a relationship."); *Sciabacucchi v. Liberty Broadband Corp., 2018 Del. Ch. LEXIS 252, 2018 WL 3599997, at *14 (Del. Ch. July 26, 2018)* ("It is reasonable to infer that, if Zinterhofer voted to authorize a derivative suit against Malone, the relationship between Searchlight and Liberty Global might be in jeopardy. After all, '[c]ausing a lawsuit to be brought against another person is no small matter, and is the sort of thing that might plausibly endanger a relationship.'"); *In re Oracle Corp. Derivative Litig., 824 A.2d 917, 940 (Del. Ch. 2003)* ("In evaluating the independence of a special litigation committee, this court must take into account the extraordinary importance and difficulty of such a committee's responsibility. It is, I daresay, easier to say no to a friend, relative, colleague, or boss who seeks assent for an act (*e.g.*, a transaction) that has not yet occurred than it would be to cause a corporation to sue that person. This is admittedly a determination of so-called 'legislative fact,' but one that can be rather safely made. Denying a fellow director the ability to proceed on a matter important to him may not be easy, but it must, as a general matter, be less difficult than finding that there is reason to believe that the fellow director has committed serious wrongdoing and that a derivative suit should proceed against him.") (footnotes omitted).

[96] *See* *Beam ex rel. Martha Stewart Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1051-52 (Del. 2004)*.

[97] *152 A.3d 124, 130 (Del. 2016)* (holding that owning an airplane with the interested party "is suggestive of the type of very close personal relationship that, like family ties, one would expect to heavily influence a human's ability to exercise impartial judgment").

[98] ***124 A.3d 1017, 1020-22 (Del. 2015)*** (holding that being "close personal friends for more than five decades" with the interested party gives rise to "a pleading stage inference . . . that it is important to the parties" and suggests that the director is not independent).

[99] *See* *Stone v. Ritter, 911 A.2d 362, 372 (Del. 2006)* ("[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.") (internal quotation marks omitted); *Guttman v. Huang, 823 A.2d 492, 506 (Del. Ch. 2003)* ("A *Caremark* claim is a difficult one to prove."); *In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996)* ("The theory here advanced is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.").

[100] *Caremark, 698 A.2d at 970* ("[I]t 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.").

to define the mindset **[*821]** of a disloyal director."[101]

Bad faith is established, under *Caremark*, when "the directors [completely] fail[] to implement any reporting or information system **[**31]** or controls[,] or . . . having implemented such a system or controls, consciously fail[] to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."[102] In short, to satisfy their duty of loyalty, directors must make a good faith effort to implement an oversight system and then monitor it.

As with any other disinterested business judgment, directors have great discretion to design context-and industry-specific approaches tailored to their companies' businesses and resources.[103] But *Caremark* does have a bottom-line requirement that is important: the board must make a good faith effort—*i.e.*, try—to put in place a reasonable board-level system of monitoring and reporting.[104] Thus, our case law gives deference to boards and has dismissed *Caremark* cases even when illegal or harmful company activities escaped detection, when the plaintiffs have been unable to plead that the board failed to make the required good faith effort to put a reasonable compliance and reporting system in place.[105]

For that reason, our focus here is on the key issue of whether the plaintiff **[**32]** has pled facts from which we can infer that Blue Bell's board made no effort to put in place a board-level compliance system. That is, we are not examining the effectiveness of a board-level compliance and reporting system after the fact. Rather, we are focusing on whether the complaint pleads facts supporting a reasonable inference that the board did not undertake good faith efforts to put a board-level system of monitoring and reporting in place.

[*822] Under *Caremark*, a director may be held liable if she acts in bad faith in the sense that she made no good faith effort to ensure that the company had in place any "system of controls."[106] Here, the plaintiff did as our law encourages and sought out books and records about the extent of board-level compliance efforts at Blue Bell regarding what has to be one of the most central issues at the company: whether it is ensuring that the only product it makes—ice cream—is safe to eat.[107] **[**34]** Using these books and records, the complaint fairly alleges that before the *listeria* outbreak engulfed the company:

- no board committee that addressed food safety existed;

---

[101] *Desimone v. Barrows, 924 A.2d 908, 935 (Del. Ch. 2007)*.

[102] *Stone, 911 A.2d at 370-72*.

[103] ***In re Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 125-26 (Del. Ch. 2009)*** (Chandler, C.) (noting that *Caremark* "does not eviscerate the core protections of the business judgment rule"); *Caremark, 698 A.2d at 970* ("Obviously the level of detail that is appropriate for such an information system is a question of business judgment."); *Desimone, 924 A.2d at 935 n.95* (noting that the approaches boards take to monitoring the corporation under their *Caremark* duty "will obviously vary because of the different circumstances corporations confront"); *see also* *Caremark, 698 A.2d at 971* ("But, of course, 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. Such a requirement would simple [sic] be inconsistent with the scale and scope of efficient organization size in this technological age.").

[104] *Stone, 911 A.2d at 370*; *see also* *Caremark, 698 A.2d at 971* ("Generally 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.").

[105] *See, e.g.*, *Stone, 911 A.2d at 372-73* (dismissing a *Caremark* claim despite the fact that the company violated the *Bank Secrecy Act* and was fined $50 million); *In re General Motors Derivative Litig., 2015 Del. Ch. LEXIS 179, 2015 WL 3958724, at *1, 17 (Del. Ch. 2015)* (dismissing a *Caremark* claim despite the fact that the company's actions "led to monetary loss on the part of the corporation, via fines, damages and punitive damages from lawsuits; reputational damage; and most distressingly, personal injury and death to GM customers"); ***In re Citigroup Inc. S'holder Derivative Litig., 964 A.2d at 127*** (dismissing a *Caremark* claim despite the fact that the company suffered billions of dollars in losses because of its exposure to subprime mortgages).

[106] *Stone, 911 A.2d at 370*; *see also* *Caremark, 698 A.2d at 971* ("Generally 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.").

[107] Though, to be fair and completely accurate, Blue Bell does make a few other related products, such as frozen yogurt.

- no regular process or protocols that required management to keep the board apprised of food safety **[**33]** compliance practices, risks, or reports existed;
- no schedule for the board to consider on a regular basis, such as quarterly or biannually, any key food safety risks existed;
- during a key period leading up to the deaths of three customers, management received reports that contained what could be considered red, or at least yellow, flags, and the board minutes of the relevant period revealed no evidence that these were disclosed to the board;
- the board was given certain favorable information about food safety by management, but was not given important reports that presented a much different picture; and
- the board meetings are devoid of any suggestion that there was any regular discussion of food safety issues.

And the complaint goes on to allege that after the *listeria* outbreak, the FDA discovered a number of systematic deficiencies in all of Blue Bell's plants—such as plants being constructed "in such a manner as to [not] prevent drip and condensate from contaminating food, food-contact surfaces, and food-packing material"—that might have been rectified had any reasonable reporting system that required management to relay food safety information to the board on an ongoing basis been in place.[108]

In sum, the complaint supports an inference that no system of board-level compliance monitoring and reporting existed at Blue Bell. Although *Caremark* is a tough standard for plaintiffs to meet, the plaintiff has met it here. When a plaintiff can plead an inference that a board has undertaken no efforts to make sure it is informed of a compliance issue intrinsically critical to the company's business operation, then that supports an inference that the board has not made the good faith effort that *Caremark* requires.

In defending this case, the directors largely point out that by law Blue Bell had to meet FDA and state regulatory requirements for food safety, and that the company **[*823]** had in place certain manuals for employees regarding safety practices and commissioned audits from time to time.[109] In the same vein, the directors emphasize that the government regularly inspected Blue Bell's facilities, and Blue Bell management got the results.[110]

But the fact that Blue Bell nominally complied with FDA regulations does not imply that the *board* implemented a system to monitor food safety *at the board level*.[111] Indeed, these types of routine regulatory requirements, although **[**35]** important, are not typically directed at the board. At best, Blue Bell's compliance with these requirements shows only that management was following, in a nominal way, certain standard requirements of state and federal law. It does not rationally suggest that the board implemented a reporting system to monitor food safety or Blue Bell's operational performance. The mundane reality that Blue Bell is in a highly regulated industry and complied with some of the applicable regulations does not foreclose any pleading-stage inference that the directors' lack of attentiveness rose to the level of bad faith indifference required to state a *Caremark* claim.

In answering the plaintiff's argument, the Blue Bell directors also stress that management regularly reported to them on "operational issues." This response is telling. In decisions dismissing *Caremark* claims, the plaintiffs usually lose because they must concede the existence of board-level systems of monitoring and oversight such as a relevant committee, a regular protocol requiring board-level reports about the relevant risks, or the board's use of third-party monitors, auditors,

---

[108] App. to Opening Br. at A94-96 (Food and Drug Administration Inspection Report for Blue Bell Creameries facility in Sylacauga, Alabama (Apr. 30, 2015)).

[109] Answering Br. at 28-29.

[110] Answering Br. at 28-29; *see also* Marchand v. Barnhill, 2018 Del. Ch. LEXIS 316, 2018 WL 4657159, at *17 (Del. Ch. Sept. 27, 2018) ("[D]ocuments incorporated by reference in the Complaint reveal that Blue Bell distributed a sanitation manual with standard operating and reporting procedures, and promulgated written procedures for processing and reporting consumer complaints. Blue Bell engaged a third-party laboratory and food safety auditor to test for the presence of dangerous contaminates in its facilities.").

[111] *Stone, 911 A.2d at 368* ("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.'") (quoting Caremark, 698 A.2d at 970) (emphasis added).

or consultants.[112] For example, in *Stone v.* ***[**36]*** *Ritter*, **[*824]** although the company paid $50 million in fines related "to the failure by bank employees" to comply with "the federal Bank Secrecy Act,"[113] the"[b]oard dedicated considerable resources to the [Bank Secrecy Act] compliance program and put into place numerous procedures and systems to attempt to ensure compliance."[114] Accordingly, this Court affirmed the Court of Chancery's dismissal of a *Caremark* claim. Here, the Blue Bell directors just argue that because Blue Bell management, in its discretion, discussed general operations with the board, a *Caremark* claim is not stated.

But if that were the case, then *Caremark* would be a chimera. At every board meeting of any company, it is likely that management will touch on some operational issue. Although *Caremark* may not require as much as some commentators wish,[115] it does require that a board make a good faith effort to put in place a reasonable system of monitoring and reporting about the corporation's central compliance risks. In Blue Bell's case, food safety was essential and mission critical. The complaint pled facts supporting a fair inference that no board-level system of monitoring **[**37]** or reporting on food safety existed.

If *Caremark* means anything, it is that a corporate board must make a good faith effort to exercise its duty of care. A failure to make that effort constitutes a breach of the duty of loyalty. Where, as here, a plaintiff has followed our admonishment to seek out relevant books and records[116] and then uses those books and records to plead facts supporting a fair inference that no reasonable compliance system and protocols were established as to the obviously most central consumer safety and legal compliance issue facing the company, that the board's lack of efforts resulted in it not receiving official notices of food safety deficiencies for several years, and that, as a failure to take remedial action, the company exposed consumers to *listeria*-infected ice cream, resulting in the death and injury of company customers, the plaintiff has met his onerous pleading burden and is entitled to discovery to prove out his claim.

III. Conclusion

We therefore reverse the Court of Chancery's decision and remand for proceedings consistent with this opinion.

End of Document

---

[112] *See, e.g.*, ***City of Birmingham Ret. Sys. v. Good, 177 A.3d 47, 59 (Del. 2017)*** (affirming the Court of Chancery's dismissal of a *Caremark* claim because "reports to the board showed that the board 'exercised oversight by relying on periodic reports' from the officers" and that board presentations "identified issues with the coal ash disposal ponds, but also informed the board of the actions taken to address the regulatory concerns"); *Stone, 911 A.2d at 372-73* (affirming the Court of Chancery's dismissal of a *Caremark* claim, in part, because an outside auditor's report "reflect[s] that the Board received and approved relevant policies and procedures, delegated to certain employees and departments the responsibility for filing [suspicious activity reports] and monitoring compliance, and exercised oversight by relying on periodic reports from them"); *In re General Motors Derivative Litig., 2015 Del. Ch. LEXIS 179, 2015 WL 3958721, at *14 (Del. Ch. 2015)* (dismissing a *Caremark* claim where "GM *had* a system for reporting risk to the Board, but in the Plaintiffs' view it should have been a better system"); ***In re Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 127 (Del. Ch. 2009)*** (dismissing a *Caremark* claim because "[p]laintiffs do not contest that Citigroup had procedures and controls in place that were designed to monitor risk"); *Desimone v. Barrows, 924 A.2d 908, 940 (Del. Ch. 2007)* (dismissing a *Caremark* claim premised on the plaintiff's allegations that a properly formed and well-functioning audit committee must have known about options backdating despite the fact that management intentionally kept this information from the audit committee); *Guttman v. Huang, 823 A.2d 492, 506-07 (Del. Ch. 2003)* (dismissing a *Caremark* claim because the plaintiff failed to plead any particularized facts about the audit committee's lack of reporting or information systems).

[113] *911 A.2d at 365-66*.

[114] *Id. at 371*.

[115] *See, e.g.*, John Armour, et al., *Board Compliance*, 104 MINNESOTA L. REV. (forthcoming 2020) (manuscript at 47), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3205600 ; John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEGAL ANALYSIS 35, 46 (2014); Hillary A. Sale, *Monitoring* Caremark*'s Good Faith*, *32 DEL. J. CORP. L. 719, 753 (2007)*.

[116] *See* *Sandys v. Pincus, 152 A.3d 124, 128 (Del. 2016)* ("For many years, this Court and the Court of Chancery have advised derivative plaintiffs to take seriously their obligations to plead particularized facts justifying demand excusal.").

McElrath v. Kalanick

Supreme Court of Delaware

October 30, 2019, Submitted; January 13, 2020, Decided

No. 181, 2019

Reporter

224 A.3d 982 *; 2020 Del. LEXIS 15 **; 2020 WL 131371

LENZA H. MCELRATH, III, derivatively on behalf of UBER TECHNOLOGIES, INC., Plaintiff Below, Appellant, v. TRAVIS KALANICK, GARRETT CAMP, RYAN GRAVES, ARIANNA HUFFINGTON, YASIR AL-RUMAYYAN, WILLIAM GURLEY, DAVID BONDERMAN, Defendants Below, Appellees. and UBER TECHNOLOGIES, INC., Nominal Defendant Below, Appellee.

Subsequent History: Case Closed January 28, 2020.

Prior History: **[**1]** Court Below: Court of Chancery. C.A. No. 2017-0888.

McElrath v. Kalanick, 2019 Del. Ch. LEXIS 107 (Del. Ch., Apr. 1, 2019)

Disposition: AFFIRMED.

Counsel: Michael J. Barry, Esq. (argued), John C. Kairis, Esq., Kimberly A. Evans, Esq., GRANT & EISENHOFER P.A., Wilmington, Delaware; Jeffrey Reeves, Esq., Atlanta, Georgia; Attorneys for Plaintiff-Appellant Lenza H. McElrath, III, derivatively on behalf of Uber Technologies, Inc.

R. Judson Scaggs, Jr., Esq., Susan W. Waesco, Esq., Sabrina M. Hendershot, Esq., MORRIS, NICHOLS, ARSHT & TUNNELL LLP, Wilmington, Delaware; Susan S. Muck, Esq., Kevin P. Muck, Esq., Marie C. Bafus, Esq., FENWICK & WEST LLP, San Francisco, California; Attorneys for Defendants-Appellees Garrett Camp, Ryan Graves, Arianna Huffington, Yasir Al-Rumayyan, William Gurley and David Bonderman.

Donald J. Wolfe, Jr., Esq., T. Brad Davey, Esq., J. Matthew Belger, Esq., Jacob R. Kirkham, Esq., POTTER ANDERSON & CORROON LLP, Wilmington, Delaware; Joseph G. Petrosinelli, Esq., Kenneth J. Brown, Esq., WILLIAMS & CONNOLLY LLP, Washington, D.C.; Attorneys for Defendant-Appellee Travis Kalanick.

A. Thompson Bayliss, Esq., Michael A. Barlow, Esq., ABRAMS & BAYLISS LLP, Wilmington, Delaware; Mark Gimbel, Esq. (argued), C. William Phillips, Esq., COVINGTON & BURLING, LLP, New York, **[**2]** New York; Bryant Pulsipher, Esq., COVINGTON & BURLING, LLP, San Francisco, California; Attorneys for Nominal Defendant-Appellee Uber Technologies, Inc.

Judges: Before SEITZ, Chief Justice; VALIHURA, and TRAYNOR, Justices.

Opinion by: SEITZ

Opinion

[*986] **SEITZ**, Chief Justice:

In 2016, Uber Technologies, Inc. acquired Ottomotto LLC to gain more traction in the autonomous vehicle space. The acquisition was high risk from the start. Although Uber ostensibly bought a company, and paid only $100,000 up front, it hired key employees from Google's more mature autonomous vehicle program. Uber took some steps to ensure the former Google employees did not misuse Google's confidential information, but the transaction ended in embarrassment. Uber fired its key hire from Google after it came to light Google's proprietary information had been misused. It also ended up settling Google's misappropriation claims by issuing additional Uber stock to Google valued at $245 million.

The plaintiff, an Uber stockholder and former Uber employee, filed suit in the Court of Chancery against the directors who approved the Otto acquisition. The plaintiff claimed that the directors ignored the alleged theft of Google's intellectual property and failed **[**3]** to investigate pre-closing diligence that would have revealed problems with the transaction. According to the plaintiff, the board should not have relied on the CEO's representations that the transaction had the necessary protections because he and Uber had a history of misusing the intellectual property of others.

The defendants responded by moving to dismiss the complaint under [Court of Chancery Rule 23.1](). As they asserted, the plaintiff first had to make a demand on the board of directors before pursuing litigation on the corporation's behalf. The Court **[*987]** of Chancery found that a majority of the Uber board of directors could have fairly considered the demand, and dismissed the complaint. The plaintiff has appealed the Court of Chancery's decision.

By any reasonable measure, the Uber board of directors approved a flawed transaction. But we, like the Court of Chancery, do not decide the merits of the claims at this stage of the proceedings. Instead, we consider the gating issue of the demand requirement in a derivative action. Under Delaware law, the board of directors manage the business and affairs of the corporation. That responsibility normally includes deciding whether to bring litigation on the corporation's **[**4]** behalf. When the board is disabled from making the decision, however—whether because of interestedness or lacking independence from those who are interested—a stockholder can control the litigation decision.

We find, as did the Court of Chancery, that a majority of the board was disinterested because it had no real threat of personal liability due to Uber's exculpatory charter provision. And a majority of the board was also independent of the one interested director. Thus, the board, and not the plaintiff, controlled the decision whether to bring litigation on Uber's behalf, which meant the plaintiff had to make a demand on the board that Uber bring the litigation. He did not. The Court of Chancery's judgment dismissing the complaint with prejudice is affirmed.

I.

According to the allegations of the complaint, Uber operates a leading "ride share" mobile application.[1] In 2015, Travis Kalanick, Uber's founder, feared Uber was falling behind in the race to develop an autonomous vehicle—an "existential" threat to the company.[2] To regain lost ground, in June 2015 Uber recruited Anthony Levandowski, then the Engineering Manager of Google's autonomous vehicle project, to leave Google and join **[**5]** Uber.[3] Kalanick communicated extensively with Levandowski. They developed an "extremely close" relationship.[4]

On January 15, 2016, Levandowski founded Otto while still employed by Google.[5] At the end of January, Levandowski left Google and hired over a dozen former Google employees at Otto. Weeks later, Uber and Otto signed a term sheet for Uber to acquire Otto.[6] According to the plaintiff, Otto had no real operations and was run from Levandowski's house.[7] Kalanick testified in another proceeding that **[*988]** the acquisition was "basically [] hiring [Levandowski] and his team."[8]

After signing the term sheet, Uber and its outside counsel hired Stroz Friedberg, LLC, a computer forensic investigation firm, to conduct an independent investigation into whether Otto employees took with them Google's proprietary information or might breach non-solicitation, non-compete, or fiduciary obligations if they moved from Google to Otto.[9] The board was aware that Stroz had been hired to conduct an investigation.[10]

---

[1] At this stage of the proceedings, we accept as true the complaint's well-pleaded allegations and also rely on documents referred to or incorporated by reference. *See* ***Marchand v. Barnhill, 212 A.3d 805, 809 n.13 (Del. 2019)***. The complaint incorporated Uber's charter, the Stroz Friedberg final report, a redacted version of the Merger Agreement between Uber and Otto, a redacted version of the indemnification agreement between Uber and Otto that accompanied the Merger Agreement, a redacted version of a slide deck used in Uber management's presentation to the board on the Otto acquisition, and part of Uber director William Gurley's testimony in another litigation that the plaintiff quoted in the complaint. [McElrath on behalf of Uber Techs., Inc. v. Kalanick, 2019 Del. Ch. LEXIS 107, 2019 WL 1430210, at *2 n.2 (Del. Ch. Apr. 1, 2019)]().

[2] App. to Opening Br. at A172-73 (Verified Amended Stockholder Derivative Complaint 12-13 ¶ 37 (hereinafter "Am. Compl.")).

[3] *Id.* at A172-73 (Am. Compl. 12-13 ¶¶ 35, 39).

[4] *Id.* at A174 (Am. Compl. 14 ¶ 40).

[5] *Id.* at A175 (Am. Compl. 15 ¶ 44).

[6] *Id.* at A176 (Am. Compl. 16 ¶ 46).

[7] *Id.* at A176 (Am. Compl. 16 ¶ 47).

[8] *Id.*

[9] *Id.* at A177 (Am. Compl. 17 ¶ 49), A163 (Am. Compl. 3 ¶ 5).

[10] *Id.* at A177 (Am. Compl. 17 ¶ 50).

In early April, Stroz delivered its preliminary report to Uber's outside counsel, Uber's general counsel, and Otto's counsel. The complaint contained little **[**6]** detail about the contents of the report, except a finding that some Otto employees "possessed substantial files containing confidential and proprietary Google information, and surreptitiously tried to delete more on the eve of the Stroz interviews."[11] Uber's general counsel knew of the preliminary findings by April 10, 2016, and, as alleged, expressed "serious reservations" to Kalanick about the Otto acquisition, but did not otherwise inform the board.[12]

On April 11, 2016, the board—then composed of Kalanick, Garrett Camp, Ryan Graves, William Gurley, and David Bonderman—met to approve the acquisition. When Kalanick presented the transaction to the board, according to the plaintiff, Kalanick "failed to present the preliminary findings of the Stroz investigators."[13] Also, as alleged, none of the other directors asked to see the report.[14] Otherwise, the record reflects that diligence was discussed and represented to be "okay."[15]

The board also discussed what the plaintiff characterizes as atypical indemnification provisions of the merger agreement that "were clearly explained in the presentations to the [b]oard regarding the transaction."[16] Otto would not indemnify Uber post-closing for **[**7]** Otto's breaches of representations and warranties.[17] Also, certain Otto employees, including Levandowski, would have limited indemnification rights for pre-signing misconduct disclosed during the Stroz investigation, but not for undisclosed pre-signing or any post-signing misconduct.[18] After discussion, the board approved the transaction.

On August 5, 2016, Stroz delivered its final report, which described how some **[*989]** Otto employees had retained, accessed, or deleted confidential Google information on their personal devices after their departure from Google. The plaintiff did not, however, allege that the report found any Google confidential information transferred to Otto or Uber.[19] And while the plaintiff relied on a list of findings in the final Stroz report, it is unclear whether they differ from the preliminary report.[20] Also, the plaintiff does not allege that the directors knew that the final report differed from the preliminary report.

The board—having added Arianna Huffington and Yasir Al-Rumayyan—met before closing the transaction. The directors discussed the risk of Google suing, the critical nature of the diligence, and the details of the indemnification **[**8]** provision.[21] The plaintiff alleges they did not, however, specifically read or inquire about the Stroz report.[22]

After the transaction closed, in December 2016, Google mistakenly received an email intended for Uber from one of its vendors. The email contained drawings of a

---

[11] *Id.* at A179 (Am. Compl. 19 ¶ 55).

[12] *Id.* at A178-79 (Am. Compl. 18-19 ¶ 53).

[13] *Id.* at A179 (Am. Compl. 19 ¶ 54).

[14] *Id.*

[15] McElrath, 2019 Del. Ch. LEXIS 107, 2019 WL 1430210, at *11. The Court of Chancery found that the complaint incorporated Gurley's testimony in another suit where Gurley testified that there was "discussion about the due diligence that had been done. And we as a group made a decision that we're going to move forward because the due diligence was okay." 2019 Del. Ch. LEXIS 107, [WL] at *4; App. to Opening Br. at A159. While the plaintiff argues this was not expressly alleged in his complaint, he does not challenge the incorporation of the relevant Gurley testimony.

[16] App. to Opening Br. at A187 (Am. Compl. 27 ¶ 78).

[17] *Id.* at A182 (Am. Compl. 22 ¶ 62) ("[T]he Merger Agreement contains customary representations regarding Otto's ownership of IP, but it omits any post-closing indemnification remedy for Uber. Contrary to what is customary, Uber is not indemnified for breaches of representations and warranties nor is it indemnified for any species of third party claims.").

[18] *Id.* at A183-84 (Am. Compl. 23-24 ¶ 65).

[19] *Id.* at A130 (According to the report, "[w]hile Levandowski retained, and in some cases, accessed Google confidential information after his departure from Google, Stroz Friedberg discovered no evidence indicating that he transferred any of that data to Ottomotto or other third parties.").

[20] *Compare id.* at A179 (Am. Compl. 19 ¶ 55) (describing the preliminary findings that "Levandowski and others at Otto possessed substantial files containing confidential and proprietary Google information, and surreptitiously tried to delete more on the eve of the . . . interview"), *with id.* at A185-86 (Am. Compl. 25-26 ¶¶ 70-73) (describing the final report's findings that Otto employees possessed confidential files and Levandowski attempted to delete files before and during his interview).

[21] *Id.* at A186-87 (Am. Compl. 26-27 ¶¶ 75, 78).

[22] *Id.* at A179-80 (Am. Compl. 19-20 ¶ 56); Opening Br. at 37.

circuit board for autonomous vehicle technology that allegedly resembled Google's internal engineering drawings. Google sued Uber and Otto in February 2017 for misappropriation of proprietary information. Uber eventually settled the lawsuit by issuing additional Uber stock to Google valued at $245 million.[23] Uber also terminated Levandowski's employment.[24]

After Uber announced the settlement, the plaintiff filed this derivative suit against the directors who decided to proceed with the Otto transaction, the directors who decided to close the transaction, and two Uber officers.[25] According to the plaintiff, making a demand on the Uber board before filing suit was futile because a majority of the Uber directors at the time he filed his complaint—Kalanick, Graves, Camp, Huffington, Al-Rumayyan, Matt Cohler, David Trujillo, Ursula Burns, and John Thain—were interested or not independent of those who were interested.[26] Uber and **[**9]** the individual defendants moved to dismiss for failure to make a demand under *Court of Chancery Rule 23.1*. They argued that the Uber board could have fairly considered whether to pursue the litigation brought by the plaintiff. The Court of Chancery found that Kalanick was the only interested director, **[*990]** and a majority of the board was independent from him at the time of the complaint. Thus, *Rule 23.1* required the plaintiff to demand the board pursue litigation on Uber's behalf. Because the plaintiff did not, the Court of Chancery dismissed the complaint.

II.

We review *de novo* the Court of Chancery's decision to dismiss the complaint.[27] At this stage, we must accept as true any "particularized allegations of fact."[28] And while we must draw all reasonable inferences in the plaintiff's favor, we do not draw unreasonable inferences.[29] Under *Rule 23.1*, the plaintiff has "a heightened burden to plead particularized facts establishing a 'reasonable doubt that . . . the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.'"[30]

A.

Under Delaware law, the board of directors manages the business and affairs of the corporation, which includes deciding whether the **[**10]** corporation should pursue litigation against others.[31] To protect the directors' managerial authority, a stockholder must comply with *Court of Chancery Rule 23.1* before pursuing derivative litigation.[32] A stockholder must first make a demand on the board to pursue the claim, and, if the board declines, "attempt to demonstrate that the directors wrongfully refused the demand."[33] The demand requirement affords "the corporation the opportunity to address an alleged wrong without litigation and to control any litigation which does occur."[34] Further, it "insure[s] [sic] that a stockholder exhausts his intracorporate remedies" and "safeguard[s] against strike suits."[35]

A stockholder can bypass the demand requirement if he

---

[23] According to Uber, Google "already owned Uber shares." Uber's Answering Br. at 14.

[24] App. to Opening Br. at A192 (Am. Compl. 32 ¶ 94).

[25] *Id.* at A161.

[26] Wan Ling Martello and Dara Khosrowshahi were also on the Uber board at the time the plaintiff filed his complaint, but he does not contest their disinterestedness or independence. *Id.* at A194 (Am. Compl. 34 ¶ 104).

[27] *Brehm v. Eisner, 746 A.2d 244, 254 (Del. 2000)* ("We . . . decide *de novo* whether the Complaint was properly dismissed for failure to set forth particularized facts to support the plaintiffs' claim that demand is excused.").

[28] ***City of Birmingham Ret. and Relief Sys. v. Good, 177 A.3d 47, 55-56 (Del. 2017)***.

[29] ***Id. at 56***.

[30] *Id.* (quoting *Rales v. Blasband, 634 A.2d 927, 934 (Del. 1993))*.

[31] ***Id. at 54***; *Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984)* (citing *8 Del. C. § 141(a)*) *overruled on other grounds by Brehm, 746 A.2d at 253*.

[32] *Ct. Ch. R. 23.1(a)*.

[33] ***City of Birmingham Ret. and Relief Sys., 177 A.3d at 55***; *see Ct. Ch. R. 23.1(a)*.

[34] *Kaplan v. Peat, Marwick, Mitchell & Co., 540 A.2d 726, 730 (Del. 1988)*.

[35] *Aronson, 473 A.2d at 811-12*; *see Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1050 (Del. 2004)* (finding that a purpose of the demand requirement is to deter suits "where there is only a suspicion expressed solely in conclusory terms") (quoting *Grimes v. Donald, 673 A.2d 1207, 1217 (Del. 1996))*.

"can allege with sufficient particularity that demand is futile and should be excused due to a disabling conflict by a majority of the directors to consider the demand."[36] The demand futility test is highly dependent on the particularity of the facts alleged in the complaint.[37] When a majority of directors at the time of the challenged conduct have been replaced, the demand futility test articulated **[*991]** in *Rales v. Blasband* applies.[38] The *Rales* test considers "whether the board that **[**11]** would be addressing the demand can impartially consider its merits without being influenced by improper considerations."[39] The plaintiff satisfies the demand futility pleading requirements under *Rales* if his allegations "create a reasonable doubt that . . . the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."[40]

First, the court must consider whether any directors were interested. A director is interested if, in this instance, she would face a substantial likelihood of personal liability for the conduct alleged in the complaint.[41] Second, if any directors were interested, the court considers whether any other directors were not independent of an interested director. Independence turns on whether "the director's ability to act impartially on a matter important to the interested party can be doubted because that director may feel either subject to the interested party's dominion or beholden to that interested party."[42] After tallying the results, if a majority of the board in place when the complaint was filed was disinterested and independent, the stockholder must first make a demand on the board before **[**12]** pursuing litigation on the corporation's behalf.

B.

Examining first the Uber directors the plaintiff alleges were interested because of the substantial likelihood of personal liability for wrongdoing, Uber's Certificate of Incorporation exculpates its directors from monetary liability for fiduciary duty breaches to the fullest extent permitted by the Delaware General Corporation Law.[43] Given this protection from due care violations, the plaintiff must plead with particularity that the directors "acted with scienter, meaning 'they had actual or constructive knowledge that their conduct was legally improper.'"[44] In other words, directors are liable for "subjective bad faith" when their conduct is motivated "by an actual intent to do harm," or when there is an "intentional dereliction of duty, a conscious disregard for one's responsibilities."[45] Pleading bad faith is a difficult task and requires "that a director acted inconsistent with his fiduciary duties and, most importantly, that the director *knew* **[*992]** he was so acting."[46] Gross negligence, without more, is insufficient to get out from under an exculpated breach of the duty of care.[47]

---

[36] ***City of Birmingham Ret. and Relief Sys., 177 A.3d at 55***.

[37] *See* *Rales, 634 A.2d at 933-34*.

[38] *Id.* The Court of Chancery applied the *Rales* test. *McElrath, 2019 Del. Ch. LEXIS 107, 2019 WL 1430210, at *8*. The parties do not dispute its application.

[39] *Rales, 634 A.2d at 934*.

[40] *Id.*

[41] ***City of Birmingham Ret. and Relief Sys., 177 A.3d at 55***; *Wood v. Baum, 953 A.2d 136, 140-41 (Del. 2008)*. A director can be interested for other reasons, which are not alleged here. *See* *Rales, 634 A.2d at 936* (Director interest can be shown when "he or she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders" or "where a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders.").

[42] ***Marchand, 212 A.3d at 818*** (citing *Sandys v. Pincus, 152 A.3d 124, 128 (Del. 2016)* (quoting ***Del. Cty. Emps. Ret. Fund v. Sanchez, 124 A.3d 1017, 1024 n.25 (Del. 2015)))***.

[43] *McElrath, 2019 Del. Ch. LEXIS 107, 2019 WL 1430210, at *9*.

[44] ***City of Birmingham Ret. and Relief Sys., 177 A.3d at 55*** (quoting *Wood, 953 A.2d at 141* (internal quotations omitted)).

[45] *In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 64, 66 (Del. 2006)*; *see* *Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 243 (Del. 2009)* ("[T]here is a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties.").

[46] ***City of Birmingham Ret. and Relief Sys., 177 A.3d at 55*** (quoting *In re Massey Energy Co. Derivative & Class Action Litig., 2011 Del. Ch. LEXIS 83, 2011 WL 2176479, at *22 (Del. Ch. May 31, 2011)* (emphasis in original)); *see id.* ("Because of the difficulties in proving bad faith director action, a *Caremark* claim is 'possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.'") (citing *In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996))*.

[47] *In re Walt Disney Co. Derivative Litig., 906 A.2d at 65*.

Of the eleven directors on the board when **[**13]** the plaintiff filed his complaint, the plaintiff alleges that five were interested because they faced a substantial likelihood of liability for approving and closing the deal—Kalanick, Camp, Graves, Huffington, and Al-Rumayyan.[48] While the defendants claim they dispute the Court of Chancery's finding that Kalanick was interested,[49] they make no serious argument on appeal to challenge the finding. Thus, we start from the Court of Chancery's finding that Kalanick was interested and unable to fairly consider a demand.[50]

The plaintiff challenges the Court of Chancery's finding that the directors did not act in bad faith when approving the Otto transaction.[51] First, the plaintiff argues that, because Kalanick as CEO was the one who brought the transaction to the board and was involved with diligence, the directors should have been wise enough not to rely on someone with a reputation as a law breaker. In support, the plaintiff points to one of Kalanick's prior businesses, Scour, which offered music and film releases. Scour was eventually shut down for copyright violations and sued for $250 billion. Further, the plaintiff alleges that Uber had a practice of hiring employees from competitors **[**14]** to steal trade secrets and a general practice of ignoring and violating regulations.[52] When these allegations are combined, the plaintiff argues that the board was on notice that Kalanick might be ignoring intellectual property laws in the Otto acquisition.

Second, the plaintiff argues that the allegedly unusual indemnification clauses in the merger agreement put the board on **[*993]** notice that Kalanick wanted to steal Google's proprietary information. The agreement indemnified certain Otto employees for pre-signing misconduct disclosed during the Stroz investigation, but prevented Uber from seeking indemnification from Levandowski for violating non-compete and infringement claims. And, as the plaintiff alleged, Uber hired Stroz to investigate whether Otto employees stole Google's intellectual property, but the board approved the transaction without personally reviewing the preliminary or final Stroz reports. The plaintiff argues that, viewed holistically, these facts entitle him "to a reasonable inference that the [b]oard's failure to inquire or inform themselves about the scope of potential legal and financial risk faced by Uber in connection with the [Otto] [t]ransaction amounts to bad faith." **[**15]** [53]

We agree, however, with the Court of Chancery that the plaintiff did not meet his particularized burden of alleging that the board in place when the plaintiff filed his complaint, besides Kalanick, acted in bad faith. As noted before, a showing of bad faith in the context of demand excusal is a high hurdle, and essentially requires the plaintiff to demonstrate intentional wrongdoing by the board. The complaint alleges, however, that Uber's directors heard a presentation that summarized the transaction, reviewed the risk of litigation with Google, generally discussed due diligence, asked questions, and participated in a discussion.[54] The inference from these allegations shows a functioning board that did more than rubberstamp the transaction presented by Uber's CEO.

Further, Kalanick might have a background that would lead a reasonable board member to dig deeper into representations he made about the transaction. But, as

---

[48] App. to Opening Br. at A199 (Am. Compl. 39 ¶ 113). Kalanick, Camp, Graves, Gurley, and Bonderman were the entire board that approved the Otto transaction. *Id.* at A167-68 (Am. Compl. 7-8 ¶¶ 18-24). Huffington and Al-Rumayyan joined the board after the transaction's approval, but before closing. *Id.* While Gurley and Bonderman were not directors at the time the plaintiff filed his complaint, his allegation that Trujillo and Cohler were conflicted relies, in part, on finding that Gurley and Bonderman faced a substantial likelihood of liability for approving and closing the deal.

[49] Uber's Answering Br. at 19 n.3; Kalanick's Joinder in Answering Br. at 2.

[50] *McElrath, 2019 Del. Ch. LEXIS 107, 2019 WL 1430210, at *10*; *Sullivan v. Mayor of Town of Elsmere, 23 A.3d 128, 134 (Del. 2011)* (finding that a trial court's determination became the "law of this case" when the party did not challenge that determination in a cross-appeal); *see also* *Greenlaw v. United States, 554 U.S. 237, 244, 128 S. Ct. 2559, 171 L. Ed. 2d 399 (2008)* ("Under [the cross-appeal rule,] an appellate court may not alter a judgment to benefit a nonappealing party.").

[51] Because Kalanick was interested, we will refer to the directors as those directors other than Kalanick.

[52] The plaintiff also alleges other reasons to doubt Kalanick's reliability, including Uber's "internal espionage market analytics team," Kalanick's public disdain for the law, Uber's "Greyball" operation, and the lawsuits and criminal probes against Uber. Opening Br. at 24-25.

[53] *Id.* at 28.

[54] App. to Opening Br. at A183 (Am. Compl. 23 ¶ 63), A186 (Am. Compl. 26 ¶ 75), A187 (Am. Compl. 27 ¶ 78); Opening Br. at 28 ("The [b]oard knew about these unusual provisions . . . and specifically discussed the possibility of being sued by Google, yet it still approved the [Otto] [t]ransaction . . . .").

the Court of Chancery found, there were no allegations that Kalanick had a history of lying to the board.[55] And the record supports the conclusion that the diligence presented to the board was, in fact, "okay."[56] The complaint's allegations do not lead to a reasonable inference **[**16]** that the board intentionally ignored the risks of the transaction.[57] On the contrary, it appears that the directors considered the risks and nonetheless proceeded with the transaction. As we have noted before, "there is a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties."[58] It is not enough to allege that the directors should have been better informed—a due care violation exculpated by the corporation's charter provision.[59]

Turning to the indemnification provisions, while unusual, those provisions were "clearly explained to the board" and did **[*994]** provide some protection for Uber—Uber would not have to indemnify Levandowski and others for conduct that was not disclosed to Uber before closing.[60] The Court of Chancery concluded correctly that the allegations as pleaded did not support a reasonable inference that the directors knew the transaction was nothing more than a vehicle to steal Google's proprietary information.[61] Instead, the reasonable inference is the board should have done more, not that it acted in bad faith. Thus, we agree with the Court of Chancery that the unusual indemnification provisions approved by **[**17]** the board do not lead to any inference other than the board approved a flawed transaction.

The plaintiff attempts to analogize the allegations here to *In re Walt Disney Co. Derivative Litigation*, where the Court of Chancery found that "the facts alleged . . . suggest that the defendant directors consciously and intentionally disregarded their responsibilities . . ." and the plaintiff sufficiently pleaded bad faith.[62] In *Disney*, the board approved a high profile hiring decision before the details were negotiated and assigned the responsibility to the CEO to negotiate the employment contract with the new hire who was his friend of many years.[63] The court explained:

> Less than one and one-half pages of the fifteen pages of Old Board minutes were devoted to discussions of Ovitz's hiring as Disney's new president. . . . No presentations were made to the Old Board regarding the terms of the draft agreement. No questions were raised, at least so far as the minutes reflect. At the end of the meeting, the Old Board authorized Ovitz's hiring as Disney's president. No further review or approval of the employment agreement occurred. Throughout both meetings, no expert consultant was present to advise **[**18]** the compensation committee or the Old Board. Notably, the Old Board approved Ovitz's hiring even though the employment agreement was still a "work in progress." The Old Board simply passed off the details to Ovitz and his good friend, Eisner.[64]

Here, like the Court of Chancery, we find the *Disney* allegations different. Unlike *Disney*, where the directors devoted very little time, had no presentations, and asked no questions, the Uber board met to consider the Otto acquisition. Outside counsel and an investigative firm assisted with due diligence. Kalanick made a presentation, and the board discussed the terms of the deal and its risks. Although there might have been reason to dig deeper into Kalanick's representations about the transaction, the board's failure to investigate further cannot be characterized fairly as an "intentional dereliction" of its responsibilities.

The plaintiff also argues that the directors who decided

---

55 *McElrath, 2019 Del. Ch. LEXIS 107, 2019 WL 1430210, at *15 n.173*.

56 App. to Opening Br. at A159; *see McElrath, 2019 Del. Ch. LEXIS 107 2019 WL 1430210, at *4, *11*.

57 *8 Del. C. § 141(e)* (The board "shall . . . be fully protected in relying in good faith upon the . . . information, opinions, reports or statements presented" by the corporation's officers.).

58 *Lyondell Chem. Co., 970 A.2d at 243*.

59 *Id. at 243-44* ("[I]f the directors failed to do all that they should have under the circumstances, they breached their duty of care. Only if they knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty.").

60 App. to Opening Br. at A183-84 (Am. Compl. 23-24 ¶ 65), A187 (Am. Compl. 27 ¶ 78).

61 *McElrath, 2019 Del. Ch. LEXIS 107, 2019 WL 1430210, at *15*.

62 *825 A.2d 275, 289 (Del. Ch. 2003)* (emphasis omitted).

63 *Id. at 279-81*.

64 *Id. at 287*.

to close the deal acted in bad faith because they should have reviewed the final Stroz report before allowing the transaction to close. Besides relying on the same argument that approving the transaction was done in bad faith, the plaintiff argues only that the final **[**19]** Stroz report showed that Uber could have terminated the deal because Otto breached a representation.[65] But the plaintiff did not **[*995]** allege that the directors were informed of any change or had any additional reasons to doubt the diligence process since the approval decision. Like the approval decision, Uber's directors heard a presentation that summarized the transaction, reviewed the risk of litigation with Google, generally discussed due diligence, asked questions, and participated in a discussion.[66] We agree with the Court of Chancery that the plaintiff has "not sufficiently [pleaded] that the directors knew [intellectual property] misappropriation was not [] simply a risk, but was actually Kalanick's goal, and that, in light of that knowledge, the directors closed their eyes to evidence of IP misappropriation by refusing to look at Stroz' final report."[67]

C.

Having found only one interested director, Kalanick, we turn to the allegations that a majority of directors were not independent of Kalanick. Because Uber's board consisted of eleven directors when the plaintiff filed his complaint, dismissal depends on whether we find that at least six directors were independent of Kalanick. The plaintiff **[**20]** does not challenge the independence of three directors—Martello, Khosrowshahi, and Al-Rumayyan. And he does not challenge Cohler's or Trujillo's independence from Kalanick.[68] Thus, if one additional director was independent of Kalanick, the plaintiff failed to plead demand futility.

A director's independence turns on "whether the plaintiffs have [pleaded] facts from which the director's ability to act impartially on a matter important to the interested party can be doubted because that director may feel either subject to the interested party's dominion or beholden to that interested party."[69] We must consider the full context of "all the [pleaded] facts regarding a director's relationship to the interested party,"[70] and decide whether the relationship is "of a bias-producing nature."[71] Importantly, being nominated or elected by a director who controls the outcome is insufficient by itself to reasonably doubt a director's independence because "[t]hat is the usual way a person becomes a corporate director."[72]

The plaintiff challenged Thain's independence because Kalanick appointed Thain "during a power struggle within Uber" after the board ousted Kalanick as CEO and an investor had sued Kalanick **[**21]** for **[*996]** fraud.[73] The Court of Chancery found that Thain was independent because the plaintiff does not allege that Thain had a personal or financial connection to Kalanick or that the directorship was of substantial material importance to him.[74]

We agree with those determinations. The plaintiff challenged Thain's independence, in part, because Kalanick had the ability to appoint and remove him. Otherwise, the plaintiff relied only on the circumstances surrounding Thain's appointment and the allegation that Kalanick sought to use Thain as a means of retaining control. But appointment to the board is an insufficient

---

[65] Opening Br. at 36. The defendants dispute whether there was a breach. Answering Br. at 33-34.

[66] App. to Opening Br. at A186-87 (Am. Compl. 26-27 ¶¶ 75, 78).

[67] McElrath, 2019 Del. Ch. LEXIS 107, 2019 WL 1430210, at *16. The plaintiff also briefly raises his waste claim. Opening Br. at 31. But because this claim requires finding waste on the same facts that we do not find bad faith, we also find it to be without merit.

[68] The plaintiff challenged Cohler's and Trujillo's independence from their predecessor directors who were also partners of their respective investment firms. But, like the Court of Chancery, we need not decide whether Cohler and Trujillo were independent from their predecessors because we find that their predecessors were not interested.

[69] Sandys, 152 A.3d at 128 (quoting ***Sanchez, 124 A.3d at 1024 n.25***).

[70] ***Sanchez, 124 A.3d at 1022***.

[71] Beam, 845 A.2d at 1050.

[72] Aronson, 473 A.2d at 816; *see* Beam, 845 A.2d at 1052 ("To create a reasonable doubt about an outside director's independence, a plaintiff must plead facts that would support the inference that because of the nature of a relationship or additional circumstances other than the interested director's stock ownership or voting power, the non-interested director would be more willing to risk his or her reputation than risk the relationship with the interested director.").

[73] App. to Opening Br. at A202 (Am. Compl. 42 ¶ 117).

[74] McElrath, 2019 Del. Ch. LEXIS 107, 2019 WL 1430210, at *19.

basis for challenging Thain's independence.[75] And the context of Thain's appointment—that Kalanick appointed him in a power struggle and that Thain might be loyal to him—without more does not allow a reasonable inference that Thain and Kalanick's relationship was of a "bias-producing nature."[76] Otherwise, a director would be automatically disqualified if appointed during a board conflict. We agree with the Court of Chancery that Thain was independent of Kalanick.[77]

III.

We stop here because we find that six directors—a majority of the board at the time the plaintiff filed the **[**22]** complaint—were disinterested and independent. Thus, the plaintiff was required to demand that the board pursue the claim. Because the plaintiff did not make a demand before filing suit, we affirm the Court of Chancery's decision to dismiss the complaint.

End of Document

[75] *See also* *Blaustein v. Lord Baltimore Capital Corp., 84 A.3d 954, 958-59 (Del. 2014)* (finding that allegations that a director was appointed by a party and voted with the party in the past were insufficient, without more, to demonstrate a lack of independence).

[76] *See* *Beam, 845 A.2d at 1050*.

[77] The plaintiff also alleged comments by the successor CEO that characterized Kalanick's appointments as "disappointing news" and "highly unusual," and that a "corporate governance expert said that [Thain] 'seem[s] to be walking in the door with a button that says Team Travis, instead of Team Shareholder.'" App. to Opening Br. at A203 (Am. Compl. 43 ¶ 118). Hearsay and hyperbole, however, are no substitute for pleading particularized facts to meet the plaintiff's heightened pleading burden.

Noto v. 22nd Century Grp., Inc.

United States Court of Appeals for the Second Circuit

September 2, 2021, Argued; May 24, 2022, Decided

No. 21-0347-cv

Reporter

35 F.4th 95 *; 2022 U.S. App. LEXIS 13935 **

Joseph Noto, Garden State Tire Corp., Stephens Johnson, Individually and on Behalf of All Others Similarly Situated, Plaintiffs-Appellants, v. 22nd Century Group, Inc., Henry Sicignano, III, John T. Brodfuehrer, Defendants-Appellees.

Prior History: [1]** Appeal from the United States District Court for the Western District of New York.

Plaintiffs Joseph Noto, Stephens Johnson, and Garden State Tire Corporation appeal from a judgment of the United States District Court for the Western District of New York (Sinatra, J.) dismissing their complaint against 22nd Century Group and its former CEO and CFO, Henry Sicignano, III and John T. Brodfuehrer. Plaintiffs, investors in 22nd Century Group, allege on behalf of an investor class that (1) defendants engaged in an illegal stock promotion scheme in which they paid authors to write promotional articles about the company while concealing the fact that they paid the authors for the articles; and (2) defendants failed to disclose an investigation by the Securities and Exchange Commission into the company's financial control weaknesses. After public articles revealed the promotion scheme and SEC investigation, the company's stock price fell, and plaintiffs allege they were harmed. The complaint was dismissed by the district court for failing to state a claim upon which relief could be granted.

On appeal, plaintiffs argue that (1) they adequately alleged material misrepresentations and manipulative **[**2]** acts sufficient to sustain claims under *subsections (a)*, *(b)*, and *(c) of SEC Rule 10b-5*; (2) their claim under *§ 20(a) of the Securities Exchange Act* was premised on a valid predicate violation of *§ 10(b)*; and (3) the district court erred in dismissing the complaint with prejudice. On the first and second points, we agree that the allegation that defendants failed to disclose the SEC investigation states a material misrepresentation and could also support *§ 20(a)* liability. We find no merit in the remaining challenges. Accordingly, we AFFIRM in part, VACATE in part, and REMAND for further proceedings consistent with this opinion.

Noto v. 22nd Century Grp., Inc., 2021 U.S. Dist. LEXIS 7477, 2021 WL 131050 (W.D.N.Y., Jan. 14, 2021)

Counsel: JEREMY A. LIEBERMAN, Pomerantz LLP, New York, NY, for Plaintiffs-Appellants.

JOHN A. TUCKER (Jonathan H. Friedman, on the brief), Foley & Lardner LLP, Jacksonville, FL, New York, NY; Charles C. Ritter, Jr., on the brief, Duke, Holzman, Photiadis & Gresens LLP, Buffalo, NY, for Defendants-Appellees.

Judges: Before: WALKER, CALABRESI, AND LOHIER, Circuit Judges.

Opinion by: JOHN M. WALKER, JR.

Opinion

[*99] JOHN M. WALKER, JR., *Circuit Judge*:

Plaintiffs Joseph Noto, Stephens Johnson, and Garden State Tire Corporation appeal from a judgment of the Western District of New York (Sinatra, *J.*) dismissing their complaint against 22nd Century Group and its former CEO and CFO, Henry **[**3]** Sicignano, III and John T. Brodfuehrer. Plaintiffs, investors in 22nd Century Group, allege on behalf of an investor class that (1) defendants engaged in an illegal stock promotion scheme in which they paid authors to write promotional articles about the company while concealing the fact that they paid the authors for the articles; and (2) defendants failed to disclose an investigation by the Securities and Exchange Commission ("SEC") into the company's financial control weaknesses. After public articles revealed the promotion scheme and SEC investigation, the company's stock price fell, and plaintiffs allege they were harmed. The complaint was dismissed by the district court for failing to state a claim upon which relief could be granted.

On appeal, plaintiffs argue that (1) they adequately alleged material misrepresentations and manipulative acts sufficient to sustain claims under *subsections (a)*, *(b)*, and *(c) of SEC Rule 10b-5*; (2) their claim under *§ 20(a) of the Securities Exchange Act* was premised on a valid predicate violation of *§ 10(b)*; and (3) the district court erred in dismissing the complaint with prejudice. On the first and second points, we agree that the allegation that defendants failed to disclose the SEC investigation states a material **[**4]** misrepresentation and could also support *§ 20(a)* liability. We find no merit in the remaining challenges. Accordingly, we **AFFIRM** in part, **VACATE** in part, and **REMAND** for further proceedings consistent with this opinion.

BACKGROUND

The corporate defendant, 22nd Century Group, Inc. ("22nd Century" or "the Company"), is a publicly traded company that strives to genetically engineer tobacco and cannabis plants to regulate their nicotine levels or cannabinoids. From 2015 to 2019, Henry Sicignano, III was the Company's CEO, and from 2013 to 2019, John T. Brodfuehrer was the Company's CFO. Shortly after Sicignano became CEO, he engaged the consulting firm IRTH Communications ("IRTH") to handle 22nd Century's investor relations. For purposes of this appeal, we accept as true the following allegations in the complaint.[1]

I. Stock Promotion Scheme

Confidential Witness 1 ("CW1"), Sicignano's executive assistant from January 2016 to February 2018, worked directly with Sicignano and interacted frequently with Brodfuehrer. CW1 saw Sicignano review and approve the Company's press releases. In February and March 2017, Sicignano told CW1 several times that he was "working behind the scenes" to prop up 22nd Century's **[**5]** stock price because the Company "did not have enough cash to operate for much longer."[2] The same year, Brodfuehrer repeatedly told CW1 that, because he had concerns about Sicignano's conduct, he was not comfortable signing the Company's SEC filings.

From February 2017 through October 2017, various writers published positive online articles about the prospects for 22nd Century's stock. Many articles repeated statements from the Company's press releases, the FDA's press releases, and Sicignano **[*100]** on earnings calls, in presentations, and at conferences. Defendants paid the writers directly, or indirectly through IRTH, to publish the articles. The articles did not reveal that the Company was compensating the writers.

Based on his conversations with Sicignano, CW1 "came to understand that Sicignano and the Company were paying for writers to write articles disguised as [] legitimate articles that just promoted [the Company's] stock" but which were not identified as stock promotion articles.[3] Based on Sicignano's comments, it was "clear" to CW1 that Sicignano knew that paying third parties to write promotional articles without disclosing that the Company had paid for them was inappropriate.[4] CW1 **[**6]** stated that he was "sure" that Sicignano "reviewed, edit[ed], and/or approv[ed]" the paid stock promotion articles "because Sicignano was intensely focused on everything that was said publicly about the Company and 'went over every Company press release with a fine-toothed comb.'"[5]

On multiple occasions, after the articles were published, 22nd Century's stock price rose. From February 2017 until October 2017, the stock price more than tripled. On October 10, 2017, the Company closed a registered direct common stock offering that yielded $50.7 million in net proceeds.

Then, in the Company's annual 2017 Form 10-K submitted in March 2018 to the SEC, the Company reported that it had sufficient cash on hand to sustain normal operations for several years. The 2017 10-K, as well as the other 10-Ks filed in the class period, also stated that the Company's stock price was subject to volatility and listed 19 factors that, "in addition to other risk factors . . . may have a significant impact on" its stock price.[6]

---

[1] *Palin v. N.Y. Times Co., 940 F.3d 804, 809 (2d Cir. 2019)*.

[2] Joint App. at 32-33.

[3] Joint App. at 33-34.

[4] Joint App. at 34.

[5] Joint App. at 34.

[6] Joint App. at 62-65.

II. SEC Investigation

In February 2016, defendants filed the Company's 2015 10-K. That 10-K disclosed that the Company's management had concluded that its "internal controls over financial **[**7]** reporting were not effective and that material weaknesses exist[ed] in [its] internal control over financial reporting" as it related to segregation of duties.[7] To ameliorate these weaknesses, defendants hired an accounting manager, Confidential Witness 2 ("CW2"), who reported directly to CFO Brodfuehrer. In its SEC Forms 10-Q for the first, second, and third quarters of 2016, as well as its 2016 10-K, the Company repeated that its financial reporting controls and procedures were not effective and noted that it was undertaking remediation efforts.[8] Ultimately, in its Form 10-Q for the second quarter of 2018, the Company stated that it had "completed the implementation and testing of a remediation plan that was targeted at eliminating our previously reported material weakness in our internal controls over financial reporting primarily resulting from a lack of segregation of duties."[9]

According to CW2, the SEC was investigating the Company at the time he was hired in 2016. CW2 stated that the investigation continued throughout 2016, and that, by the time he left in 2019, he had not seen any statement from the SEC **[*101]** formally closing the investigation. The Company retained counsel to represent **[**8]** it in connection with the investigation, and, in 2016, Brodfuehrer traveled to Washington, D.C. to meet with the SEC. Brodfuehrer told CW2 that he feared that the investigation could cost Brodfuehrer his CPA license or lead to his imprisonment. The SEC investigation was underway throughout the time that the Company was disclosing its ineffective financial reporting controls.

On July 16, 2018, the SEC received a nonpublic *Freedom of Information Act ("FOIA")* request seeking "all documents in the [SEC's] possession . . . pertaining to investigations regarding [the Company] for the time period January 1, 2016 through July 16, 2018."[10] On August 13, 2018, a FOIA Officer denied the request pursuant to the FOIA exemption that authorizes the withholding of "records or information compiled for law enforcement purposes, but only to the extent that production of such law enforcement records or information . . . could reasonably be expected to interfere with enforcement proceedings."[11] The SEC Office of the General Counsel affirmed the denial.

III. The Public Revelations

On February 2, 2018, an online commentator, "Fuzzy Panda" posted an online article that claimed that 22nd Century engaged in a paid stock promotion scheme to illegally **[**9]** inflate its share price. The Company's stock price fell by 16.9%. On October 25, 2018, Fuzzy Panda posted a second article that disclosed the FOIA request denial and suggested that the SEC was investigating the Company. The article also suggested that the Company had paid undisclosed promoters to pump up its stock price in advance of the October 2017 stock offering. The next day, the Company's stock price fell by 4.3%.

In response, on October 26, 2018, the Company, for the first time, broke its silence about the SEC investigation. But it did so by denying any knowledge of an "enforcement proceeding." The Company issued a press release saying the October 25 article was "highly deceptive" and that the Company "has not received any notice of, and the Company has no knowledge of, any enforcement proceeding against [the Company] by the SEC or any other regulator."[12]

On April 17, 2019, Fuzzy Panda posted a third article, repeating the undisclosed stock promoters and SEC investigation allegations. The Company's stock price fell again. The next day, the Company issued another statement denying both the illegal stock promotion and SEC investigation claims, stating that the article "falsely alleges **[**10]** that [the Company] is supposedly under SEC investigation."[13]

On July 26, 2019, the Company announced that Sicignano had resigned as CEO for "personal reasons" but would continue to act as a consultant to the Company.[14] The Company's stock price fell in the days

---

[7] Joint App. at 27.

[8] The complaint makes no mention here of SEC filings for 2017. *See* Joint App. at 76-77.

[9] Joint App. at 27.

[10] Joint App. at 55.

[11] Joint App. at 55-56 (ellipses in original).

[12] Joint App. at 57.

[13] Joint App. at 59.

[14] Joint App. at 60.

following the announcement. On December 3, 2019, CFO Brodfuehrer retired.

IV. Procedural History

In November 2019, after this case was transferred to the Western District of New York, plaintiffs filed the amended class action complaint at issue in this appeal. **[*102]** The class consisted of any person or entity that acquired 22nd Century securities between February 18, 2016, and July 31, 2019.

On May 1, 2020, defendants moved to dismiss the amended complaint for failure to state a claim. Plaintiffs asked the district court for an opportunity to further amend the complaint should the court grant any part of defendants' motion. On January 14, 2021, the district court dismissed the entirety of the amended complaint with prejudice and denied plaintiffs' request for leave to amend as futile.

This appeal followed.

DISCUSSION

We review the grant of a motion to dismiss *de novo*.[15] To survive a motion to dismiss under Federal Rule of Civil Procedure 12(b)(6), the complaint must contain sufficient **[**11]** factual matter, accepted as true, to "state a claim to relief that is plausible on its face."[16] "The plausibility standard is not akin to a probability requirement, but it asks for more than a sheer possibility that a defendant has acted unlawfully."[17] In evaluating a complaint, the court draws all reasonable inferences in the plaintiff's favor.[18] But the court is free to disregard conclusory allegations or legal conclusions couched as factual allegations.[19]

We also review *de novo* a district court's denial of leave to amend when denial is based on a legal interpretation, such as the conclusion that amendment would be futile.[20]

I. *Rule 10b-5(b)* Claims

The complaint alleges that defendants violated § 10(b) of the Exchange Act[21] and SEC Rule 10b-5(b).[22] Plaintiffs claim that defendants unlawfully published promotional articles and concealed an SEC investigation, all in an effort to artificially inflate the Company's stock price. Plaintiffs contend that when these infractions were brought to light, the stock price fell.

Under Rule 10b-5(b), it is "unlawful for any person, directly or indirectly, . . . [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of **[**12]** the circumstances under which they were made, not misleading" in connection with the purchase or sale of securities.[23] To support a claim for material misrepresentation under that rule, a plaintiff must plead: (1) a material misrepresentation or omission, (2) scienter, (3) a connection between the misrepresentation or omission and the purchase or sale of a security, (4) reliance on the misrepresentation or omission, (5) economic loss, and (6) loss causation.[24] The first two elements must be pled with **[*103]** heightened specificity pursuant to the Private Securities Litigation Reform Act of 1995 and Federal Rule of Civil Procedure 9(b).[25]

A. Stock Promotion Scheme

The complaint alleges that defendants omitted the

---

[15] Ganino v. Citizens Utils. Co., 228 F.3d 154, 161 (2d Cir. 2000).

[16] Ashcroft v. Iqbal, 556 U.S. 662, 678, 129 S. Ct. 1937, 173 L. Ed. 2d 868 (2009) (internal quotation marks omitted).

[17] *Id.* (internal quotation marks omitted).

[18] Palin, 940 F.3d at 809.

[19] Dixon v. von Blanckensee, 994 F.3d 95, 101 (2d Cir. 2021) (internal quotation marks omitted).

[20] Hutchison v. Deutsche Bank Sec. Inc., 647 F.3d 479, 490 (2d Cir. 2011).

[21] 15 U.S.C. § 78j.

[22] 17 C.F.R. § 240.10b-5.

[23] *Id.*

[24] Janus Cap. Grp., Inc. v. First Derivative Traders, 564 U.S. 135, 140 n.3, 131 S. Ct. 2296, 180 L. Ed. 2d 166 (2011).

[25] *See* 15 U.S.C. § 78u-4(b); Rombach v. Chang, 355 F.3d 164, 170 (2d Cir. 2004).

material fact that they were paying authors to promote the Company's stock. The district court found that defendants had no duty to disclose that fact and therefore made no material omission.

On appeal, plaintiffs first argue that defendants had a duty to disclose that the Company and IRTH paid the authors of the promotional articles because defendants provided content for, edited, reviewed, and/or approved those articles. But only an article's maker, not its benefactor, has a duty to disclose that it was paid for.[26] And the Supreme Court has made clear that neither the **[**13]** Company nor the individual defendants qualify as a maker here. In *Janus Capital Group v. First Derivative Traders*, the Court held that a mutual fund investment advisor could not be held liable for misstatements included in its client mutual funds' prospectuses.[27] "For purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it."[28] Thus, because the mutual funds filed the prospectuses with the SEC and had ultimate control over their content, they were the makers of the statements in the prospectuses. The investment advisor, even if he was involved in the preparation of the prospectuses, was not.[29]

The complaint does not adequately allege that defendants had ultimate control over the articles. It contains conclusory statements that "[d]efendants furnished information and language for, prepared, reviewed, approved, and/or ratified the articles,"[30] but does not contain sufficient factual allegations to support that contention. To be sure, the complaint alleges that Sicignano reviewed and approved statements in the Company's press releases,[31] which **[**14]** were then often copied and repeated by the promotional articles.[32] But a person's preparation of a press release that is then repeated in a separate article by a different author does not qualify that person as the "maker" of the separate article's statements. The Supreme Court specifically rejected a holding that would allow plaintiffs "to sue a person who 'provides the false or misleading information that another person then puts into [a] **[*104]** statement.'"[33] The complaint does not adequately allege that Sicignano directly wrote the articles, controlled what the authors put into the articles, or even saw them before their publication. "Threadbare recitals of the elements of a cause of action, supported by mere conclusory statements," are insufficient to state a claim.[34]

Moreover, even if Sicignano had provided some input on the content of the articles, the complaint does not support the conclusion that Sicignano had the "ultimate authority" necessary to brand him the articles' maker.[35] The complaint made no sufficient factual allegation that the articles were published by anyone except the authors. Nor did it sufficiently allege that those authors lacked final control over the articles' **[**15]** contents or did not make the ultimate decision as to what specific information to include. The complaint also does not contain sufficient factual allegations that defendants collaborated with the authors to such an extent that they controlled the articles' publication.[36] Here, any such

---

[26] Janus, 564 U.S. at 141 ("Under Rule 10b-5, it is unlawful for any person, directly or indirectly, to make any untrue statement of a material fact . . . . To be liable, therefore, [a defendant] must have 'made' the material misstatements . . . ." (internal quotation marks and alterations omitted)).

[27] Id. at 137-38.

[28] Id. at 142.

[29] Id. at 147-48. This finding is buttressed by Section 17(b) of the Securities Act, which provides that "[i]t shall be unlawful for any person . . . *to publish, give publicity to, or circulate* any . . . article . . . which . . . describes [a] security for a consideration received or to be received, directly or indirectly, from an issuer . . . without fully disclosing the receipt . . . of such consideration." 15 U.S.C. § 77q(b) (emphasis added). Again, only the publisher or author—the maker—of such articles can be liable under § 17(b) for failing to disclose that he has been paid for the article.

[30] Joint App. at 35.

[31] Joint App. at 35.

[32] *See, e.g.*, Joint App. 46-47.

[33] Janus, 564 U.S. at 144-45 (internal quotation marks omitted).

[34] Iqbal, 556 U.S. at 678.

[35] *See* Janus, 564 U.S. at 142-43 (noting that "[e]ven when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it," and so the speaker, but not the speechwriter, is its maker).

[36] *Cf.* In re Pfizer Inc. Sec. Litig., 819 F.3d 642, 657 (2d Cir. 2016) (finding that there was a genuine dispute as to whether Pfizer had ultimate authority over statements given by another

inference is pure speculation.

Plaintiffs next contend that defendants had a duty to disclose the article payments because defendants, in their SEC filings, affirmatively warned investors of the volatility of the Company's stock price. This argument also fails.

"Silence, absent a duty to disclose, is not misleading under *Rule 10b-5*."[37] *Rule 10b-5(b)*, however, makes unlawful the omission of a material fact "necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."[38] Thus, disclosure is required when a corporate statement would otherwise be "inaccurate, incomplete, or misleading."[39] In the Company's 2015-2017 10-Ks, defendants disclosed 19 different factors that could lead to stock price volatility but did not include its paid stock promotion scheme on the list.[40]

Notably, under *§ 17(b) of the Securities Act of 1933*, an issuer who merely pays an author to write positive **[**16]** articles on a stock does not, without more, violate the Act.[41] The articles themselves did little more than republish publicly-available content. Moreover, there is no allegation that the press releases, the content of which was captured in the articles themselves, were false or misleading.

[*105] Because the complaint does not adequately allege that defendants had a duty to disclose that they paid for the articles' publication, plaintiffs fail to state a claim that the existence of the stock promotion scheme constituted a materially misleading omission.

B. SEC Investigation

The complaint next alleges that defendants violated *Rule 10b-5(b)* by failing to disclose the SEC investigation into the Company's accounting controls. The district court found that defendants had no duty to disclose the investigation. Plaintiffs contend that defendants had such a duty because, by not mentioning the investigation, their disclosures of the accounting deficiencies were misleading. Here we agree with plaintiffs.

According to the complaint, throughout 2016 to 2018, the Company's 10-Ks and 10-Qs reported material weaknesses in its internal financial controls, until one 2018 10-Q reported that the Company had completed the **[**17]** implementation and testing of a remediation plan targeted at eliminating those weaknesses.[42] Relatedly, at some point prior to CW2's hiring in 2016, the SEC opened an investigation into the Company.[43] The Company retained counsel and CFO Brodfuehrer traveled to Washington, D.C. to meet with the SEC.[44] Then, in 2018, the SEC responded to a FOIA request by stating that its disclosure of information about any investigations into the Company from 2016 to 2018 "could reasonably be expected to interfere with enforcement proceedings."[45] After Fuzzy Panda published the SEC's response, the Company publicly denied any notice of an investigation or enforcement proceeding against it.

Defendants had a duty to disclose the SEC investigation in light of the specific statements they made about the Company's accounting weaknesses.[46] "Even when there is no existing independent duty to disclose information, once a company speaks on an issue or topic, there is a duty to tell the whole truth."[47] An omission is material when a reasonable investor would

---

company's employees because of a fax that stated that Pfizer and the other company *each* had to give final sign-off on statements given by those employees).

[37] *Basic Inc. v. Levinson, 485 U.S. 224, 239 n.17, 108 S. Ct. 978, 99 L. Ed. 2d 194 (1988)*; *see also* *Stratte-McClure v. Morgan Stanley, 776 F.3d 94, 101 (2d Cir. 2015)* ("[A]n omission is actionable under the securities laws only when the corporation is subject to a duty to disclose the omitted facts." (quotation omitted)).

[38] *17 C.F.R. § 240.10b-5(b)*.

[39] *Glazer v. Formica Corp., 964 F.2d 149, 157 (2d Cir. 1992)*.

[40] *See, e.g.*, Joint App. at 62-65.

[41] *See* *15 U.S.C. § 77q(b)*; *In re Galectin Therapeutics, Inc. Sec. Litig., 843 F.3d 1257, 1272-73 (11th Cir. 2016)*.

[42] Joint App. at 27, 78-79.

[43] Joint App. at 27-28.

[44] Joint App. at 28.

[45] Joint App. at 55-56.

[46] *See* *Setzer v. Omega Healthcare Invs., Inc., 968 F.3d 204, 214 n.15 (2d Cir. 2020)* (noting that *Rule 10b-5* imposes a duty to disclose not "all the facts that pertain to a subject," but rather only material facts).

[47] *Meyer v. Jinkosolar Holdings Co., 761 F.3d 245, 250 (2d Cir. 2014)*.

attach importance to it when making a decision.[48] Here, the fact of the SEC investigation would directly bear on the reasonable investor's assessment of the severity of **[**18]** the reported accounting weaknesses. Thus, the Company had a duty to disclose the SEC investigation into the weaknesses throughout the class period.[49] Because defendants here specifically noted the deficiencies and that they were working on the problem, and then stated that they had solved the issue, "the failure to disclose [the investigation] would cause a reasonable investor to make an overly optimistic assessment of the risk."[50]

[*106] Throughout this period, the existence of an SEC investigation related to the accounting weaknesses was material information that a reasonable investor would have wanted to know. Indeed, the nondisclosure remained a material omission even after the Company represented that it had rectified the problem because the SEC investigation was ongoing. By not disclosing that the SEC was investigating the Company's specific accounting weakness, defendants' statements about that weakness were not accurate and complete.

Finally, defendants' false public denial of any knowledge of the SEC investigation amounts to an admission of the materiality of its nondisclosure. Otherwise, the Company would not have tried to hide it. Moreover, these denials were affirmatively **[**19]** misleading in their own right. Thus, we easily find that the complaint adequately alleged that defendants violated Rule 10b-5(b) both by first omitting mention of the SEC investigation and then by affirmatively denying its existence.[51]

II. Rule 10b-5(a) and (c) Claims

The complaint next alleges that defendants violated Rule 10b-5, specifically subsections (a) and (c), by illegally manipulating the market through the stock promotion scheme.[52] The district court found that the complaint did not adequately allege a manipulative act or market activity sufficient to state a claim under those rules. We agree.

To state a claim for market manipulation under § 10(b) and Rules 10b-5(a) and (c), a plaintiff must allege: "(1) manipulative acts; (2) damage (3) caused by reliance on an assumption of an efficient market free of manipulation; (4) scienter; (5) in connection with the purchase or sale of securities; (6) furthered by the defendant's use of the mails or any facility of a national securities exchange."[53] Manipulation "connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities."[54] Accordingly, "[t]he critical question [is] what activity 'artificially' affects a security's price in a deceptive **[**20]** manner."[55] A court must ask whether a defendant injected inaccurate information into the marketplace.[56]

The complaint fails to support a claim that defendants manipulated the market. It does not allege that the market was manipulated by either the information in the articles, the payments to the writers, or the non-disclosure of the payments. There is no allegation that the articles themselves, which consisted of analysis and information derived from public filings, press releases, and statements by management, manipulated the market. Relatedly, there is no claim that defendants **[*107]** paying the articles' authors somehow manipulated the market or was intentionally designed to

---

48 *See* *Ganino, 228 F.3d at 161-62*.

49 *See* *Caiola v. Citibank, N.A., 295 F.3d 312, 331 (2d Cir. 2002)* ("[U]pon choosing to speak, one must speak truthfully about material issues. Once Citibank chose to discuss its hedging strategy, it had a duty to be both accurate and complete." (internal citations omitted)).

50 *Jinkosolar, 761 F.3d at 251*.

51 Defendants argue that plaintiffs' *§ 10(b)* material misrepresentation claims also should be dismissed for the additional reasons that the complaint fails to adequately plead scienter and loss causation. But the district court declined to consider those arguments. *Noto v. 22nd Century Grp., Inc., 2021 U.S. Dist. LEXIS 7477, 2021 WL 131050, at *2 n.1 (W.D.N.Y. Jan. 14, 2021)*. "It is this Court's usual practice to allow the district court to address arguments in the first instance." *Eric M. Berman, P.C. v. City of New York, 796 F.3d 171, 175 (2d Cir. 2015)* (per curiam) (quotation and alteration omitted). Accordingly, we do not address them here.

52 The complaint does not base this claim on the non-disclosure of the SEC investigation.

53 *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd., 493 F.3d 87, 101 (2d Cir. 2007)*.

54 *Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199, 96 S. Ct. 1375, 47 L. Ed. 2d 668 (1976)*.

55 *ATSI, 493 F.3d at 100*.

56 *Id. at 101*.

do so. While plaintiffs argue that the non-disclosure of defendants' payments to the authors was materially misleading to investors (the point addressed—and rejected in Part I), that, in and of itself, does not equate to market manipulation.[57] There is therefore no allegation that defendants affirmatively "injected" inaccurate information into the market: even *if* the payments were material, which we have determined not to be the case, because defendants were not the articles' "makers," they had no responsibility for the payments' **[**21]** disclosure. And there is no allegation that defendants directed the authors not to disclose the payments, or that defendants were anything but indifferent as to whether the authors did so. Thus, plaintiffs fail to plead that *defendants* engaged in any manipulative act sufficient to sustain a market manipulation claim based on the undisclosed payments.

III. Section 20(a) Claim

The complaint also alleges that Sicignano and Brodfuehrer are liable under the control person provision of *§ 20(a)* of the Exchange Act. To state a claim under *§ 20(a)*, a plaintiff must demonstrate, *inter alia*, a primary violation by the controlled person.[58]

The district court held that, because plaintiffs failed to plead a primary violation under *§ 10(b)* and *Rule 10b-5*, the dependent *§ 20(a)* claims must necessarily fail. Because we remand the *§ 10(b)* material misrepresentation claim based on the non-disclosure of the SEC investigation, we also vacate the *§ 20(a)* claim dismissal solely as it pertains to that particular non-disclosure.

IV. Leave to Amend

At the conclusion of their opposition to the motion to dismiss, plaintiffs requested an opportunity to amend their complaint should any part of defendants' motion be granted. The district court denied the request.[59] While **[**22]** we remand on the dismissal of the SEC investigation non-disclosure aspect of plaintiffs' *Rule 10b-5(b)* claim, we agree that plaintiffs should not be permitted to amend their complaint to reallege any violations stemming from the nondisclosure of the article promotion scheme.

"[T]his circuit strongly favors liberal grant of an opportunity to replead after dismissal of a complaint under *Rule 12(b)(6)*."[60] But a court need not always allow a party to replead simply because it asked. In particular, denial of leave to amend is proper "where the request gives no clue as to how the complaint's defects would be cured."[61] That is the situation here. In their briefing on appeal, plaintiffs contend that they could "cure any deficiencies with additional testimony . . . about [d]efendants' editing, review, and approval" of the promotional articles, but do not allege what specific facts they would include to demonstrate the level of control needed for *Rule 10b-5(b)* liability.[62] And, at oral argument, plaintiffs' counsel conceded that plaintiffs did not presently have any **[*108]** additional facts regarding defendants' control not already included in the complaint.[63] Plaintiffs also did not explain what they would add to demonstrate how defendants engaged **[**23]** in market manipulation related to the articles. The district court thus properly denied plaintiffs' request to replead their allegations stemming from the stock promotion scheme.

CONCLUSION

For the foregoing reasons, we AFFIRM in part and VACATE in part the judgment of the district court and REMAND for further proceedings consistent with this opinion.

End of Document

[57] *Id.* ("A market manipulation claim [] cannot be based solely upon misrepresentations or omissions.").

[58] *Id. at 108*.

[59] *Noto, 2021 U.S. Dist. LEXIS 7477, 2021 WL 131050, at *2 n.2*.

[60] *Porat v. Lincoln Towers Cmty. Ass'n, 464 F.3d 274, 276 (2d Cir. 2006)* (per curiam).

[61] *Loreley Fin. (Jersey) No. 3 Ltd. v. Wells Fargo Sec., LLC, 797 F.3d 160, 190 (2d Cir. 2015)* (internal quotation marks omitted).

[62] Appellants' Br. at 54.

[63] Oral Arg. Tr. at 31-32.

Pettry v. Gilead Scis., Inc.

Court of Chancery of Delaware

August 26, 2020, Submitted; November 24, 2020, Decided

C.A. No. 2020-0132-KSJM, C.A. No. 2020-0138-KSJM, C.A. No. 2020-0155-KSJM, C.A. No. 2020-0173-KSJM

Reporter

2020 Del. Ch. LEXIS 347 *; 2020 WL 6870461

DEBORAH PETTRY and GAIL FRIEDT, Plaintiffs, v. GILEAD SCIENCES, INC., Defendant.RICHARD C. COLLINS, Plaintiff, v. GILEAD SCIENCES, INC., Defendant.HOLLYWOOD POLICE OFFICERS' RETIREMENT SYSTEM, Plaintiff, v. GILEAD SCIENCES, INC., Defendant.ANTHONY RAMIREZ, Plaintiff, v. GILEAD SCIENCES, INC., Defendant.

Notice: THIS OPINION HAS NOT BEEN RELEASED FOR PUBLICATION. UNTIL RELEASED, IT IS SUBJECT TO REVISION OR WITHDRAWAL.

Subsequent History: Motion granted by, Costs and fees proceeding at *Pettry v. Gilead Scis., Inc., 2021 Del. Ch. LEXIS 156 (Del. Ch., July 22, 2021)*

Counsel: **[*1]** Blake A. Bennett, COOCH AND TAYLOR, P.A., Wilmington, Delaware; Brian J. Robbins, Stephen J. Oddo, Eric M. Carrino, ROBBINS LLP, San Diego, California; Counsel for Plaintiffs Deborah Pettry and Gail Friedt.

Kurt M. Heyman, Gillian L. Andrews, HEYMAN, ENERIO, GATTUSO & HIRZEL LLP, Wilmington, Delaware; Gustavo F. Bruckner, Daryoush Behbood, POMERANTZ LLP, New York, New York; Counsel for Plaintiff Richard C. Collins.

Gregory V. Varallo, BERNSTEIN, LITOWITZ, BERGER & GROSSMANN LLP, Wilmington, Delaware; David Wales, Alla Zayenchik, BERNSTEIN, LITOWITZ, BERGER & GROSSMANN LLP, New York, New York; Robert D. Klausner, KLAUSNER, KAUFMAN, JENSEN, & LEVINSON; Counsel for Plaintiff Hollywood Police Officers' Retirement System.

Gregory V. Varallo, BERNSTEIN, LITOWITZ, BERGER & GROSSMANN LLP, Wilmington, Delaware; Francis A. Bottini, Jr., Anne B. Beste, BOTTINI & BOTTINI, INC., La Jolla, California; Mark C. Molumphy, Tyson C. Redenbarger, Noorjahan Rahman, COTCHETT, PITRE & MCCARTHY, LLP; Counsel for Plaintiff Anthony Ramirez.

Brian C. Ralston, Aaron R. Sims, David M. Hahn, POTTER, ANDERSON & CORROON LLP, Wilmington, Delaware; John C. Dwyer, Shannon M. Eagan, Tijana Brien, Christopher Vail, COOLEY **[*2]** LLP, Palo Alto, California; Counsel for Defendant Gilead Sciences, Inc.

Judges: McCORMICK, V.C.

Opinion by: McCORMICK

Opinion

MEMORANDUM OPINION

McCORMICK, V.C.

Each of the five stockholder plaintiffs seeks to inspect books and records of Gilead Sciences, Inc. ("Gilead" or the "Company"). The stated purpose of their respective inspections is to investigate possible wrongdoing in connection with the Company's development, marketing, and sale of HIV drugs.[1] When a stockholder seeks inspection for the purpose of investigating wrongdoing, the stockholder must demonstrate a credible basis to suspect possible wrongdoing.

To demonstrate a credible basis, the complaint tells a story as replete with inequity as the biblical verse that the Company's namesake brings to mind.[2] In 2001,

[1] There are two forms of HIV, HIV-1 and HIV-2, and both can develop into the most severe phase of HIV infection, AIDS. While acknowledging that these are extremely important distinctions, this decision describes Gilead's products as "HIV" drugs or treatments to avoid overcomplicating an already complex set of facts.

[2] *See, e.g., Hosea* 6:8.

Gilead received FDA approval for tenofovir disoproxil fumarate ("TDF"), a life-saving medication for persons living with HIV. TDF has generated billions in revenue for Gilead year after year. These revenues incentivized Gilead to protect the market for TDF by forestalling the market entry of generic TDF and delaying the development of Gilead's safer TDF-substitute drug called tenofovir alafenamide ("TAF"). The plaintiffs say that there is a credible **[*3]** basis to suspect that Gilead violated antitrust laws, committed mass torts, infringed on government patents, and defrauded government programs in its efforts to protect the TDF market.

In stating their credible basis, the plaintiffs join in chorus with a host of other accusers. Gilead's activities have drawn lawsuits and investigations from persons living with HIV, activists, regulatory agencies, the Department of Justice, and Congress. As just one example, in 2019, activists and union benefit funds filed a class action complaint in federal court alleging that Gilead and its competitors violated federal and state antitrust laws by engaging in anticompetitive conduct to prevent competition in the market for TDF-based drugs. The plaintiffs in that case seek billions of dollars in damages. In March 2020, the federal court partially denied a motion to dismiss, allowing portions of the case to move forward.

The credible basis standard is widely described as the "lowest possible burden of proof" under Delaware law,[3] and Gilead does not meaningfully attack the plaintiffs' credible basis. Gilead half-heartedly argues that the plaintiffs' credible basis is merely an echo of unsubstantiated **[*4]** allegations made in other lawsuits and should be given no credence. But Gilead does not explain why a credible basis analysis should ignore allegations forming the basis of other lawsuits, and there is no principled ground for categorically disregarding such information.

Gilead's main strategy is to launch a number of peripheral attacks designed to chip away at the plaintiffs' proper purposes. Gilead asserts a defense based on *Wilkinson v. A. Schuman, Inc.*, in which this court denied inspection where the defendant proved that the plaintiff was a passive conduit in a purely lawyer-driven inspection effort.[4] As multiple subsequent decisions of this court have made clear, *Wilkinson* involved extreme facts, and Gilead's argument that five separate plaintiffs represented by four separate sets of counsel committed the same blunders found in *Wilkinson* borders on absurd. A corporation is entitled to assert defenses in a *Section 220* action and probe the bona fides of a plaintiff's stated purpose. In this case, however, Gilead's pursuit of the *Wilkinson* defense raises more questions about Gilead's purposes than the plaintiffs'.

Gilead asserts myriad other defenses, arguing that the plaintiffs **[*5]** should be denied inspection because any follow-on derivative claims they might pursue would not pass the pleading stage. Gilead peddles these points as "standing" arguments, presumably because this court recently rejected a series of nearly identical points when framed as "proper purpose" deficiencies.[5] This semantic sleight of hand is unsuccessful, and Gilead's so-called "standing" arguments fare no better.

As a fallback, Gilead makes a series of arguments concerning the scope of inspection, contending that inspection should be limited to formal board materials. This decision rejects those arguments because multiple other categories of documents are necessary and essential to the plaintiffs' stated purposes.

Regrettably, Gilead's overly aggressive defense strategy epitomizes a trend. As described recently by a group of scholars, defendants are increasingly treating *Section 220* actions as "surrogate proceeding[s] to litigate the possible merits of the suit" and "place obstacles in the plaintiffs' way to obstruct them from employing it as a quick and easy pre-filing discovery tool."[6] Defendants like Gilead adopt this strategy with the apparent belief that there is no real downside to doing so, **[*6]** ignoring that this court has the power to shift fees as a tool to deter abusive litigation tactics. Gilead's approach might call for fee shifting in this case, and the plaintiffs are granted leave to move for their expenses, including attorneys' fees, incurred in connection with their efforts to obtain books and records.

I. FACTUAL BACKGROUND

---

[3] *See, e.g., Seinfeld v. Verizon Communs., Inc., 909 A.2d 117, 123 (Del. 2006)*.

[4] *See 2017 Del. Ch. LEXIS 798, 2017 WL 5289553, at *3-4 (Del. Ch. Nov. 13, 2017)*.

[5] *See Leb. Cty. Employees' Ret. Fund v. Amerisourcebergen Corp., 2020 Del. Ch. LEXIS 17, 2020 WL 132752, at *6-24 (Del. Ch. Jan. 13, 2020)*.

[6] James D. Cox et al., *The Paradox of Delaware's "Tools at Hand" Doctrine: An Empirical Investigation, 75 Bus. Law. 2123, 2150 (2020)*.

The facts are drawn from the factual stipulations in the parties' pre-trial order, the testimony of each plaintiff (all by deposition and one also at trial), and the 262 joint trial exhibits submitted by the parties.[7]

A. Gilead's HIV Treatments

For more than a decade, Gilead has been a leader in the discovery, development, and commercialization of antiretroviral therapy for HIV.[8] Some estimate that Gilead controls approximately 75% of the HIV drug market.[9] Millions of people depend on Gilead's HIV treatments for their survival.[10] The corollary is that Gilead depends on the sale of HIV treatments for much of its financial survival. In 2019, for example, the sale of HIV treatments produced more than $16.4 billion in revenue or 73% of its top-line.[11]

A brief history **[*7]** of the development and commercialization of Gilead's HIV treatments lays the backdrop for this lawsuit. Gilead received Food and Drug Administration ("FDA") approval for its ground-breaking HIV treatment—TDF—in 2001.[12] Initially sold commercially as Viread, TDF was a significant improvement over other drugs.[13] After TDF was approved, Gilead shifted its efforts toward reducing the number of pills a persons infected with HIV would take daily. Gilead developed a combined formulation of TDF and a drug called emtricitabine that could be administered as a fixed-dose, once-daily tablet.[14] The result, Truvada, was approved as an HIV treatment in 2004.[15] Truvada was later approved for use by high-risk, uninfected adults as part of an HIV-preventative strategy called pre-exposure prophylaxis ("PrEP").[16] In addition to Viread and Truvada, the FDA approved three of Gilead's other TDF-based HIV treatments: Atripla in 2006, Complera in 2011, and Stribild in 2012.[17]

TDF poses safety risks for the patients' kidneys and bones.[18] In 2007, Gilead scientists published an article discussing TDF safety issues, which identified the most common adverse events as including renal failure, Fanconi syndrome, and serum **[*8]** creatinine increase.[19] In 2007, Gilead updated its labeling to recognize that TDF-associated renal damage also causes bone softening in patients.[20] A high dose of TDF is typically required to achieve the desired therapeutic effect.[21] The higher the dose of TDF, the greater are its toxic effects.[22]

Before the FDA approved Gilead's first TDF-based drug in 2001, Gilead had discovered another way of administering tenofovir—TAF.[23] TDF and TAF both deliver tenofovir to the target blood cells, but TAF delivers tenofovir more efficiently, which allows for a dose of less than one-tenth that of TDF.[24] The lower dosage in turn reduces toxicity levels and makes TAF safer than TDF.[25] Gilead highlighted the benefits of TAF-based drugs over its TDF-based drugs in a 2001 10-K,[26] and Gilead continued testing TAF through 2004, frequently touting positive results from clinical studies on

---

[7] Unless otherwise noted, pleadings are cited by reference to items docketed in C.A. No. 2020-0173-KSJM ("Dkt."). Factual citations are to: the Amended Pre-Trial Stipulation and Order, Dkt. 101 ("PTO"); Transcripts of Depositions of Richard C. Collins, Gail Friedt, Deborah Pettry, Anthony E. Ramirez, and Hollywood's *Rule 30(b)(6)* Representative, David M. Williams, Dkt. 82 (cited using the deponent's last name and "Dep. Tr."); the Trial Transcript, Dkt. 97 ("Trial Tr."); and Joint Trial Exhibits (cited by "JX" number).

[8] JX-213.

[9] *See, e.g.*, JX-250 at 2.

[10] *See* JX-213.

[11] *See* JX-135 at 34.

[12] JX-77 at 3.

[13] *See id.*

[14] *Id.* at 4.

[15] JX-3 at 1.

[16] JX-26 at 1.

[17] JX-27 at 1.

[18] JX-244 ¶ 215.

[19] JX-68 ¶ 221.

[20] *Id.* ¶ 224.

[21] *Id.* ¶ 212.

[22] *Id.*

[23] *Id.* ¶ 194.

[24] JX-68 ¶ 195; JX-41 at 1-2.

[25] *See id.*

[26] JX-68 ¶ 243 (citing Gilead Sciences, Inc., Form 10-K 13, https://www.sec.gov/Archives/edgar/data/882095/0000912057 02011690/a2073842z10-k.htm).

the market.[27]

Despite its safety benefits, Gilead shelved the development of TAF-based drugs in October 2004, attributing the decision to patients' increasing use of TDF-based Viread and the FDA approval of TDF-based Truvada, among other things.[28]

Gilead did not renew development of TAF-based drugs until 2010, six **[*9]** years after it shelved the project.[29] Gilead did not submit a new drug application for a TAF-based drug until November 2014.[30] When rolling out its TAF products, Gilead repeatedly marketed TAF as a safer replacement for TDF.[31]

Gilead expanded its TAF franchise through 2015, submitting new drug applications for a fixed-dose combination of emtricitabine and TAF and a single-tablet TAF regimen in April and July 2015, respectively.[32] The FDA approved Gilead's TAF-based treatment, Genvoya, in November 2015.[33] Within two weeks of Genvoya's approval, TAF became listed as a preferred treatment option under the U.S. Department of Health and Human Services guidelines.[34] Gilead later received approval for the TAF-based drugs Odefsey, Descovy, and Biktarvy.[35]

B. Criticisms of Gilead's Development and Commercialization of HIV Treatments

Gilead's development and commercialization of its HIV treatments has drawn extensive criticism from persons living with HIV, regulatory agencies, HIV activists, the Department of Justice (the "DOJ"), and Congress. Gilead has faced antitrust lawsuits, mass tort claims, patent infringement litigation, and False Claims Act investigations.

1. Anticompetitive [*10] Activities

Gilead is accused of delaying the launch of generic versions of its TDF-based HIV treatments by entering into anticompetitive licensing agreements with several branded drug manufacturers and collusive settlement agreements with generic drug manufacturers.[36]

Gilead is regulated by multiple agencies, including the FDA.[37] After a new drug is approved, federal law

[27] *Id.* ¶¶ 244-48.

[28] *Id.* ¶ 249 (quoting Press Release, Gilead, Gilead Discontinues Development of GS 9005 and GS 7340; Company Continues Commitment to Research Efforts in HIV (Oct. 21, 2004), https://www.gilead.com/news/press-releases/2004/10/gilead-discontinues-development-of-gs-9005-and-gs-7340-company-continues-commitment-to-research-efforts-in-hiv).

[29] *Id.* ¶ 255.

[30] JX-35 at 1.

[31] *See, e.g.*, JX-40 (describing TAF as a product for patients who wanted to "replace their current antiretroviral treatment regimen" and touting the "safety and efficacy" of TAF, despite acknowledging that "TAF-based regimens are investigational products and have not been determined to be safe or efficacious"); JX-42 at 2 (Gilead's then-EVP of Commercial Operations, Paul Carter, stating that "[Genvoya] has been launched in the context of HIV patient around the world who are getting older and older. And the average age in the US now is actually over 50 years, for an HIV patient. And HIV in itself causes renal issues and can have impact on bone density. And so, I think everyone is very happy to see that we now have a new generation of HIV single-tablet regimens which have a much better safety profile and tolerability and can be used for many, many years."); *id.* (stating that Genvoya would replace Truvada as the "backbone" component of the combination therapies); JX-58 at 2 (Gilead's President and CEO, John Milligan, stating that he hopes TAF will be the "safest gentlest, yet most powerful option" available to HIV patients).

[32] *See* JX-39 (fixed-dose combination TAF); JX-40 (single-tablet TAF regimen).

[33] JX-41 at 1.

[34] *See* JX-42 at 2 (noting that becoming listed that quickly as a preferred treatment option was "unprecedented").

[35] *See* JX-47 at 1 (Odefsey); JX-49 at 1 (Descovy); JX-64 at 1 (Biktarvy); *see also* JX-90 at 1 (press release announcing approval of Descovy for PrEP use). Gilead also received approval for certain TAF-based drugs used to treat Hepatitis B. In January 2016, Gilead submitted an application for TAF to treat chronic Hepatitis B. JX-45 at 1. In November 2016, the FDA approved Vemlidy, a TAF-based regimen, for the treatment of chronic Hepatitis B. JX-55 at 1.

[36] *See* JX-244.

[37] JX-135 at 20 ("Our operations depend on compliance with complex FDA and comparable international regulations. Failure to obtain broad approvals on a timely basis or to maintain compliance could delay or halt commercialization of

provides certain exclusivity benefits to pharmaceutical companies, such as a five-year new chemical exclusivity.[38] After four years of exclusivity, a generic manufacturer can file an Abbreviated New Drug Application ("ANDA") showing, among other things, that the generic drug contains the same active ingredients as the branded drug and does not infringe on the branded drug's patent.[39] If the branded drug manufacturer brings a claim against the generic drug manufacturer for patent infringement within the first 45 days after the filing of the ANDA, then the FDA stays the ANDA until the earlier of (a) the passage of 30 months running from date that exclusivity ends, or (b) the issuance of a decision holding that the patent is invalid or there was no infringement.[40] Thus, seven and a half years is usually the longest that a new **[*11]** chemical exclusivity period will run.

Generally, the introduction of a generic drug on the market causes price declines and sales erosion of branded drugs.[41] Branded drug manufacturers therefore have incentives to restrict and impede generics from entering the market.

Between 2004 and 2011, Gilead entered into a number of agreements with branded drug manufacturers, including Bristol-Myers Squibb Company ("Bristol-Myers"), Japan Tobacco, Inc. ("Japan Tobacco"), and Janssen R&D Ireland ("Janssen"), to create combination therapies that have multiple active ingredients or to license certain compounds for exclusive commercialization.[42] The agreements allegedly included "No-Generics Restraints" barring the creation of competing versions of the combination therapies that use generic TDF.[43]

In 2013, Gilead entered into a settlement agreement with the largest generic manufacturer in the world, Teva Pharmaceutical Industries Ltd. ("Teva").[44] Under the terms of the settlement, Teva would be prevented from

our products.").

[38] JX-244 at ¶¶ 88-91 (citing *21 U.S.C. §§ 355(j)(5)(F)(ii), 355(c)(3)(E)(ii)*; *21 C.F.R. § 314.108(b)(2)*). During this period, no other drug using that chemical as an active ingredient can obtain FDA approval.

[39] *Id.* ¶¶ 73-76 (citing *21 U.S.C. § 355(j)(8)(B)*).

[40] *See id.* ¶¶ 78, 88-91, 280 (citing *21 U.S.C. § 355*; *21 C.F.R. § 314.108(b)(2)*).

[41] A Federal Trade Commission study found that, on average, within one year of generic entry into the market, generics capture 90% of sales and prices decrease 85%. *Id.* ¶ 93 (citing FTC, Pay-for-Delay: How Drug Company Pay-Offs Cost Consumers Billions at 8 (January 2010), https://www.ftc.gov/sites/default/files/documents/reports/pay-delay-how-drug-company-pay-offs-cost-consumers-billions-federal-trade-commission-staff-study/100112payfordelayrpt.pdf). Gilead has recognized the potential for sales erosion in its public filings. *See, e.g.*, JX-135 at 12 ("[A]s new branded or generic products are introduced into major markets, our ability to maintain pricing and market share may be affected.").

[42] In December 2004, Gilead and Bristol-Myers formed a joint venture to develop and commercialize a once-daily, fixed-dose combination HIV treatment regimen later named Atripla. *See* JX-6 at 1; JX-74 ¶¶ 114-18. In March 2005, Gilead and Japan Tobacco entered into a licensing agreement that gave Gilead the exclusive right to develop and commercialize a novel HIV integrase inhibitor in all countries except Japan. JX-7 at 1. In July 2009 and June 2011, Gilead entered into licensing agreements with Janssen to develop and commercialize once-daily fixed-dose combination antiretroviral products. *See* JX-12 at 1 (press release announcing 2009 licensing agreement); JX-21 at 1 (press release announcing 2011 licensing agreement). (Janssen was formerly known as "Tibotec Pharmaceuticals." *See, e.g.*, JX-12; JX-21.) In December 2014, Gilead expanded its agreements with Janssen to allow for the development and commercialization of a new once-daily, single tablet regiment containing Gilead's TAF and emtricitabine, and Janssen's rilpivirine. JX-36 at 1. The agreement provided that the new product would be distributed by Janssen in "approximately 17 markets" and by Gilead in all other markets. *Id.* In October 2011, Gilead entered into a licensing agreement with BMS to develop and commercialize a fixed-dose combination of BMS's REYATAZ and Gilead's cobicistat—later named Evotaz. *See* JX-24 at 1; JX-242 at 23.

[43] JX-74 ¶¶ 89-112.

[44] *See* JX-29. In 2008, Teva submitted an ANDA requesting permission to manufacture and commercialize a generic version of Truvada. JX-10. Teva alleged that two of the patents associated with Truvada were invalid, unenforceable, or would not be infringed by Teva's manufacture of the product described in its ANDA. *Id.* If Gilead agreed, then Teva could begin producing its generic product immediately. If Gilead sued for patent infringement within 45 days, however, Teva would be unable to produce its generic product until the earlier of 30 months or a district court decision that is adverse to Gilead. *Id.* Gilead sued Teva for patent infringement less than 45 days after Teva submitted its ANDA. *See* JX-11. In 2012, Lupin Limited ("Lupin") and Cipla Ltd. ("Cipla") both submitted an ANDA to manufacture and commercialize generic versions of Truvada and Viread, respectively. JX-32 at 23. Gilead filed patent infringement lawsuits in response to those ANDA submissions as well. *Id.*

launching a generic version of Truvada until December 2017.[45] The settlement also reduced the incentives for ANDA second-filers to enter the market before December **[*12]** 2017 because the settlement allowed Teva to enter the market should a second-filer gain market entry.[46]

In 2017, a group of prominent HIV activists, including Peter Staley, implored the New York attorney general to investigate the Teva settlement and other agreements with generic drug manufacturers concerning the generic production of Truvada.[47] The activists accused Gilead of paying generic drug manufacturers to delay launching generics.[48]

In May 2019, Staley and others filed a thirteen count class action complaint against Gilead and other companies in the United States District Court for the Northern District of California (the "*Staley* Action").[49] The complaint alleges that Gilead and other branded drug manufacturers violated federal and state antitrust laws by engaging in anticompetitive conduct in the market for Gilead's TDF-based drugs.[50] Several additional class action lawsuits followed, and they were subsequently consolidated into the *Staley* Action.[51]

The plaintiffs in the *Staley* Action seek billions of dollars in damages on behalf of a class of persons who purchased or reimbursed purchasers of HIV treatments sold by Gilead and the other defendants.[52] On March **[*13]** 3, 2020, the United States District Court (the "District Court") in the *Staley* Action granted in part and denied in part Gilead's motion to dismiss, and granted leave to amend certain of the claims that were dismissed.[53]

In relevant part, the District Court dismissed with leave to amend the claims that there was an overarching conspiracy among Gilead, Bristol-Myers, Japan Tobacco, and Janssen.[54] The court dismissed with prejudice the claims based on the Gilead/Japan Tobacco licensing agreement because the plaintiffs did not plead any specific allegations that "the exclusive license would be used in an anticompetitive way."[55]

The District Court denied the motion to dismiss as to claims based on: the No-Generics Restraints in the Gilead/Bristol-Myers and Gilead/Janssen agreements; the Teva settlement agreement; and Gilead's commercialization of TAF.[56] As to the Gilead/Bristol-Myers and Gilead/Janssen agreements, the court found that a question of fact existed as to whether the No-Generics Restraints had sufficient anticompetitive effect to constitute an antitrust violation.[57] As to the Teva settlement agreement, the court cited several "yellow flag[s]" that could give rise to a finding **[*14]** of anticompetitive conduct.[58] As to Gilead's delayed commercialization of TAF, the District Court found that the plaintiffs have "a plausible argument that there is no

[45] *See* JX-29.

[46] *See* JX-74 ¶¶ 321-55.

[47] JX-59; JX-60.

[48] JX-59; JX-60.

[49] JX-74. On the same day that the *Staley* Action was filed, the House Committee on Oversight and Reform announced that it would hold a hearing to examine Gilead's pricing of Truvada. *See* JX-75. Gilead Chairman and CEO Daniel O'Day testified at the hearing on May 16, 2019. *See* JX-77. After discussing Gilead's contribution to the development of Truvada and related patents for PrEP, O'Day testified: "We priced Truvada, when it was originally approved, based on the price of its two component drugs, without adding a premium. We have increased its list price over the years at a rate consistent with average price increases in the industry." JX-77, at 2, 7-8. An expert later testified that "Gilead insisted on valuing drug shipments based on the commercial price in the United States, rather than the cost of manufacturing, which was at least 300 times less. . . . PrEP [treatments] can be manufactured and distributed, including a profit, for about $6 per person per month. Gilead charges more than $2100 per person per month, a 35000% markup." JX-76 at 3, 2-5. On June 26, 2019, the committee sent Gilead requests for documents and information regarding its pricing of Truvada. JX-81.

[50] JX-74.

[51] *See* JX-255.

[52] *See* JX-74 ¶ 429; *see also* PTO ¶ 4 ("If plaintiffs are successful in their claims, [Gilead] could be required to pay significant monetary damages or could be subject to permanent injunctive relief.").

[53] JX-242 at 85-87.

[54] *Id.* at 15-16.

[55] *Id.* at 32, 31-33.

[56] *Id.* at 85-86.

[57] *Id.* at 26.

[58] *Id.* at 41, 38-42.

procompetitive justification for" it.[59]

In January 2020, a group of healthcare insurers filed a class action against Gilead and other companies in a Florida federal court, asserting claims substantially similar to those in the *Staley* Action.[60]

2. Mass Torts

Gilead is accused of intentionally withholding from the market its safer and potentially more effective TAF-based HIV treatments in order to extend the sales window for its more dangerous and less effective TDF-based treatments.[61]

As discussed above, multiple parties have alleged that Gilead shelved the development of TAF after receiving approval for Truvada, even though Gilead knew that TAF was a safer product.[62] Gilead then allegedly waited to resume development and commercialization of TAF-based products until the introduction of generic TDF-based treatments was imminent.[63]

Gilead is the subject of at least 250 tort actions pending in state and federal courts in California, Delaware, and Florida. The actions involve more than 15,000 plaintiffs **[*15]** claiming that Gilead's TDF-based HIV medications caused them to suffer personal injury and economic loss.[64] If those claims are successful, Gilead "could be required to pay significant monetary damages."[65]

3. Patent Infringement

Gilead is accused of infringing on government patents in the sales of its HIV PrEP treatments.

The U.S. government claims that when administered as a PrEP treatment, Truvada and Descovy rely on patents developed by the Centers for Disease Control and Prevention ("CDC") and owned by the U.S. government.[66]

During a May 2019 hearing before the U.S. House Committee on Oversight and Reform, an expert in HIV research and clinical care testified:

> The US Government is by far the majority funder of PrEP research. PrEP regimen selection was guided by research conducted by scientists at the CDC who demonstrated that adding emtricitabine to a tenofovir regimen increased protection. . . . The critically important research done by scientists at the CDC led to a US Government patent on the combined use of emtricitabine and tenofovir esters for PrEP. . . . Gilead Sciences did not provide leadership, innovation, or funding for these projects; Gilead's role was limited to donating study **[*16]** medication and placebos. Our protocols were shared with Gilead, in accordance with an agreement between the [National Institutes of Health] and Gilead; I do not recall receiving any comments.[67]

On November 6, 2019, the U.S. government filed suit against Gilead.[68] The complaint alleges that Gilead has wrongfully denied the validity of the CDC's patents and refused to obtain a license from the CDC to use the patented regimens.[69]

---

[59] *Id.* at 46. On April 21, 2020, the plaintiffs in the *Staley* Action filed an amended complaint, and on May 4, Gilead filed a motion to dismiss the amended complaint. *See* JX-175 (motion to dismiss amended complaint); JX-244 (amended complaint).

[60] *See* JX-117; *see also* JX-118 at 3 ("The allegations are similar to those made in four consolidated class actions against Gilead pending in the Northern District of California.").

[61] *See* JX-252; *see also* PTO ¶ 4 (noting that "Gilead has been named as a defendant in product liability lawsuits related to Gilead's HIV medications").

[62] *See, e.g.*, JX-244 ¶¶ 236-98; JX-252.

[63] *See* JX-244 ¶¶ 236-98; JX-252.

[64] *See* JX-134 at 80; JX-255 at 2.

[65] PTO ¶ 4; JX-134 at 80.

[66] JX-73 at 1.

[67] JX-76 at 2. The expert, Professor Robert M. Grant, is a credible source. As he explained to the committee, he had decades of experience "with research and clinical care related to HIV," "pioneered research on PrEP that led to FDA approval in 2012 [and] recommendations from the CDC in 2014," and "devoted . . . 20 years of [his] career to the development of PrEP." *Id.*

[68] JX-98; *see also* JX-99 (11/8/19 New York Times article discussing the lawsuit); JX-102 (11/8/19 Science Magazine article discussing the lawsuit).

[69] *Id.* ¶¶ 8-9.

In February 2020, the Patent Trial and Appeals Board declined to institute Gilead's petitions for *inter partes* review of the four U.S. government-held patents, finding that Gilead "has not demonstrated a reasonable likelihood of prevailing."[70]

In April 2020, Gilead filed a lawsuit against the U.S. government related to the use of the same anti-HIV regimens.[71] Gilead's complaint alleges that the CDC breached the agreements between the parties and the government's patents are therefore invalid and unenforceable.[72]

4. False Claims Act Violations

Gilead is currently facing a federal investigation and civil litigation related to alleged violations of the False Claims Act.[73]

Under federal law, drug companies cannot provide direct **[*17]** copayment assistance to patients covered by Medicare.[74] Drug companies are permitted to donate to charities that help Medicare patients, so long as the companies' donations do not exert sway over the nonprofit's operations.[75] If a drug company uses donations to encourage a nonprofit to promote the company's products, however, that conduct may violate anti-kickback laws.[76]

On May 27, 2016, Gilead received a subpoena from the U.S. Attorney for the District of Massachusetts seeking documents related to the Company's relationship with nonprofits that provide financial assistance to patients.[77] Corporate disclosures "describe an expanding investigation by the U.S. Attorney's Office" into Gilead and other pharmaceutical companies' potential kickback violations.[78] In December 2017, one of the companies agreed to pay $210 million to resolve the Justice Department's claims.[79]

C. The Inspection Demands

The plaintiffs are Deborah Pettry, Gail Friedt, Richard C. Collins, Hollywood Police Officers' Retirement System ("Hollywood"), and Anthony Ramirez (collectively, "Plaintiffs"). Each Plaintiff made a written demand on Gilead to inspect and copy certain books and records of the **[*18]** Company pursuant to Section 220 (collectively, the "Demands").[80] The Demands sought to investigate possible wrongdoing in connection with aspects of the development and commercialization of Gilead's HIV treatments.[81]

Gilead declined to provide even a single document in response to any of the Demands, taking the position that each Demand was unfounded and deficient.[82]

---

[70] JX-246 at 21; JX-247 at 12.

[71] JX-170, *Gilead Scis., Inc. v. United States*, 1:20-cv-00499-CFL (Fed. Cl. Apr. 24, 2020).

[72] *Id.* ¶¶ 1-21.

[73] *See* JX-50; JX-88.

[74] JX-51 at 1.

[75] *Id.*

[76] *Id.*

[77] JX-50.

[78] JX-51.

[79] JX-61. Gilead is also facing a *qui tam* action alleging False Claims Act violations related to the Company's TDF- and TAF-based Hepatitis-B treatments. JX-88. On September 19, 2019, a group of plaintiffs filed a second amended *qui tam* complaint against Gilead in Pennsylvania federal court, alleging multiple violations of the anti-kickback provisions of the False Claims Act. *See id.* ¶¶ 1, 12-13. The complaint alleges that Gilead used its speaker program and other methods to encourage healthcare providers to write prescriptions for Gilead's name-brand drugs as opposed to generics. *Id.* ¶¶ 1-6. In particular, the complaint alleges that Gilead used illegal kickbacks to encourage healthcare providers to transition patients from Viread, a TDF-based drug that was about to face generic competition, to Vemlidy, its new TAF-based drug. *Id.* ¶¶ 30-35.

[80] *See* JX-103 (Collins's 12/2/19 inspection demand); JX-114 (Collins's 1/13/20 reply to Gilead's initial response); JX-128 (Collins's 2/18/20 supplemental demand); JX-108 (Pettry's 12/30/19 inspection demand); JX-113 (Friedt's 1/8/20 inspection demand); JX-120 (Pettry and Friedt's 1/29/20 consolidated reply to Gilead's initial response); JX-123 (Ramirez's 2/4/20 inspection demand); JX-136 (Ramirez's 2/27/20 reply to Gilead's initial response); JX-124 (Hollywood's 2/10/20 inspection demand).

[81] *See infra* note 95 and accompanying text.

[82] *See* JX-106 (Gilead's 12/10/19 response to Collins's initial demand); JX-130 (Gilead's 2/25/20 response to Collins's supplemental demand); JX-115 (Gilead's 1/15/20 response to Pettry's demand); JX-116 (Gilead's 1/15/20 response to

D. This Litigation

Each Plaintiff filed suit under *Section 220* to enforce their inspection rights, with Pettry and Friedt filing a joint complaint.[83] Gilead answered the complaints.[84]

Gilead requested that the court enter and order requiring Plaintiffs to coordinate their efforts,[85] and the parties stipulated to a coordinated schedule and approach to discovery.[86]

Gilead served interrogatories on, sought documents from, and moved to compel discovery from Plaintiffs.[87] Gilead also deposed each Plaintiff.[88]

Gilead fought discovery directed to it and moved for a protective order, which the court denied.[89]

The court held trial on June 23, 2020, and the parties completing post-trial briefing on August 26, 2020.

II. LEGAL ANALYSIS

To inspect books and records under *Section 220*, a plaintiff must establish by a preponderance of the evidence that **[*19]** the plaintiff is a stockholder, has complied with the statutory form and manner requirements for making a demand, and has a proper purpose for conducting the inspection.[90] If a stockholder meets these requirements, the stockholder must then establish "that each category of the books and records requested is essential and sufficient to the stockholder's stated purpose."[91]

Gilead disputes two of these requirements, arguing that Plaintiffs lack proper purposes and have failed to justify the scope of their inspections. Gilead also raises what it refers to as "standing" issues, arguing that Plaintiffs must overcome defenses to anticipated derivative claims in order to have standing to enforce their rights in this *Section 220* action. Gilead's so-called "standing" arguments in substance speak to Plaintiffs' proper purposes and this decision addresses the arguments in that context.

A. Each Plaintiff Has Demonstrated a Proper Purpose.

"The paramount factor in determining whether a stockholder is entitled to inspection of corporate books and records is the propriety of the stockholder's purpose in seeking such inspection."[92] A purpose is "proper" under *Section 220* where it is "reasonably related" **[*20]** to the stockholder's interest as a stockholder.[93] "In a *section 220* action, a stockholder has the burden of

Friedt's demand, containing multiple mistaken references to "Ms. Pettry" as opposed to "Ms. Friedt"); JX-126 (Gilead's 2/14/20 response to Pettry and Friedt's 1/29/20 communication); JX-125 (Gilead's 2/11/20 response to Ramirez's 2/4/20 demand); JX-139 (Gilead's 3/2/20 response to Ramirez's 2/27/20 communication); JX-127 (Gilead's 2/18/20 response to Hollywood's demand); JX-131 (Gilead's 2/25/20 rejection of Hollywood's invitation to meet and confer).

[83] *See* JX-132; JX-137; JX-140; JX-141; *see also* JX-129.

[84] JX-142; JX-144; JX-261; JX-262.

[85] Dkt. 5, Def.'s Resp. to Pls.' Mots. for Expedited Proceedings at 5-6 ("Gilead respectfully submits that the Court should enter an order coordinating the actions.").

[86] Dkt. 8, Stipulation and Appointment of Counsel and Case Scheduling Order.

[87] *See* JX-147 (Def.'s First Set of Interrogs. Directed to Pls.); JX-148 (Def.'s First Set of Reqs. for Produc. of Docs. Directed to Pls.); Dkt. 38, Def.'s Mot. to Compel Disc. from Pls. Plaintiffs provided Defendants with responses and supplemental responses to these requests. *See* JX-155; JX-156; JX-157; JX-158; JX-159; JX-160; JX-161; JX-162; JX-163; JX-167; JX-169.

[88] *See* Dkt. 82.

[89] *See* Dkt. 17, Def.'s Mot. for Protective Order; Dkt. 65, May 8, 2020 Oral Arg. re Def.'s Mot. for Protective Order and the Ct.'s Ruling; *see also* JX-164 (Def's. Responses and Objs. to Pls.' Am. First Set of Interrogs. Directed to Def. Gilead Sciences, Inc.); JX-149 (Pls.' Am. Notice of *Rule 30(b)(6)* Dep. of Def. Gilead Sciences, Inc.).

[90] *See* *8 Del. C. § 220(c)*; *Cent. Laborers Pension Fund v. News Corp., 45 A.3d 139, 144 (Del. 2012)*; *Amalgamated Bank v. Yahoo! Inc., 132 A.3d 752, 775 (Del. Ch. 2016)*, *abrogated on other grounds by* ***Tiger v. Boast Apparel, Inc., 214 A.3d 933 (Del. 2019)***.

[91] *Thomas & Betts Corp. v. Leviton Mfg. Co., 681 A.2d 1026, 1035 (Del. 1996)* (citing *Helmsman Mgmt. Servs., Inc. v. A & S Consultants, Inc., 525 A.2d 160, 167 (Del. Ch. 1987))*.

[92] *CM & M Gp., Inc. v. Carroll, 453 A.2d 788, 792 (Del. 1982)* (citing *8 Del. C. § 220(b)*; *Gen. Time Corp. v. Talley Indus., 43 Del. Ch. 531, 240 A.2d 755 (Del. 1968)*; *Skoglund v. Ormand Indus., 372 A.2d 204, 207 (Del. Ch. 1976))*.

[93] *8 Del. C. § 220(b)*.

proof to demonstrate a proper purpose by a preponderance of the evidence."[94]

The Demands state that they are for the purpose of investigating possible mismanagement, wrongdoing, or waste in connection with aspects of the development and commercialization of Gilead's HIV treatments, although each Demand uses slightly different verbiage to express this purpose.[95]

Although a stockholder's desire to investigate wrongdoing is a proper purpose under Delaware law,[96] a mere statement of that purpose without more will not entitle a stockholder to inspection.[97] To inspect documents for the purpose of investigating mismanagement or wrongdoing, a stockholder "must present some evidence to suggest a credible basis from which a court can infer that mismanagement . . . or wrongdoing may have occurred."[98]

Gilead argues that no Plaintiff has demonstrated a credible basis to suspect possible wrongdoing.[99] Gilead further argues that each Plaintiff is acting as a Manchurian candidate for a law firm such that none of Plaintiffs' stated purposes are their own.[100] Gilead additionally argues that legal defenses **[*21]** to a follow-on lawsuit challenging the wrongdoing foreclose Plaintiffs' ability to investigate possible wrongdoing under Section 220.[101]

1. Plaintiffs Have Demonstrated a Credible Basis to Suspect Wrongdoing.

The credible basis standard imposes "the lowest possible burden of proof."[102] It does not require a stockholder to prove that the wrongdoing "actually occurred."[103] Nor does it require a stockholder "to show

---

[94] Seinfeld, 909 A.2d at 121.

[95] Collins seeks to "[i]nvestigat[e] whether any member of the Board or the Company's senior officers have mismanaged the Company and/or breached their fiduciary duties to the Company and its stockholders." JX-103 at 5; JX-128 at 15. Friedt and Petty seek to "investigate potential corporate mismanagement, wrongdoing, and waste by fiduciaries of the Company, including the [Board]." JX-108 at 1; JX-113 at 1. Hollywood seeks to investigate "possible breaches of fiduciary duty," "possible violations of positive law," "possible corporate misconduct by members of the [Board] and/or management in connection with . . . core HIV products," and "possible prolonged concealment of the misconduct described herein." JX-124 at 1. Ramirez seeks to "investigate whether the [Board] and certain senior Gilead executives may have breached their fiduciary duties to the Company by engaging in massive and long-standing wrongdoing in connection with the Company's development, patenting, marketing of, and restraints related to, its antiviral HIV/AIDS drugs." JX-89 at 4. Some of the demands also state that they are for the purpose of assessing the independence and disinterestedness of the members of the Board with respect to the possible wrongdoing at issue, *see* JX-124 at 1; JX-103 at 5; JX-128 at 15, but Plaintiffs did not treat this as an independent purpose in briefing. *See* Dkt. 100, Pls.' Corrected Combined Post-Trial Br. ("Pls.' Opening Br.") at 3-45, 56; Dkt. 104, Pls.' Combined Post-Tr. Reply Br. at 3-24, 32. This decision treats Plaintiffs' desire to investigate the independence and disinterestedness of Gilead's Board members as a component of its investigation into possible wrongdoing. *See infra* Section II.C.2.e.

[96] *E.g.*, ***KT4 Partners LLC v. Palantir Techs., Inc., 203 A.3d 738, 758 (Del. 2019)*** ("One of the most traditional proper purposes for a § 220 demand is the investigation of possible wrongdoing by management. When a stockholder has made a colorable showing of potential wrongdoing, inspecting the company's books and records can help the stockholder to ferret out whether that wrongdoing is real and then possibly file a lawsuit if appropriate."); City of Westland Police & Fire Ret. Sys. v. Axcelis Techs., Inc., 1 A.3d 281, 287 (Del. 2010) ("Our law recognizes investigating possible wrongdoing or mismanagement as a 'proper purpose.'"); Seinfeld, 909 A.2d at 121 ("It is well established that a stockholder's desire to investigate wrongdoing or mismanagement is a 'proper purpose.' Such investigations are proper, because where the allegations of mismanagement prove meritorious, investigation furthers the interests of all stockholders and should increase stockholder return.").

[97] Seinfeld, 909 A.2d at 122 (quoting Helmsman, 525 A.2d at 166).

[98] Id. at 118 (internal quotation marks omitted).

[99] Dkt. 102, Def. Gilead Sciences, Inc.'s Post-Trial Answering Br. ("Def.'s Answering Br.") at 5-15.

[100] *Id.* at 22-36.

[101] *See id.* at 36-44.

[102] Seinfeld, 909 A.2d at 123.

[103] Marmon v. Arbinet-Thexchange, Inc., 2004 Del. Ch. LEXIS 44, 2004 WL 936512, at *4 (Del. Ch. Apr. 28, 2004); *accord.* Thomas & Betts, 681 A.2d at 1031 ("While stockholders have the burden of coming forward with specific and credible allegations sufficient to warrant a suspicion of waste and mismanagement, they are not required to prove by a

by a preponderance of the evidence that wrongdoing is probable."[104] Any such requirement "would completely undermine the purpose of Section 220 proceedings, which is to provide shareholders the access needed to make that determination in the first instance."[105] Rather, a stockholder need only establish by a preponderance of the evidence that there is a credible basis to suspect a *possibility* of wrongdoing.[106]

In determining whether a plaintiff has presented a credible basis for inspection, the court looks at the allegations collectively.[107] The "threshold may be satisfied by a credible showing, through documents, logic, testimony or otherwise, that there are legitimate issues of wrongdoing."[108] When evaluating whether a credible basis exists, the court may consider on-going lawsuits, **[*22]** investigations, circumstantial evidence, and even hearsay statements evincing possible wrongdoing.[109]

The Demands seek to investigate four categories of possible wrongdoing:

1. Anticompetitive activity resulting in a multi-billion dollar lawsuit accusing Gilead of violating federal and state antitrust laws by colluding with its competitors to unlawfully extend patent protection and drive up the price of its HIV drugs;[110]
2. Mass torts resulting in more than 15,000 claims by plaintiffs who allege that they were seriously harmed by Gilead's decision to intentionally delay the introduction of safer and more effective HIV treatments in order to protect the profitability of existing branded medications;[111]
3. Patent infringement resulting in a lawsuit by the DOJ against Gilead for its "deliberate" and "wanton" infringement of patents held by the federal government relating to PrEP treatment regimens;[112] and
4. Kick-back schemes resulting in DOJ investigations into False Claims Act violations.[113]

At trial, Plaintiffs presented evidence to establish a credible basis to suspect possible wrongdoing in connection **[*23]** with each of these four categories.

preponderance of the evidence that waste and mismanagement are actually occurring.").

[104] *AmerisourceBergen, 2020 Del. Ch. LEXIS 17, 2020 WL 132752, at *8*.

[105] *La. Mun. Police Emples. Ret. Sys. v. Countrywide Fin. Corp. (LAMPERS), 2007 Del. Ch. LEXIS 138, 2007 WL 2896540, at *12 (Del. Ch. Oct. 2, 2007)*, *order clarified*, *2007 Del. Ch. LEXIS 175, 2007 WL 4373116 (Del. Ch. Dec. 6, 2007)*.

[106] *See* *AmerisourceBergen, 2020 Del. Ch. LEXIS 17, 2020 WL 132752, at *8-9*; *see also* *Seinfeld, 909 A.2d at 118* (holding that a Section 220 plaintiff need only allege a "'credible basis' from which a court can infer that mismanagement, waste or wrongdoing *may* have occurred" (emphasis added)).

[107] *See, e.g.,* *In re Lululemon Athletica Inc. 220 Litig., 2015 Del. Ch. LEXIS 127, 2015 WL 1957196, at *11-14 (Del. Ch. Apr. 30, 2015)* (collectively assessing founder's inside knowledge based on company emails, suspicious timing and magnitude of founder's trades, and the speed at which founder hit his monthly trading cap); *Paul v. China MediaExpress Holdings, Inc., 2012 Del. Ch. LEXIS 3, 2012 WL 28818, at *4 (Del. Ch. Jan. 5, 2012)* (determining that plaintiff had identified a credible basis for Section 220 demand based on evidence which included "numerous third-party media reports," "the noisy resignations of three board members" and a publicly announced "internal investigation").

[108] *Seinfeld, 909 A.2d at 123* (quoting *Sec. First Corp. v. U.S. Die Casting & Dev. Co., 687 A.2d 563, 568 (Del. 1997))*.

[109] *See, e.g.,* *AmerisourceBergen, 2020 Del. Ch. LEXIS 17, 2020 WL 132752, at *9* ("Ongoing investigations and lawsuits can provide the necessary evidentiary basis to suspect wrongdoing or mismanagement warranting further investigation. This type of evidence is strong when governmental agencies or arms of law enforcement have conducted the investigations or pursued the lawsuits."); *LAMPERS, 2007 Del. Ch. LEXIS 138, 2007 WL 2896540, at *10-12* (finding a news article and independent statistical analysis of stock option grant dates sufficient to suspect options backdating); *Elow v. Express Scripts Holding Co., 2017 Del. Ch. LEXIS 92, 2017 WL 2352151, at *5, *5-6 (Del. Ch. May 31, 2017)* (finding "pleadings in the Anthem Action, the Securities Action complaints, and public statements by Express Scripts" sufficient to establish a credible basis), *abrogated on other grounds by* ***Tiger, 214 A.3d 933***; *Carapico v. Phila. Stock Exch., Inc., 791 A.2d 787, 792 (Del. Ch. 2000)* (finding an "SEC inquiry" and "SEC Order" were "sufficiently concrete" to suspect mismanagement).

[110] *See* JX-113 at 1; JX-123 at 1-2; JX-124 at 4; JX-128 at 1.

[111] *See* JX-124 at 3-4; JX-128 at 1.

[112] *See* JX-103 at 1; JX-113 at 1; JX-124 at 5-6; JX-128 at 1.

[113] *See* JX-128 at 1.

To demonstrate a credible basis as to the anticompetitive activity, Plaintiffs rely primarily on the allegations and information contained in the *Staley* complaint as well as the federal court's decision on the motion to dismiss the *Staley* Action.[114] The *Staley* complaint spans 134 pages and outlines a litany of allegedly anticompetitive conduct, reflecting significant research by the plaintiffs in that action.[115] The parties to the *Staley* Action collectively filed thirty-eight exhibits during briefing on a motion to dismiss, including copies of the relevant agreements.[116]

The *Staley* complaint discusses three broad categories of conduct that allegedly delayed the entry of generic competition: (i) No-Generics Restraints in agreements between Gilead and Japan Tobacco, Gilead and Bristol-Myers, and Gilead and Janssen; (ii) the Teva settlement; and (iii) the commercialization of TAF.[117] These categories of action are allegedly part of a broader scheme to restrain competition and increase the prices of HIV drugs.[118] The complaint contends that the No-Generics Restraints barred the creation of competing versions of combination **[*24]** therapies that use generic TDF.[119] The complaint further contends that the Teva settlement delayed Teva's entry in the TDF market and created disincentives for ANDA second-filers to launch their products. By thwarting the market entry of generic TDF, these agreements allowed Gilead to continue to charge high prices for TDF-based Stribild despite its toxicity, and later help Gilead shift prescriptions from Stribild to TAF-based Genvoya.[120] The agreements also allowed Gilead to avoid being pressured to release a standalone TAF product, because prescribers could not pair Gilead's standalone TAF with drugs offered by Gilead's competitors.[121] The plaintiffs allege that Gilead's actions, taken collectively, "unlawfully manipulated the regulatory framework in order to impair and delay . . . competition."[122]

In response to Gilead's motion to dismiss, the District Court held that the plaintiffs' allegations regarding the Gilead/Bristol-Myers, Gilead/Janssen, and Gilead/Teva agreements and the commercialization of TAF stated a claim on which relief could be granted.[123] The federal motion-to-dismiss standard is higher than Section 220's credible basis standard.[124] It follows that allegations which survive **[*25]** a motion to dismiss under the federal standard are sufficient to meet the credible basis standard. Thus, the court finds that the allegations that survived the motion to dismiss in the *Staley* Action supply a credible basis to suspect possible wrongdoing as to the Gilead/Bristol-Myers, Gilead/Janssen, and Gilead/Teva agreements and the commercialization of TAF.

To demonstrate a credible basis as to the mass torts, Plaintiffs rely on the allegations and information in the pleadings in state and federal courts in California, Delaware, and Florida.[125] The mass tort class action in California, as of June 12, 2020, involved more than 15,000 plaintiffs.[126] The complaint in that action runs forty-four pages, alleges injuries stemming from Gilead's decision to intentionally delay its TAF-based HIV drugs,

[114] *See* Pls.' Opening Br. at 7-9.

[115] *See* JX-74.

[116] *See* Decl. of Jayne A. Goldstein in Supp. of Pls.' Omnibus Mem. in Opp'n to Defs.' Mot. to Dismiss, *Staley v. Gilead Scis., Inc.*, Case No. 3:19-cv-02573-EMC (N.D. Cal. 2019); Decl. of Heather M. Burke in Supp. Of Gilead's Mot. to Dismiss, *Staley*, Case No. 3:19-cv-02573-EMC. The court can take judicial notice of these filings because they are "not subject to reasonable dispute." *See, e.g., In re Gen. Motors (Hughes) S'holder Litig., 897 A.2d 162, 169 (Del. 2006)* (citing *D.R.E. 201(b)*).

[117] *See* JX-74 ¶¶ 88-355.

[118] *Id.* ¶¶ 1-15.

[119] *Id.* ¶ 4.

[120] *Id.* ¶¶ 237-44.

[121] *Id.* ¶ 245.

[122] *Id.* ¶ 285.

[123] *See* JX-242 at 85-86. The court dismissed the overarching conspiracy claims and the claim related to the Gilead/Japan Tobacco agreement. JX-242 at 15, 33. Plaintiffs have since filed an amended complaint. *See* JX-244.

[124] *Compare* *Bell Atl. Corp. v. Twombly, 550 U.S. 544, 570, 127 S. Ct. 1955, 167 L. Ed. 2d 929 (2007)* (requiring a plaintiff to plead facts sufficient to "nudge[] their claims across the line from conceivable to plausible") *and* *Ashcroft v. Iqbal, 556 U.S. 662, 679, 129 S. Ct. 1937, 173 L. Ed. 2d 868 (2009)* (requiring a Section 220 plaintiff seeking to investigate wrongdoing to holding that the *Twombly* plausibility standards applies to all civil cases in federal courts) *with* *Seinfeld, 909 A.2d at 123* (describing the credible basis standard as "the lowest possible burden of proof" (internal quotation markets omitted)).

[125] Pls.' Opening Br. at 9-11.

[126] JX-255 at 2.

and asserts claims for negligence, strict product liability, breach of express warranty, breach of implied warranty, fraud, and concealment.[127] In particular, the complaint alleges that Gilead developed and marketed its toxic TDF-based medications and withheld the safer TAF-based medications from the market.[128] Rather than releasing the TAF-based medication, Gilead allegedly **[*26]** continued to add ingredients to its existing TDF-based medications "in order to extend its monopoly on tenofovir in the treatment of HIV-1."[129] The plaintiffs contend that Gilead did so knowing that reasonable alternatives were not available to patients.[130] The complaint references and quotes from papers that Gilead has published, submissions that Gilead made to U.S. and European patent offices, public announcements by Gilead representatives, statistics that have been corroborated by the CDC, studies conducted by third parties, and FDA findings.[131] The plaintiffs' complaint is cohesive and coherent, and the information and allegations in the complaint as well as the myriad evidence supporting it, supply a credible basis to suspect possible wrongdoing in the form of mass torts.

To demonstrate a credible basis as to patent infringement, Plaintiffs rely on congressional testimony and subsequent litigation regarding Gilead's alleged infringement of U.S. government patents in the sales of Gilead's HIV PrEP treatments.[132] After an expert provided the U.S. House Committee on Oversight with a detailed description of his work with the CDC and Gilead,[133] the U.S. **[*27]** government filed a patent infringement lawsuit against Gilead.[134] The complaint totaled 1,739 pages including the ninety-two attached exhibits, and its filing was reported by multiple news outlets.[135] The exhibits included the relevant patents, various news articles, and relevant scholarship from the scientific community.[136] When Gilead sought review of the U.S. government's patents, the Patent Trial and Appeals Board held that Gilead "has not demonstrated a reasonable likelihood of prevailing."[137] The thoroughness of the U.S. government's complaint and the Patent Trial and Appeals Board's ruling easily clear the hurdle to establish a credible basis to suspect possible wrongdoing as to patent infringement.

To demonstrate a credible basis as to False Claims Act violations, Plaintiffs rely on the existence of four subpoenas issued by the DOJ.[138] By 2016, Gilead was the subject of an "expanding investigation" by the U.S. Attorney for the District of Massachusetts related to possible violations of the False Claims Act.[139] As disclosed in its public filings, Gilead received subpoenas in 2016 and 2017 requesting documents related to Gilead's relationship with certain charitable organizations, **[*28]** Gilead's copay coupon program, and Gilead's Medicaid price reporting methodology.[140]

Further, Gilead is facing a *qui tam* action in Pennsylvania federal court that alleges multiple violations of the anti-kickback provisions of the *False Claims Act*.[141] Although that action focuses on Hepatitis

[127] *See* JX-82. Further illustrating the scope of the litigation, Gilead produced nearly 2.6 million pages of documents in response to the plaintiffs' first and second requests for production—including FDA regulatory files, license agreements, a listing of clinical trials, and other documents—and trial is set for January 2022. *See id.*; JX-255 at 10-11.

[128] JX-82 ¶¶ 12-14, 33-48.

[129] *Id.* ¶¶ 76, 51-86.

[130] *Id.* ¶ 2.

[131] *See, e.g., id.* ¶ 40 (quoting Gilead paper comparing the relative effectiveness and safety of TAF as compared to TDF); *id.* ¶ 41 (citing Gilead patent submission showing that TAF was more effective than TDF); *id.* ¶ 60 (citing an October 2004 company announcement regarding the future of TAF development); *id.* ¶ 67 (citing HIV-treatment statistics that have been corroborated by the CDC); *id.* ¶ 78 (citing an April 2012 HIV study conducted by researchers at San Francisco's Veterans' Administration Medical Center and the University of California, San Francisco); *id.* ¶ 79 (quoting FDA characterization of TDF's safety profile); *id.* ¶ 91 (quoting Gilead's Chief Scientific Officer during an October 2010 earnings call).

[132] Pls.' Opening Br. at 11-14.

[133] *See supra* note 67 and accompanying text.

[134] *See* JX-98.

[135] *See id.* (complaint); JX-99 (11/8/19 New York Times article covering the litigation); JX-102 (11/8/19 Science Magazine article covering the litigation).

[136] *See* JX-98 at 77-1739.

[137] JX-246 at 21; JX-247 at 12.

[138] *See* Pls.' Opening Br. at 14-15.

[139] *See* JX-51 at 1.

[140] JX-134 at 79.

[141] *See* JX-88 at ¶¶ 1, 13.

B-providers, one of the drugs at issue (Viread) is also used to treat HIV.[142] The complaint alleges that Gilead provided healthcare providers with illegal kickbacks in exchange for prescribing Gilead products.[143] It contains public payment information from relevant healthcare providers to Gilead, detailed information regarding the composition of Gilead's advisory boards, public pricing information regarding the drugs at issue, and quotes from internal emails referencing the speaker programs.[144] The combination of multiple government investigations relating to possible False Claims Act violations plus the ongoing *qui tam* litigation alleging the exact same conduct with respect to Gilead's Hepatitis B business, establishes a credible basis to suspect possible wrongdoing as to False Claims Act violations.

Gilead takes issue with Plaintiffs' reliance on the complaints in the other **[*29]** lawsuits, contending that unsubstantiated allegations cannot supply a credible basis to suspect possible wrongdoing.[145] As discussed above, however, the credible basis requirement does not require that allegations of wrongdoing be substantiated or even probable;[146] they only need be credible. One of the reasons why Delaware courts urge stockholders to conduct pre-suit investigations is to investigate allegations before filing plenary litigation to determine whether they are substantiated. In furtherance of that objective, this court attempts to avoid "placing an unduly difficult obstacle in the path of stockholders seeking to investigate . . . mismanagement."[147] The allegations, information, and evidence in the complaints on which Plaintiffs rely meet this standard for the reasons discussed above. Requiring that Plaintiffs demonstrate more would place "an unduly difficult obstacle" in the path of stockholders.

[142] *See id.; see also* JX-55 (noting that Vemlidy is a TAF-based drug and an alternative to Viread).

[143] JX-88 ¶¶ 58-99.

[144] *Id.* ¶ 64 & n.2 (citing "Open Payment" information, which is defined as "payments that are not associated with a research study such as compensation, food and beverage and lodging"); *id.* ¶ 69 (listing 2017 advisory boards and each of their composition); *id.* ¶ 76 (listing prices of drugs at issue in the litigation); *id.* ¶ 134 (quoting an internal email that allegedly read: "Let them hear the Message for $3,000").

[145] *See* Def.'s Answering Br. at 5-22.

[146] *See supra* notes 102-09 and accompanying text.

[147] *See* Thomas & Betts, 681 A.2d at 1032.

The parties also dispute whether Plaintiffs have presented evidence demonstrating that Gilead's board of directors and senior officers were aware of the categories of alleged wrongdoing.[148] Such a showing is not required to support a credible basis where, as here, Plaintiffs **[*30]** have not limited their purposes to pursuing derivative claims.[149] If Plaintiffs must demonstrate a credible basis to suspect wrongdoing at the level of the board or senior management, then they have done so. Gilead's HIV drugs generate 73% of Gilead's revenue and were thus "intrinsically critical to the company's business operation."[150] There is thus a credible basis to suspect that the board and senior management knew about the possible wrongdoing. If they did not, there is a credible basis to suspect that they failed to monitor a business segment that was "mission critical," as well as vitally important to the lives of millions of people.[151]

2. Plaintiffs' Purposes Are Their Own.

Only one Plaintiff must demonstrate a proper purpose for the court to grant some level of inspection. Thus, for Gilead to avoid inspection entirely, Gilead must accomplish the difficult task of undermining all five Plaintiffs' purposes. Gilead's primary argument toward this end is that each Plaintiff was a passive conduit in a purely lawyer-driven endeavor and thus lacks a proper purpose under *Wilkinson v. A. Schulman, Inc.*[152] Gilead bears the burden of proving this defense.[153]

[148] *See* Pls.' Opening Br. at 15-17; Def.'s Answering Br. at 14-15.

[149] *See* AmerisourceBergen, 2020 Del. Ch. LEXIS 17, 2020 WL 132752, at *15, *19.

[150] *See* **Marchand v. Barnhill, 212 A.3d 805, 822 (Del. 2019)**; *accord.* In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 967-70 (Del. Ch. 1996).

[151] *See* **Marchand, 212 A.3d at 824**.

[152] *See* Def.'s Answering Br. at 22-36 (citing 2017 Del. Ch. LEXIS 798, 2017 WL 5289553 (Del. Ch. Nov. 13, 2017)).

[153] *See* Inter-Local Pension Fund GCC/IBT v. Calgon Carbon Corp., 2019 Del. Ch. LEXIS 47, 2019 WL 479082, at *9 (Del. Ch. Jan. 25, 2019) ("A corporate defendant may resist demand where it shows that the stockholder's stated proper purpose is not the actual purpose for the demand. However, in order to succeed, the defendant must prove that the plaintiff pursued its claim under false pretenses. Such a showing is

In *Wilkinson* ***[*31]*** , the plaintiff's deposition testimony revealed a discrepancy between the plaintiff's actual purpose and the stated purpose in the demand.[154] The plaintiff wanted to investigate the company's negative financial results, but the demand sought to investigate a board decision to accelerate equity awards.[155] Wilkinson's counsel had ignored his client's purpose and chose to send a demand concerning the counsel's purpose.[156] The disconnect between the client and counsel persisted through the *Section 220* enforcement action.[157] Wilkinson verified the complaint, but he did nothing to confirm the accuracy of its allegations and knew nothing about the inspection process or litigation.[158] He failed to play any meaningful role in the litigation and testified that he was unaware of any facts concerning the wrongdoing that his counsel sought to investigate.[159] This confluence of unusual facts led the court to find that the plaintiff lacked a proper purpose.[160]

Gilead fails to prove that the facts of this case rise to the level seen in *Wilkinson*. In this case, Plaintiffs testified that they actually sought to investigate wrongdoing.[161] They reviewed their respective Demands and complaints prior **[*32]** to authorizing their service and filing.[162] For the most part, they were knowledgeable about the basis for their Demands.[163] They remained in contact with their respective counsel throughout the demand process and litigation.[164] This testimony is sufficient to establish that Plaintiffs' purposes are their own.

To be sure, Gilead proved that lawyers were heavily involved in the process, but that is to be expected considering the significant role lawyers play in representative litigation generally.

On that point, *In re Fuqua Industries, Inc. Shareholder Litigation*[165] is instructive. There, former Chancellor Chandler denied a motion to disqualify a derivative plaintiff who was unfamiliar with the basic facts of the case and largely deferred control of the litigation to counsel.[166] After canvasing state and federal case law concerning the adequacy standard imposed on derivative plaintiffs, the court held that the plaintiffs' bare knowledge of the "basic facts" was sufficient to meet the adequacy requirement, and that knowledge of "the

fact intensive and difficult to establish." (internal quotation marks omitted)), *aff'd* ***237 A.3d 818 (Del. 2020)***.

[154] *See* *Wilkinson, 2017 Del. Ch. LEXIS 798, 2017 WL 5289553, at *2-3*.

[155] *Id.*

[156] *Id.*

[157] *See id.*

[158] *2017 Del. Ch. LEXIS 798, [WL] at *3*.

[159] *2017 Del. Ch. LEXIS 798, [WL] at *2-3*.

[160] *See* *2017 Del. Ch. LEXIS 798, [WL] at *2-4*; *see also* *Calgon Carbon, 2019 Del. Ch. LEXIS 47, 2019 WL 479082, at *9* (noting that the "misalignment of goals between the stockholder and his counsel was a key factor in the [*Wilkinson*] Court's determination that there was no proper purpose for the demand.").

[161] *See* Collins Dep. Tr. at 86:22-87:11; Friedt Dep. Tr. at 65:24-66:8; Pettry Dep. Tr. at 77:5-78:11; Trial Tr. at 12:23-13:15 (Ramirez); Ramirez Dep. Tr. at 87:15-19, 98:6-7, 119:9-22; Williams Dep. Tr. at 57:22-58:10.

[162] *See* Collins Dep. Tr. at 67:21-24; Friedt Dep. Tr. at 74:18-22, 111:18-112:12, 124:42-125:2; Pettry Dep. Tr. at 59:15-61:21, 101:9-18; Trial Tr. at 12:20-22 (Ramirez); Ramirez Dep. Tr. at 58:22-24; Williams Dep. Tr. at 54:21-24, 77:5-18.

[163] *See* Collins Dep. Tr. at 95:17-113:22; Pettry Dep. Tr. at 79:16-82:17; Trial Tr. at 12:23-13:15, 32:5-34:4 (Ramirez); Ramirez Dep. Tr. at 50:22-53:4, 87:15-93:18; Williams Dep. Tr. at 58:21-62:13. Although Friedt demonstrated a general understanding the subject matter of her demand (*see* Friedt Dep. Tr. at 65:24-66:8), her knowledge of the basis for her demand was exceptionally weak; this fact standing alone does not compare to the confluence of unusual facts present in *Wilkinson*.

[164] *See* Collins Dep. Tr. at 40:3-122:9; Friedt Dep. Tr. at 61:9-125:2; Pettry Dep. Tr. at 53:6-81:18; Trial Tr. at 10:10-23, 14:8-15:8, 23:20-24:6, 41:20-42:20 (Ramirez); Ramirez Dep. Tr. at 56:5-213:9; Williams Dep. Tr. at 23:4-85:24. Gilead accuses Collins of lying about who initiated the process and his level of involvement based mostly on Collins' poor recall of demands he served on Gilead in 2016 and 2018 and his lack of direct contact with litigation counsel. *See* Def.'s Post-Trial Answering Br. at 28-31. But those demands are largely irrelevant, and Collins' sworn testimony established that he had reviewed the demand letters sent on his behalf and maintained contact with his referring counsel. *See* Collins Dep. Tr. at 40:3-122:9. This is sufficient to support the finding that Collins' stated purposes were his own.

[165] *752 A.2d 126 (Del. Ch. 1999)*.

[166] *Id. at 134-37*.

particulars" was not required.[167] In reaching this conclusion, the court observed that Delaware law provides incentives for private attorneys to **[*33]** bring derivative suits as a solution to the collective action problem, that those attorneys naturally play a "dominant role in prosecuting litigation on behalf of clients," and that lawyer involvement is particularly appropriate "in cases involving fairly abstruse issues of corporate governance and fiduciary duties."[168]

Of course, the adequacy requirement of *Court of Chancery Rule 23.1* at issue in *Fuqua* and the proper purpose requirement of *Section 220* at issue in this case are not the same. This decision does not suggest otherwise. The point is that Delaware courts have encouraged stockholders to pursue *Section 220* actions in advance of derivative suits for decades.[169] It would be inconsistent with this policy to require that *Section 220* plaintiffs know more than what is required of derivative plaintiffs. It would also be inconsistent with this policy to prohibit lawyers from playing a "dominant role" in *Section 220* actions while permitting them to do so in derivative litigation. This is particularly so given the increasing complexities plaguing *Section 220* actions.[170]

The incentives in representative litigation are imperfect, and judicial oversight is required in *Section 220* actions as elsewhere. In *Fuqua*, the court went on to admonish the plaintiffs' **[*34]** counsel for effectively "supplanting" his client in a deposition, explaining that "extreme facts call for the court to exercise its discretion and to curb the agency costs inherent in private regulatory and enforcement mechanisms."[171] It was similarly extreme facts that drove the outcome in *Wilkinson*, where the attorneys disregarded their client's objectives entirely and pursued their own.[172]

In this case, the degree of lawyer involvement does not come close to the line-crossing conduct at issue in *Fuqua* or *Wilkinson*. This case reflects benign manifestations of the role that plaintiffs' law firms play generally in representative litigation.

Gilead singles out Pettry and Friedt because they were enrolled in a portfolio monitoring program and had no knowledge of alleged wrongdoing at Gilead before

[167] *Id. at 136* ("[The plaintiff] was at times quite lucid and able to independently communicate the basic facts and claims underlying her lawsuit. She did not know the particulars.").

[168] *Id. at 135*; *id. at 133* ("Our legal system has privatized in part the enforcement mechanism . . . by allowing private attorneys to bring suits on behalf of nominal shareholder plaintiffs."); *see also* *In re Del Monte Foods Co. S'holders Litig., 2011 Del. Ch. LEXIS 94, 2011 WL 2535256, at *14 (Del. Ch. June 27, 2011)* ("Delaware courts recognize the value of representative litigation."); *In re Revlon, Inc. S'holders Litig., 990 A.2d 940, 959 (Del. Ch. 2010)* ("[R]epresentative litigation serves as a valuable check on managerial conflicts of interest. Stockholder plaintiffs can and do achieve meaningful results." (citation omitted)); *Bird v. Lida, Inc., 681 A.2d 399, 402-03 (Del. Ch. 1996)* (explaining that entrepreneurial plaintiff attorneys can "pursue monitoring activities that are wealth increasing for the collectivity (the corporation or the body of its shareholders)").

[169] *See, e.g.,* ***Cal. State Tchrs.' Ret. Sys. v. Alvarez, 179 A.3d 824, 839 (Del. 2018)*** ("[T]his Court has repeatedly admonished plaintiffs to use the 'tools at hand' and to request company books and records under *Section 220* to attempt to substantiate their allegations before filing derivative complaints."); *Sec. First Corp., 687 A.2d at 571 (Del. 1997)* ("[A*] Section 220* proceeding may serve a salutary mission as a prelude to a derivative suit."); *Ash v. McCall, 2000 Del. Ch. LEXIS 144, 2000 WL 1370341, at *15 n.56 (Del. Ch. Sept. 15, 2000)* ("As the Delaware Supreme Court has repeatedly exhorted, shareholders plaintiffs should use the 'tools at hand,' most prominently *§ 220* books and records actions, to obtain information necessary to sue derivatively.").

[170] *See, e.g.,* *Wilkinson, 2017 Del. Ch. LEXIS 798, 2017 WL 5289553, at *3* ("A stockholder obviously can use counsel to seek books and records. *Section 220* expressly contemplates that a stockholder can make a demand 'in person or by attorney or other agent.' Indeed, given the complexity of Delaware's sprawling *Section 220* jurisprudence, a stockholder is well-advised to secure counsel's assistance." (quoting *8 Del. C. § 220(b)*)); *Calgon Carbon, 2019 Del. Ch. LEXIS 47, 2019 WL 479082, at *10* (holding that stockholders are entitled to rely on counsel "to raise concerns, to advise them on how to remedy those concerns, and to pursue appropriate remedies"); *Kosinski v. GGP Inc., 214 A.3d 944, 951-52 (Del. Ch. 2019)* ("The fact that Plaintiff sought and accepted the advice of counsel is to his credit, not his detriment."); *see also* *Cox et al., supra note 6, at 2150* (attributing the increased complexity in *Section 220* actions to the fact that "defendants have turned books and records litigation into a surrogate proceeding to litigate the possible merits of the suit where they place obstacles in the plaintiffs' way to obstruct them from employing it as a quick and easy pre-filing too").

[171] *Fuqua, 752 A.2d at 133-34*.

[172] *See* *Wilkinson, 2017 Del. Ch. LEXIS 798, 2017 WL 5289553, at *2-3*.

counsel contacted them.[173] But there is nothing inappropriate about such programs. They are voluntary and serve the purpose of keeping stockholders abreast of corporate developments that may affect the value of their stock holdings. They do not obligate participants to send *Section 220* demands or file suits.[174]

Gilead also complains about Hollywood's involvement in portfolio monitoring programs,[175] but those **[*35]** arguments are similarly misguided. Hollywood is a police officers' retirement fund that is run by a seven-member Board of Trustees, all of whom are volunteers.[176] Hollywood works with portfolio monitoring counsel, who raise potential issues with Hollywood, first by bringing them the attention of Hollywood's outside general counsel.[177] If the general counsel determines that the matter is worthy of consideration, he elevates the discussion first to the Chairman of the Board and then to the Board to make the determination of whether to take action.[178] Hollywood followed its process in this case,[179] and that process is sound. Like boards of Delaware corporations,[180] boards of pension funds are encouraged to rely on professional advisors when fulfilling their duties to act in the best interests of the retirees. Hollywood's reliance on professional advisors, including portfolio monitoring counsel, strengthens the integrity of Hollywood's purpose, not the opposite.

Demonstrating how far Gilead was willing to go in attacking Plaintiffs, Gilead tries to impugn Ramirez's testimony based on a cut-and-paste error in Ramirez's retainer agreement with counsel.[181] The error (failing **[*36]** to replace the word "opioid") was made by counsel—not Ramirez.[182] Ramirez explained that he was caught by surprise when asked about the error at his deposition; the "curveball," as he called it, confused him because this case has nothing to with opioids.[183] Ramirez confirmed throughout his deposition and trial testimony that his aim in seeking records was true, even stating that he was inspired by an article he read related to wrongdoing related to Gilead's HIV drugs.[184]

In the end, Gilead failed to establish that any Plaintiff's lawyers' involvement undermined any Plaintiff's purpose (much less all of them). The record reflects that each Plaintiff genuinely holds its stated purpose of investigating possible wrongdoing in the development and commercialization of Gilead's HIV treatments.

B. Gilead's So-Called "Standing" Arguments

In its second attack on Plaintiffs' purposes, Gilead argues that "Plaintiffs' Demands are defective because Plaintiffs lack standing to investigate the claimed wrongdoing."[185] This is so, according to Gilead, because any derivative claims challenging the wrongdoing at issue would be dismissed for the following reasons: (i) Plaintiffs did not own shares **[*37]** at the time of the alleged wrongdoing;[186] (ii) the

[173] *See* Def.'s Answering Br. at 24-28; Trial Tr. at 147:9-16; *id.* at 149:22-150:4; Friedt Dep. Tr. at 61:24-64:9; Pettry Dep. Tr. at 38:12-22, 40:19-41:22, 75:10-19.

[174] *See* *Calgon Carbon, 2019 Del. Ch. LEXIS 47, 2019 WL 479082, at *10* ("Advice from counsel comes in many forms. Individual stockholders and smaller institutions cannot be expected to have an independent, in-house team to cultivate purely homegrown legal analyses of their investments. Stockholders are entitled to hire counsel to review and monitor their portfolios for potential mismanagement or wrongdoing. They are also entitled to rely on that counsel to raise concerns, to advise them on how to remedy those concerns, and to pursue appropriate remedies.").

[175] *See* Def.'s Answering Br. at 31-33; Trial Tr. at 156:15-158:22.

[176] *See* Williams Dep. Tr. at 22:23-23:3, 42:1-11; *see also id.* at 25:7-9 ("Q. Who at Hollywood has decision-making authority with respect to litigation decisions? A. That would be the board of trustees.").

[177] *Id.* at 41:13-21.

[178] *Id.* at 55:11-56:7.

[179] *See* JX-129 at 1; Williams Dep. Tr. 56:8-57:3.

[180] *See, e.g.*, *8 Del. C. § 141(e)*.

[181] *See* Trial Tr. at 39:21-40:8 (Ramirez).

[182] *See id.* at 10:19-11:11, 40:16-21 (Ramirez).

[183] *Id.* at 13:13-15, 32:5-34:4 (Ramirez).

[184] *See id.* at 12:23-13:15 (Ramirez); Ramirez Dep. Tr. at 87:15-19, 98:6-7, 119:9-22.

[185] Def.'s Answering Br. at 36.

[186] *See id.* at 36 (citing *Graulich v. Dell Inc., 2011 Del. Ch. LEXIS 76, 2011 WL 1843813, at *5 (Del. Ch. May 16, 2011)* ("If plaintiff would not have standing to bring suit, plaintiff does not have a proper purpose to investigate wrongdoing because its stated purpose is not reasonably related to its role as a stockholder."); *W. Coast Mgmt. & Cap., LLC v. Carrier Access Corp., 914 A.2d 636, 641 (Del. Ch. 2006)* ("If a books and

derivative claims they seek to pursue are time-barred;[187] and (iii) any derivative claims they seek to pursue would be barred by an exculpatory charter provision.[188]

Gilead devoted extensive resources to this argument. To support it, Gilead served discovery, brought a motion to compel, and took five depositions. Gilead explored these issues at trial and devoted eight pages of post-trial briefing to them.[189]

There are a number of vexing aspects of this argument. For starters, although certain of these points may speak to a plaintiff's standing to pursue a derivative suit, they do not speak to a plaintiff's standing to pursue a *Section 220* action. Under Delaware law, "[t]he issue of standing is concerned 'only with the question of *who* is entitled to mount a legal challenge and not with the merits of the subject matter in controversy.'"[190] Where the right at issue is statutory, "the real determinant" of standing "is the statutory language itself."[191] *Section 220(c)* answers the question of *who* has standing to pursue an enforcement action under *Section 220(c)*—a stockholder.[192] In this case, it is undisputed that each Plaintiff held stock when filing their complaints (and also for significant **[*38]** periods prior to filing the complaints).[193]

Gilead's arguments speak not to Plaintiffs' standing to pursue a *Section 220* action but, rather, to the viability of derivative claims that Plaintiffs might pursue in the future. "This Court has repeatedly stated that a *Section 220* proceeding does not warrant a trial on the merits of underlying claims."[194] Yet Gilead pushes the court do

records demand is to investigate wrongdoing and the plaintiff's sole purpose is to pursue a derivative suit, the plaintiff must have standing to pursue the underlying suit[.]")); *id.* at 37-38.

187 *See id.* at 36 (citing *Graulich, 2011 Del. Ch. LEXIS 76, 2011 WL 1843813, at *6* (denying *Section 220* demand where "plaintiff ha[d] articulated no stated purpose other than to investigate wrongdoing in order to bring an appropriate suit against defendant, and plaintiff [was] time-barred from bringing that suit")); *id.* at 39-43.

188 *See id.* at 43 n.26 (citing *SEPTA v. AbbVie Inc., 2015 Del. Ch. LEXIS 110, 2015 WL 1753033, at *13 (Del. Ch. Apr. 15, 2015)* (investigating corporate wrongdoing and waste were not proper purposes when the facts alleged amounted to only a possible breach of the duty of care, damages for which would be barred by the corporation's exculpation clause)).

189 *See* Trial Tr. at 185:4-190:15; Def.'s Answering Br. at 36-43.

190 *Dover Hist. Soc'y v. City of Dover Plan. Comm'n, 838 A.2d 1103, 1110 (Del. 2003)* (quoting *Stuart Kingston, Inc. v. Robinson, 596 A.2d 1378, 1382 (Del. 1991))*.

191 *Oceanport Indus., Inc. v. Wilm. Stevedores, Inc., 636 A.2d 892, 900 (Del. 1994)*; *Newark Landlord Ass'n v. City of Newark, 2003 Del. Ch. LEXIS 66, 2003 WL 21448560, at *5 (Del. Ch. June 13, 2003)*.

192 *See 8 Del. C. § 220(c)* (providing that "[i]f the corporation . . . refuses to permit an inspection sought by a stockholder . . . *the stockholder* may apply to the Court of Chancery for an order to compel such inspection" (emphasis added)); *see also Weingarten v. Monster Worldwide, Inc., 2017 Del. Ch. LEXIS 31, 2017 WL 752179, at *5 (Del. Ch. Feb. 27, 2017)* ("[T]he legislature has made clear that only those who are stockholders at the time of filing have standing to invoke this Court's assistance under *Section 220*.").

193 Collins has held Gilead stock since 1999, except for a five-month period in 2008. JX-52. Friedt has held Gilead stock since 2013. *See* JX-157 at 9; Friedt Dep. Tr. at 31:15-19, 38:13-22. Pettry has held Gilead stock since 2016. *See* JX-155 at 9; Pettry Dep. Tr. at 43:7-16. Ramirez has held Gilead stock since 2016. *See* JX-46; Ramirez Dep. Tr. at 27:3-15. Hollywood has held Gilead stock since 2010. JX-161 at 9.

194 *In re UnitedHealth Gp., Inc. Section 220 Litig., 2018 Del. Ch. LEXIS 69, 2018 WL 1110849, at *7 & n.95 (Del. Ch. Feb. 28, 2018)* (Montgomery-Reeves, V.C.) (collecting cases); *see also Lavin, 2017 Del. Ch. LEXIS 866, 2017 WL 6728702, at *9 (Slights, V.C.)* (holding that a *Corwin* defense will not impede an otherwise properly supported demand for inspection and observing that "when a stockholder demands inspection as a means to investigate wrongdoing in contemplation of a class or derivative action, Delaware courts generally do not evaluate the viability of the demand based on the likelihood that the stockholder will succeed in a plenary action"); *Amalgamated Bank v. UICI, 2005 Del. Ch. LEXIS 82, 2005 WL 1377432, *2 (Del. Ch. June 2, 2005)* (Noble, V.C.) ("The potential availability of affirmative defenses to withstand fiduciary duty claims cannot solely act to bar a plaintiff under *Section 220*. First, these are summary proceedings; the factual development necessary to assess fairly the merits of a time-bar affirmative defense, for example, as to each potential claim, is not consistent with the statutory purpose. Second, courts should not be called upon to evaluate the viability of affirmative defenses to causes of actions that have not been, and more importantly may not ever be, asserted. Third, that a claim arising out of a particular transaction may be barred does not mandate the conclusion that documents relating to that transaction are not 'necessary, essential, and sufficient'

just that—evaluate, in the context of a summary proceeding, defenses to causes of action that have not yet been asserted and might have never been asserted.

Beyond the obvious practical concerns raised by such an approach, the theoretical problems with Gilead's argument are rife, as Vice Chancellor Laster persuasively explained in AmerisourceBergen.[195] As the court held in *AmerisourceBergen*, a defense to a future derivative claim affects a stockholder's ability to invoke Section 220 only where the stockholder identifies pursuing a derivative claim as its *sole* purpose, as was the case in Graulich and West Coast Management.[196] In this case, Plaintiffs did not limit themselves to the sole purpose of pursuing derivative claims.[197] Rather, Plaintiffs expressly identified multiple **[*39]** potential end-uses for the information obtained through their investigations.[198]

Gilead acknowledges that Plaintiffs have stated multiple potential end-uses for the information obtained through their investigations,[199] but Gilead pivots to argue that "it is *obvious* based on Plaintiffs' [i] deposition testimony, coupled with their [ii] retention agreements, that their *only true purpose is to pursue such a lawsuit*."[200]

A review of Plaintiffs' testimony and a close examination of Gilead's citations reveal that Gilead's position is unsupported and its citations are misleading. As an initial matter, although Gilead makes this point as to "Plaintiffs" as a whole, Gilead does not cite to any deposition testimony from one of the five Plaintiffs—Hollywood.[201] Nor could they. Hollywood's 30(b)(6) representative Williams testified that he had not predetermined what would happen after the investigation.[202] Williams, a retired police officer,

for a shareholder's proper purpose with respect to more recent transactions."); LAMPERS, 2007 Del. Ch. LEXIS 138, 2007 WL 2896540, at *12 (Noble, V.C.) (rejecting, in a Section 220 proceeding, that no springloading ever occurred because "by raising such a defense, Countrywide seeks to litigate the ultimate issue in a possible future derivative suit that might eventually be filed by LAMPERS" and holding that "[t]his is neither the time nor the procedural setting to address that issue").

[195] *See* AmerisourceBergen, 2020 Del. Ch. LEXIS 17, 2020 WL 132752, at *14-24; *see also* Okla. Firefighters Pension & Ret. Sys. v. Citigroup Inc., 2014 Del. Ch. LEXIS 189, 2014 WL 5351345, at *6 (Del. Ch. Sept. 30, 2014) ("Although Citigroup disclaims any effort to turn this proceeding into a trial on the merits of Plaintiffs possible derivative claims, Citigroup essentially seeks that result by implying that Plaintiff must have specific, tangible evidence that Citigroup's Board or senior management was complicit in the fraud at Banamex. That argument ignores the inferences that this Court can—and must—draw under the credible basis standard, and would discourage the very behavior this Court has sought to encourage among would-be derivative or class plaintiffs.").

[196] *See* Graulich, 2011 Del. Ch. LEXIS 76, 2011 WL 1843813, at *5 ("[P]laintiff's *only* purpose is to pursue potential derivative claims." (emphasis added)); W. Coast Mgmt., 914 A.2d at 641 ("It is clear that West Coast's *sole purpose* for investigating claims of wrongdoing is to obtain additional information to replead demand futility in order to pursue a second derivative suit." (emphasis added)). To be clear, a Section 220 plaintiff is not required to limit the end-uses of the information they seek at the outset of their investigation. AmerisourceBergen 2020 Del. Ch. LEXIS 17, 2020 WL 132752, at *12 (holding that the proper purpose requirement does not require a stockholder to pick one of these end-uses at the outset, or "commit in advance to what it will do with an investigation before seeing the results of the investigation").

[197] *See* Def.'s Answering Br. at 37 (acknowledging that "Plaintiffs claim that their purposes 'are not limited to bringing a derivative lawsuit'" (citing Pls.' Opening Br. at 46)); JX-123 at 2 (Ramirez's demand stating that if the investigation supports doing so, he "*may* use the documents to pursue a shareholder derivative action" (emphasis added)); JX-128 at 15 (Collins's demand stating that the information sought will enable him "to determine whether wrongdoing or mismanagement has taken place such that it would be appropriate to initiate litigation"); JX-108 at 1 (Pettry's demand listing "presenting a litigation demand to the Board" or "suggesting corporate governance reforms" as other potential end uses of the fruits of their investigation); JX-113 at 1 (Friedt's demand listing "presenting a litigation demand to the Board" or "suggesting corporate governance reforms" as other potential end uses of the fruits of their investigation); JX-124 at 1 (Hollywood's demand expressly stating that Hollywood reserves the right to "take other action to seek appropriate relief").

[198] *See* Pls.' Opening Br. at 25-45.

[199] *See* Def.'s Answering Br. at 37 (acknowledging that "Plaintiffs claim that their purposes 'are not limited to bringing a derivative lawsuit'" (citing Pls.' Opening Br. at 46)).

[200] *Id.* (emphasis added).

[201] *See id.* at 36-43.

[202] *See* Williams Dep. Tr. at 58:1-10 ("Well, as I understand it, it's similar to a police investigation, if you will. If there is some wrongdoing that's being alleged, there's an investigation that follows. That investigation may turn out to be completely prudent. Any and all the action taken was in the best interests of the company. And as I stated before, if there's nothing

expressly likened a *Section 220* inspection to a police investigation, and stated that "[t]his is simply an investigation. If it turns out that there is no [wrongdoing], then it will be the end of it."[203] Gilead can only avoid inspection if **[*40]** it defeats all five Plaintiffs' proper purposes. By failing to show that Hollywood had predetermined what to do with the fruits of its investigation, Gilead's argument falls short from the get-go.

Gilead's other citations amount to misrepresentations of the record. For the position that it is "obvious" from "Plaintiffs' deposition testimony" that Plaintiffs' "only true purpose" was to pursue derivative claims, Gilead offers the following:

- Gilead cites to the portion of Collins's testimony where Collins directly denies any plans to file a derivative claim.[204] The examining attorney asked: "Do you intend to file a derivative action against Gilead?" Collins responded: "I don't have any plans to do that at the moment."[205] The attorney continued: "Are you aware of any other Gilead stockholders who are contemplating bringing a derivative action against Gilead?" He responded: "No, I'm not."[206]

- Gilead cites to the portion of Pettry's testimony where she directly denies that her purpose is limited to pursuing a derivative claim.[207] The examining attorney asked: "Now, at the time you entered into this engagement agreement [with counsel], did you intend to file derivative litigation **[*41]** relating to Gilead?" Pettry answered: "It was a matter of *first finding out*. I mean, obviously, although it's *potentially* a shareholder derivative matter, clearly there was first to do inspection demand to get information in order to determine *whether* it's appropriate to file derivative, shareholder litigation."[208]

- Gilead cites to the portion of Ramirez's deposition transcript where Ramirez uses equivocal language when referring to a future derivative lawsuit.[209] Counsel for the defendants identified each category of documents requested in Ramirez's demand and asked: "[F]or what purpose do you need this information?"[210] In response to the first few such questions, Ramirez vaguely indicated that he believed that the information would strengthen his "case."[211] In response to the last such question, Ramirez went further to say that he believed the information would strengthen the allegations for the purpose of a potential lawsuit, but he used conditional language, stating: "*if* there is a case to be brought."[212] The reference to a "case to be brought" called for a follow-up question, which counsel eventually asked: "What specific case are you talking about."[213] Ramirez responded by claiming privilege, **[*42]** but again using conditional language: "I think any of the discussions about any potential case, *if there is to be one*, were between my counsel and I. So I don't know if I can properly answer that for you."[214] The examining attorney let the questioning end there.[215]

- Gilead cites to the portions of Friedt's testimony where Friedt suggests that she will rely on her counsel in determining the end-uses of her

---

there, then we move on. If it turns out that there's wrongdoing, then the matter would be brought back to the board for any other consideration.").

[203] *Id.* 52:1-3; *see also id.* at 51:10-17 ("Q. And when you say 'the action,' what do you mean by that? A. The books and records investigation involving Gilead. Q. Has Hollywood considered bringing a derivative lawsuit related to the allegations in the *Section 220* demand letter? A. No.").

[204] Def.'s Answering Br. at 37 (citing Collins Dep. Tr. at 103-05).

[205] Collins Dep. Tr. at 104:19-23.

[206] *Id.* at 105:1-4.

[207] Def.'s Answering Br. at 37 (citing Pettry Dep. Tr. at 64-65).

[208] Pettry Dep. Tr. at 64:23-65:8 (emphasis added).

[209] Def.'s Answering Br. at 37 (citing Ramirez Dep. Tr. at 102-12).

[210] Ramirez Dep. Tr. at 107:21-22, 108:19-20, 110:1-2.

[211] *See id.* at 108:3-5 ("I think they could help strengthen our case against the allegations."); *id.* at 109:15-17 ("As I had previously stated, I believe they could shed some light and strengthen our case."); *id.* at 110:15-17 ("I would again say adding merit and strength to the allegations that were present . . . for all the points as like a collective.").

[212] *Id.* at 111:18-21 (emphasis added) ("[A]s previously stated, these conversations could add merit and strength to our allegations, if there is to be a case brought.").

[213] *Id.* at 112:14-15.

[214] *Id.* at 112:16-20 (emphasis added).

[215] *See id.*

> investigation.[216] The lead-off question in this series, which the examiner insisted required a "yes or no" response, was: "[H]ave you informed Gilead that you may file a derivative action against it?"[217] To this question, Friedt responded "[t]hrough counsel, yes," and then said "I left it up to my counsel to inform Gilead."[218] The examiner had not previously asked whether Friedt had considered filing a derivative claim, and thus the question assumed aspects of the very fact that Gilead seeks to prove—Friedt's intent to pursue derivative claims. Moreover, on its face, this examiner's question only asks whether Friedt "*may*" file a derivative action, and not that she has predetermined that a derivative claim is the only end-use she intended to pursue. Friedt later clarified, in other pages specifically **[*43]** relied on by Gilead, that she intended to leave it to her counsel to determine whether to pursue derivative claims, implicitly denying any then-present intention of pursuing derivative claims.[219]

This deposition testimony does not support, and portions directly contradict, Gilead's contention that Plaintiffs' "only true purpose" is to pursue a derivative lawsuit.

Plaintiffs' retention agreements with counsel similarly fail to demonstrate that Plaintiffs' sole purpose was to pursue a derivative suit. Gilead argues that "the retention agreements make clear that counsel will not be paid until Plaintiffs achieve a financial settlement or judgment—an implausible scenario absent the prosecution of derivative claims."[220] Once again, Gilead fails to make this point as to all Plaintiffs—only four of the five Plaintiffs executed retention agreements with counsel.[221] Collins represented that he did not have a retention agreement with counsel.[222]

It is true that plaintiffs' attorneys commonly take matters on contingency and receive compensation only as a consequence of the prosecution and settlement of derivative claims. This common arrangement is, again, a benign aspect **[*44]** of Delaware's solution to the collective action problem that stockholders face. Moreover, the fact that retention agreements with counsel provide that counsel only gets paid in the event of plenary litigation does not prevent Plaintiffs from using "the fruits of their investigation for other ends."[223] It is logical that the agreements would address litigation because "[t]he plaintiffs would need their counsel to conduct litigation," but not to pursue alternative courses of action.[224] The retention agreements standing alone, therefore, do not undermine Plaintiffs' proper purposes.

To sum up the defects in Gilead's so-called "standing" arguments as a whole: They are not actually about standing to bring a Section 220 action. They speak to the viability of a derivative claim, which is largely beyond the scope of Section 220 proceedings. Even the authorities on which Gilead relies limit the application of Gilead's arguments to situations where pursuing a derivative claim is the plaintiff's sole purpose. Section 220 plaintiffs generally need not specify the end-uses of their investigation at the outset of their investigation, and Plaintiffs here have stated multiple potential end-uses. Gilead's arguments to the contrary **[*45]** based on Plaintiffs' deposition testimony fail to address all Plaintiffs and are misleading. Plaintiffs' retention agreements with their counsel do not support Gilead's point.

Gilead's arguments fail for other reasons as well. Gilead argues that Plaintiffs lack standing to seek inspection because Plaintiffs did not own shares at the time of the possible wrongdoing.[225] Yet, in *Saito*, the Delaware

---

[216] Def.'s Answering Br. at 37 (citing Friedt Dep. Tr. at 54-56).

[217] Friedt Dep. Tr. at 54:1-5.

[218] *Id.* at 54:9-15.

[219] *Id.* at 81:4-9 ("Q. At the time you entered into this engagement agreement, did you intend to file a derivative action relating to Gilead . . . ? A. . . . I would leave that up to my counsel.").

[220] Def.'s Opening Br. at 37 (citing JX-79 at 2 (Friedt Retention Agreement); JX-80 at 2 (Pettry Retention Agreement); JX-87 at 1-2 (Ramirez Retention Agreement); JX-122 at 2 (Hollywood Retention Agreement)).

[221] *See* JX-79 (Friedt Retention Agreement); JX-80 (Pettry Retention Agreement); JX-87 (Ramirez Retention Agreement); JX-122 (Hollywood Retention Agreement).

[222] Collins Dep. Tr. at 45:19-24.

[223] *See* AmerisourceBergen, 2020 Del. Ch. LEXIS 17, 2020 WL 132752 at *14.

[224] *Id.*

[225] *See* Def.'s Answering Br. at 36 (citing Graulich, 2011 Del. Ch. LEXIS 76, 2011 WL 1843813, at *5 ("If plaintiff would not have standing to bring suit, plaintiff does not have a proper purpose to investigate wrongdoing because its stated purpose is not reasonably related to its role as a stockholder.")); W.

Supreme Court found that "the date on which a stockholder first acquired the corporation's stock does not control the scope of records available under § 220."[226] As the court explained, a stockholder can seek inspection of records pre-dating their stock ownership "[i]f activities that occurred before the purchase date are 'reasonably related' to the stockholder's interest as a stockholder."[227] A document can reasonably relate to a stockholder's current interests if it provides background and context to the current or ongoing wrong the stockholder seeks to investigate.[228] In this case, any records sought that arguably pre-date Plaintiffs' ownership of Gilead stock are "reasonably related" to Plaintiffs' current interest as stockholders, and concern post-purchase date wrongs that have their roots in earlier events. **[*46]**

In any event, Gilead's timing-of-ownership argument does not apply to the ongoing False Claim Acts investigations, and the antitrust abuses, mass torts, and patent violations are all alleged to be continuing.[229]

There is also a non-frivolous argument that Gilead waived its statute of limitations and Section 102(b)(7) defenses by failing to identify them in its interrogatory responses, despite this court ordering discovery into Gilead's defenses.[230] Gilead responds that it was not required to raise these defenses in its answer or otherwise because they are not defenses to a books and records action but, rather, to the plenary lawsuit.[231] This decision need not reach this argument given the multiple other defects in Gilead's position. But it bears noting that Gilead's position only underscores that Gilead's "standing" arguments speak to the viability of a potential derivative claim and not Plaintiffs' entitlement to inspection under Section 220.

C. Scope of Production

Once a Section 220 plaintiff establishes a proper purpose, the court must determine the scope of inspection. A stockholder with a proper purpose "bears the burden of proving that each category of books and records is essential to accomplishment of **[*47]** the stockholder's articulated purpose for the inspection."[232]

The Delaware Supreme Court recently articulated this burden as follows:

> Books and records satisfy this standard "if they address the 'crux of the shareholder's purpose' and if that information 'is unavailable from another source.'" That determination is "fact specific and will necessarily depend on the context in which the shareholder's inspection demand arises." Keeping in mind that § 220 inspections are not tantamount to "comprehensive discovery," the Court of Chancery must tailor its order for inspection to cover only those books and records that are "essential and sufficient to the stockholder's stated purpose." In other words, the court must give the petitioner everything that is "essential," but stop at what is "sufficient."[233]

In this case, Plaintiffs seek inspection of formal board materials, including board minutes, presentations, reports, agendas, and preparation materials, dating back to 2004 and concerning the topics of the Demands. Plaintiffs additionally seek five specific categories of documents.

Gilead's response is three-fold. Gilead first argues that

Coast Mgmt., 914 A.2d at 641 ("If a books and records demand is to investigate wrongdoing and the plaintiff's sole purpose is to pursue a derivative suit, the plaintiff must have standing to pursue the underlying suit[.]")).

[226] Saito v. McKesson HBOC, Inc., 806 A.2d 113, 117 (Del. 2002).

[227] *Id.*

[228] UICI, 2005 Del. Ch. LEXIS 82, 2005 WL 1377432, at *2 ("A document that contributes to the investigation of a continuing wrong or provides background and context to a current, actionable wrong may be relevant and, indeed, necessary to a shareholder's proper purpose regardless of whether the events revealed in the documents are themselves actionable.").

[229] *See* JX-82 at ¶ 2; JX-98 at 3, 69-75; JX-244 at ¶¶ 155, 163.

[230] *See* JX-164; JX-191; JX-206; JX-210; *see also* IQ Holdings, Inc. v. Am. Commer. Lines Inc., 2012 Del. Ch. LEXIS 212, 2012 WL 3877790, *1 (Del. Ch. Aug. 30, 2012) ("The underlying purpose of discovery in general is to reduce the element of surprise at trial . . . .").

[231] *See* Def.'s Answering Br. at 40 n.23 ("The statute of limitations is not an affirmative defense in a books and records action.").

[232] ***Palantir, 203 A.3d at 751*** (quoting Thomas & Betts, 681 A.2d at 1035).

[233] ***Id. at 751-52***.

inspection should be limited to formal board materials. Gilead next **[*48]** makes arguments as to each category of additional documents. Gilead finally argues that each Plaintiff should be limited to inspecting only the documents specifically sought in their respective Demands.

1. Formal Board Materials

Gilead agrees that, upon a finding that Plaintiffs have stated proper purposes, the production of the formal board materials is appropriate.[234] Gilead has collected and reviewed approximately 1,600 centrally-stored formal board materials from December 1, 2004 to February 25, 2020, and identified over 400 of them as potentially related to the topics sought in the Demands.[235] Because Plaintiffs have stated proper purposes, Plaintiffs are entitled to inspect this category of documents. These documents should have been produced in response to the Demands without resort to litigation.

2. Categories of Additional Documents

Gilead argues that the court should limit inspection to the formal board materials based on what Gilead describes as the "default rule that only formal board materials are necessary and essential in a *Section 220* proceeding."[236] There is no such default rule.

Gilead relies primarily on Vice Chancellor Laster's decision in *AmerisourceBergen*.[237] There, the Vice Chancellor classified **[*49]** corporate books and records into three categories: "Formal Board Materials,"[238] "Informal Board Materials,"[239] and "Officer-Level Materials."[240] The Vice Chancellor explained that "[t]he starting point (and often the ending point) for an adequate inspection will be board-level documents."[241] The premise for that observation is that companies can and should provide these documents voluntarily without forcing stockholders to litigate over them. Gilead misses this point and invokes the *AmerisourceBergen* taxonomy for a contrary purpose—to broaden the already extensive disputes among the parties.

Formal board materials need not be an end point, particularly where the wrongdoing appears vast. As the Vice Chancellor further explained in *AmerisourceBergen*, "[i]f the plaintiff makes a proper showing, an inspection may extend to informal materials,"[242] and "wide-ranging mismanagement or waste" might require a "more wide-ranging inspection."[243] In this case, Gilead's efforts to draw the line at formal board materials fall short because Plaintiffs have shown a need for additional categories of documents by demonstrating a credible basis to suspect wide-ranging misconduct and wrongdoing.

In addition **[*50]** to formal board materials, Plaintiffs seek the following categories of documents: (a) the agreements with other companies at issue in the antitrust litigation; (b) policies and procedures concerning the topics covered in the Demands; (c) senior management materials; (d) communications

---

[234] Def.'s Answering Br. at 47-50.

[235] JX-210 at 21-23.

[236] Def.'s Answering Br. at 54.

[237] *See id.*

[238] *AmerisourceBergen, 2020 Del. Ch. LEXIS 17, 2020 WL 132752 at *24* (defining "Formal Board Materials" as "board-level documents that formally evidence the directors' deliberations and decisions and comprise the materials that the directors formally received and considered") (collecting cases limiting the scope of production to Formal Board Material); *see also* ***Woods v. Sahara Enters., 238 A.3d 879, 2020 Del. Ch. LEXIS 249, 2020 WL 4200131, at *11 (Del. Ch. July 22, 2020)*** (same).

[239] *AmerisourceBergen, 2020 Del. Ch. LEXIS 17, 2020 WL 132752 at *25* (defining "Informal Board Materials" as "generally include[ing] communications between directors and the corporation's officers and senior employees, such as information distributed to the directors outside of formal channels, in between formal meetings, or in connection with other types of board gatherings" and sometimes including "emails and other types of communication sent among the directors themselves, even if the directors used non-corporate accounts").

[240] *Id.* (defining "Officer Level Materials" as "communications and materials that were only shared among or reviewed by officers and employees").

[241] *2020 Del. Ch. LEXIS 249, [WL] at *24*.

[242] *2020 Del. Ch. LEXIS 249, [WL] at *25*.

[243] *2020 Del. Ch. LEXIS 249, [WL] at *24* (first quoting *Freund v. Lucent Techs., Inc., 2003 Del. Ch. LEXIS 3, 2003 WL 139766, at *5 (Del. Ch. Jan. 9, 2003)*; then citing *Skoglund v. Ormand Indus., 372 A.2d 204, 211 (Del. Ch. 1976))*.

between Gilead and the government; and (e) director questionnaires.

a. Anticompetitive Agreements

Plaintiffs seek to inspect the agreements between Gilead and its competitors at issue in the antitrust litigation.[244] Plaintiffs suspect that these agreements violated antitrust laws or otherwise perpetuate unlawful anticompetitive activity.[245] They are core to the wrongdoing Plaintiffs seek to investigate.[246] They are therefore necessary and essential to Plaintiffs' proper purposes. They are unlikely to be available from another source. Accordingly, Plaintiffs are entitled to inspect this category of documents.[247] Because of the centrality of these agreements to Plaintiffs' purposes, Gilead should have produced them without resorting to litigation.

In holding that Plaintiffs are entitled to inspect the allegedly anticompetitive **[*51]** agreements, the court does not distinguish between the Gilead/Japan Tobacco agreement and those still at issue in the *Staley* Action. The complete set of agreements is necessary to understanding the pattern of behavior that the Demands seek to investigate.

b. Policies and Procedures

Plaintiffs seek to inspect Gilead's policies and procedures concerning Gilead's compliance with antitrust regulations and patent law.[248] These requests seek discrete categories of information, which are easy to produce, and where inspection is routinely granted.[249] Gilead argues that the formal board materials from the relevant time period are sufficient to understand whether Board and management decisions were made in compliance with Gilead's policies and procedures.[250] But the formal board materials may not reflect what, if any, policies and procedures were in place during that time period. These documents are therefore necessary and essential to Plaintiffs' proper purposes. They are unlikely to be available from another source. Accordingly, Plaintiffs are entitled to inspect this category of documents. This is another category of documents that Gilead should have produced without resorting to litigation.

c. Senior Management Materials

Plaintiffs seek to inspect two categories of officer-level

[244] Pls.' Opening Br. at 56-57.

[245] *Id.*

[246] *See, e.g.*, AmerisourceBergen, 2020 Del. Ch. LEXIS 17, 2020 WL 132752, at *28 (ordering inspection of settlement agreements with the DEA to identify the scope of the company's compliance obligations and determine whether the Board willfully disregarded them).

[247] The parties dispute the significance of *AmerisourceBergen* on this category of documents. In that case, the court ordered inspection of documents related to the defendant's participation in trade associations where the plaintiffs suspected that the defendant violated the law by collaborating with trade associations. *See id.* Plaintiffs argue that this outcome weighs in favor of production of the antitrust agreements in this action. Pls.' Opening Br. at 57 n.191. Gilead responds that the Court limited production in *AmerisourceBergen* to formal board materials, and argues that this court should "follow *AmerisourceBergen* and not order the production of the underlying antitrust agreements." Def.'s Answering Br. at 53. Defendant misconstrues *AmerisourceBergen*, where the Court found that "[t]he record is inadequate to determine whether the plaintiffs can inspect any other materials because AmerisourceBergen refused to provide any discovery into what types of books and records exist, how they are maintained, and who has them." *See* 2020 Del. Ch. LEXIS 17, 2020 WL 132752, at *1. The court expressly granted the plaintiffs the ability to seek further discovery to determine what books and records exist. *See* 2020 Del. Ch. LEXIS 17, [WL] at *29. Here, Plaintiffs obtained that discovery, so there is no need for bifurcation.

[248] Pls.' Opening Br. at 57.

[249] *See, e.g.,* ***[*52]*** AmerisourceBergen, 2020 Del. Ch. LEXIS 17, 2020 WL 132752, at *27 (ordering production of the Amerisourcebergen's written policies regarding its anti-diversion and compliance program); In re Facebook, Inc. Section 220 Litig. (Facebook 220), 2019 Del. Ch. LEXIS 197, 2019 WL 2320842, at *18 (Del. Ch. May 30, 2019) (ordering the production of Facebook's formally adopted policies and procedures regarding data privacy and access to user data, including those promulgated following the entry of the Consent Decree); UnitedHealth, 2018 Del. Ch. LEXIS 69, 2018 WL 1110849, at *10 (ordering the production of UnitedHealth's policies and procedures regarding Medicare billing); Lucent, 2003 Del. Ch. LEXIS 3, 2003 WL 139766, at *6 (ordering production of policies and procedures concerning accounting compliance, including policies for (i) preparing revenue "targets" or preparing and disclosing "financial guidance" or projections; and (ii) recognizing revenue, on sales to its distributors).

[250] Def.'s Answering Br. at 53-54.

documents that they refer to as "Senior Management Materials" to determine "whether and to what extent mismanagement occurred and what information was transmitted to Gilead's directors and officers."[251]

This court will permit inspection of officer-level documents under certain circumstances. As the Delaware Supreme Court described in *Saito* when affirming inspection of officer-level documents, "generally, the source of the documents in a corporation's possession should not control a stockholder's right to inspection under [§ 220](#)."[252] Although inspection of officer-level documents can be appropriate, in general, "the Court of Chancery should not order emails to be produced when other materials (*e.g.*, traditional board-level materials, such as minutes) would accomplish the petitioner's proper purpose, but if non-email books and records are insufficient, then the court should order emails to be produced."[253] The burden lies on Plaintiffs to establish a reasonable basis to suspect that other materials are likely to be insufficient to accomplish the stockholder's proper purpose.

First, Plaintiffs seek approximately thirty sets of materials emailed to senior management members prior to their bi-monthly "Leadership Team Meetings" and ad hoc meetings.[254] Plaintiffs observe that Gilead stores the materials circulated in connection with the bi-monthly meetings in a centralized location.[255] Plaintiffs contend that these materials are likely to include information about the government investigations, the antitrust lawsuits, and Gilead's decision to sue the U.S. government.[256] These thirty sets are necessary and essential to Plaintiffs' ability to investigate whether and to what extent wrongdoing occurred and what information was transmitted to Gilead's directors and officers.[257] They are also unlikely to be available from another source. Accordingly, Plaintiffs are entitled to inspect this category of documents.

Second, Plaintiffs request electronically stored information—previously gathered and produced in connection with the congressional investigation, the *Staley* Action, and a 2016 subpoena—from the files of two former inside directors John Milligan and John Martin.[258] Plaintiffs say that Milligan and Martin were highly influential Board members and **[*54]** thus their documents are critical because any wrongdoing will likely involve what these Board members knew.[259] As to this one category, Plaintiffs' efforts fall short. A director's status as a management member or highly influential Board member can sometimes provide a basis for inspecting that director's emails, typically where the director played a key role in the suspected wrongdoing.[260] The mere fact that a director holds a management position or is influential seldom makes their documents necessary and essential to investigating wrongdoing.[261] In this case, Plaintiffs offer no additional justification for seeking to inspect these documents. Plaintiffs have therefore failed to demonstrate that these emails are necessary and essential to their stated purposes and are not entitled to inspect this category of documents.

---

[251] Pls.' Opening Br. at 60-62.

[252] Saito, 806 A.2d at 118; *accord.* Wal-Mart Stores, Inc., 95 A.3d at 1273; *see also* ***[*53]*** Woods, 2020 Del. Ch. LEXIS 249, 2020 WL 4200131, at *11; Mudrick Capital Mgmt., L.P. v. Globalstar, Inc., 2018 Del. Ch. LEXIS 257, 2018 WL 3625680, at *9 (Del. Ch. July 30, 2018).

[253] ***Palantir, 203 A.3d at 752-53***.

[254] Trial Tr. at 87:7-21; JX-210 at 26, 39.

[255] *See* Pls.' Opening Br. at 62 & n.204; *see also* JX-210 at 40 ("From June 2019 to present, documents may be accessed via OneDrive and projected for shared viewing.").

[256] Pls.' Opening Br. at 60-62.

[257] *Cf.* Facebook 220, 2019 Del. Ch. LEXIS 197, 2019 WL 2320842, at *18 (ordering the production of "electronic communications, if coming from, directed to or copied to a member of the Board, concerning" the plaintiffs' allegations in that case, "to be collected from the following [senior management] custodians: Erskine B. Bowles, Sheryl Sandberg, Alex Stamos, and Mark Zuckerberg").

[258] Pls.' Opening Br. at 61-62; *see also* JX-210 at 27 n.4 (alleging that Milligan and Martin, as former executives, were "custodians in certain Matters by virtue of their roles as Senior Officers).

[259] Pls.' Post-Trial Opening Br. at 61-62.

[260] *See, e.g.,* Yahoo!, 132 A.3d at 791-793 (permitting inspection of CEO's "email and other electronic documents" because she "was the principal corporate actor in the hiring process").

[261] *Cf.* Kaufman v. CA, Inc. (Kaufman II), 905 A.2d 749, 755 (Del. Ch. 2006) (holding that the plaintiff "conflate[d] the usefulness or responsiveness of further discovery . . . with the proper standard of necessity under Section 220" and "[t]hat a document would be potentially discoverable under Rule 34 does not make it necessary and essential under Section 220").

d. Gilead's Communications with the Government

Plaintiffs seek to inspect high-level communications between Gilead and government investigators that state the basis for the ongoing government investigations.[262] This court regularly orders companies to produce communications related to government investigations and litigation in Section 220 cases where those investigations **[*55]** supply or support a credible basis for wrongdoing.[263]

Just as Gilead's policies and procedures are necessary and essential to reveal the degree of Gilead's compliance with internal rules, these documents are necessary and essential to reveal the degree of Gilead's compliance with positive law and government regulations. Considering that the ongoing government investigations supported Plaintiffs' credible basis for inspection, these documents are necessary and essential to assess whether wrongdoing occurred. These communications might also inform whether the Company has taken any steps to address the possible wrongdoing. Ongoing government investigations might threaten Gilead's ability to secure future government funding, which would present a serious problem for Gilead's business.

These documents are therefore necessary and essential to Plaintiffs' proper purposes. They are also unlikely to be available from another source. Accordingly, Plaintiffs are entitled to inspect this category of documents.

e. Director Questionnaires

Plaintiffs seek to inspect the directors' and officers' questionnaires for each Board member.[264] This court regularly orders companies to **[*56]** produce director questionnaires where a plaintiff has demonstrated a credible basis to suspect possible wrongdoing.[265]

Because that the Demands investigate alleged violations of positive law and government regulations, understanding the directors' motives and potential conflicts is paramount. Further, the burden on Gilead in producing these documents is minimal. Gilead stores these documents in a central location,[266] so they are easy to locate and produce. They are unlikely to be available from another source. Accordingly, Plaintiffs are entitled to inspect this category of documents.

3. Plaintiff-Specific Restrictions on Inspection

Gilead seeks to limit the scope of each Plaintiffs' inspections to the documents requested in their respective Demands.[267] Gilead argues that if a Plaintiff elected not to request a certain category of documents in its Demand, then it conceded that such category of information is nonessential to its stated purpose. Gilead

---

[262] Pls.' Opening Br. at 58-60.

[263] *See, e.g., Facebook 220, 2019 Del. Ch. LEXIS 197, 2019 WL 2320842, at *18* (ordering production of documents and communications related to "investigations conducted by the FTC, DOJ, SEC, FBI and ICO regarding Facebook's data privacy practices"); *China MediaExpress, 2012 Del. Ch. LEXIS 3, 2012 WL 28818, at *6* (ordering production of any materials provided to the United States Patent Office or any patent office in any other country, including the People's Republic of China); *Lucent, 2003 Del. Ch. LEXIS 3, 2003 WL 139766, at *5* (ordering production of "[o]rders and other communications with the SEC concerning its investigation"); *Carapico, 791 A.2d at 792* (ordering production of "reports presented to or minutes of meetings of the Exchange Board of Governors (or any committees or subgroups thereof) relating to (a) the SEC inquiry, (b) the decision to authorize the settlement of the SEC inquiry, or (c) the impact of the terms of the SEC Order on the business of the Exchange or any of its subsidiaries"); *see also AmerisourceBergen, 2020 Del. Ch. LEXIS 17, 2020 WL 132752, at *25* ("In an appropriate case, an inspection may extend further to encompass communications and materials that were only shared among or reviewed by officers and employees . . . .").

[264] Pls.' Opening Br. at 56.

[265] *See, e.g., Facebook 220, 2019 Del. Ch. LEXIS 197, 2019 WL 2320842, at *18* (ordering defendant to produce director questionnaires); *UnitedHealth, 2018 Del. Ch. LEXIS 69, 2018 WL 1110849, at *9* (same); *Lavin, 2017 Del. Ch. LEXIS 866, 2017 WL 6728702, at *14* (same). Often, a stockholder will assert the desire to investigate director independence as a separate purpose for seeking books and records. *See, e.g., Facebook 220, 2019 Del. Ch. LEXIS 197, 2019 WL 2320842, at *1* (one of the plaintiffs' stated purposes was to investigate the independence and disinterest of the board); *UnitedHealth, 2018 Del. Ch. LEXIS 69, 2018 WL 1110849, at *1 (Del. Ch. Feb. 28, 2018)* (same); *Lavin, 2017 Del. Ch. LEXIS 866, 2017 WL 6728702, at *1 (Del. Ch. Dec. 29, 2017)* (same). In this case, Plaintiffs desire to investigating director independence is a component of investigating the corporate wrongdoing at issue.

[266] JX-210 at 24 n.2.

[267] *See* Def.'s Answering Br. at 45-46.

contends that Plaintiffs may not by piggyback on other stockholders' separate Demands.[268]

As a general rule, a stockholder's inspection rights are limited by the scope of the demand letter, and a Section 220 plaintiff **[*57]** will be foreclosed from recasting the scope of its demand at the eleventh hour.[269] The conventional wisdom underlying this rule is that it is difficult and inefficient for companies to consider the merits of an evolving request. Preventing Section 220 plaintiffs from revising the scope of their demands during litigation promotes the policy of protecting corporations from the burden and additional costs created by these inefficiencies.[270]

This general rule serves to promote litigant and judicial efficiency and is not strictly applied when those purposes are not furthered. For example, Section 220 plaintiffs often lack information about what type of corporate records exist when making their demands. This informational asymmetry can force Section 220 plaintiffs to make broad requests. Tailored discovery in a Section 220 action can allow Section 220 plaintiffs to refine their requests with greater precision and drop requests for non-existent information. The iterative process that occurs through Section 220 discovery thus helps to eliminate pointless hypothetical disputes and promote judicial and litigant efficiencies, all good things this court strives to encourage.[271]

To that end, sometimes this court will ask Section 220 plaintiffs **[*58]** to revise their requests to streamline disputes. In *Facebook*, for example, the court required the defendant to respond to a demand as "refined by the parties' several and meet and confer sessions."[272] The "refined" demand was "the version of the Demand that [the defendants] addressed in their pre-trial brief and at trial."[273] The court held: "The scope of documents requested in that version, therefore, has been properly joined for decision."[274]

The general rule does not promote efficiency when applied to coordinated Section 220 actions like this case. Often, corporate actions will draw demands for inspection from multiple plaintiffs. In such cases, Section 220 plaintiffs may agree to coordinate their efforts, or sometimes the court or the defendants will ask the Section 220 plaintiffs to do so. A coordinated approach is almost always desirable because it allows the court to resolve, and the defendant to litigate, and a single Section 220 action rather than multiple actions. A coordinated approach also reduces the likelihood of inconsistent determinations on similar issues.

In this case, it was Gilead that asked Plaintiffs to

[268] *Id.* at 46 (first citing Paraflon Invs., Ltd. v. Linkable Networks, Inc., 2020 Del. Ch. LEXIS 126, 2020 WL 1655947, at *6 (Del. Ch. Apr. 3, 2020) (refusing to order production of documents not requested in demand); then citing Fuchs Family Trust v. Parker Drilling Co., 2015 Del. Ch. LEXIS 55, 2015 WL 1036106, at *4, *7 (Del. Ch. Mar. 4, 2015) (rejecting a Section 220 plaintiff's late-stage attempts to expands its inspection)).

[269] *See, e.g.,* Fuchs, 2015 Del. Ch. LEXIS 55, 2015 WL 1036106, at *4 (rejecting a Section 220 plaintiff's efforts to expand the scope of requested documents through a supplemental demand sent on the eve of trial); Quantum Tech. Partners IV, L.P. v. Ploom, Inc., 2014 Del. Ch. LEXIS 78, 2014 WL 2156622, at *14 n.118 (Del. Ch. May 14, 2014) ("I note, however, that if Quantum later seeks to inspect information that is not within the categories of information sought in this action, Quantum would need to make a new demand and, if necessary, file a new action."); Highland Select Equity Fund, L.P. v. Motient Corp., 906 A.2d 156, 167 (Del. Ch. 2006), and *aff'd sub nom.* ***Highland Equity Fund, L.P. v. Motient Corp., 922 A.2d 415 (Del. 2007)*** ("None of these revisions adequately address the court's concern as to the breadth of the original demand sued upon or the scope of relief Highland Select continues to seek.").

[270] Paraflon, 2020 Del. Ch. LEXIS 126, 2020 WL 1655947, at *6 ("Striking the proper balance between a stockholders' inspection rights and the right of a company's board to manage the corporation without undue interference from stockholders is a core principle in our Section 220 jurisprudence. Limiting inspection to what is specified in a demand letter is a key way of maintaining that balance. A corporate board is entitled to be informed of exactly what the stockholder is demanding to inspect so it can make the call, before litigation, whether to allow inspection or litigate the demand. Holding that inspection will not be ordered unless a request is presented in the stockholder's inspection demand preserves this balance and prevents a demand letter from turning into an iterative, ongoing request for production.").

[271] *See, e.g.,* ATR-Kim Eng Fin. Corp. v. Araneta, 2006 Del. Ch. LEXIS 215, 2006 WL 3783520, at *2 (Del. Ch. Dec. 21, 2006); *Loppert v. WindsorTech, Inc.*, 865 A.2d, 1282, 1290-91 (Del. Ch. 2004); *see also* Dkt. 65, Oral Arg. Re Def.'s Mot. for Protective Order and the Ct.'s Ruling at 9-10, 57-58.

[272] In re Facebook 220, 2019 Del. Ch. LEXIS 197, 2019 WL 2320842, at *18.

[273] *Id.*

[274] *Id.*

coordinate their litigation efforts, and Plaintiffs agreed.[275] As part of their coordinated **[*59]** process, Plaintiffs worked together to narrow their over sixty overlapping documents requests to a streamlined list.

In this context, limiting Plaintiffs to the documents they demanded before coordination would make no sense. There is no prejudice to Gilead in producing all categories of information deemed necessary and essential to all Plaintiffs. In fact, it would be easier for Gilead to create and track one production set rather than five. Gilead's approach would force the court to conduct four separate scope analyses, defeating some of the judicial efficiencies gained by coordination. It would also risk inconsistent rulings on whether categories of documents were necessary and essential as to certain stockholder plaintiffs but not to others who seek to investigate the same wrongdoing. In sum, strict application of the general rule in this case would defeat the rule's purpose of promote litigant and judicial efficiency.

For this reason, Gilead's final argument seems yet another indication that Gilead's real goal in this litigation is not to protect its interests but, rather, to make the process of investigating wrongdoing as difficult as possible for its stockholders.

D. Conditions [*60] on Inspection

This decision does not address whether it is appropriate to enter conditions on inspection. In its pretrial brief, Gilead asked that inspection be subject to four specific conditions.[276] In its post-trial brief, Gilead suggests that the parties should meet and confer regarding the conditions.[277] Plaintiffs appear to agree that a meet and confer is warranted.[278] The parties shall confer on whether conditions are appropriate and report to the court within twenty days of issuance of this decision.

E. Plaintiffs Are Granted Leave to Move for Their Fees and Expenses.

Delaware courts follow the American Rule that "each party is generally expected to pay its own attorneys' fees regardless of the outcome of the litigation."[279] Even under the American Rule, however, this court retains the ability to shift fees for bad faith conduct "to deter abusive litigation and protect the integrity of the judicial process."[280] In assessing "bad faith," this court can consider both litigation-related conduct and the party's pre-litigation conduct.[281] Although there is "no single, comprehensive definition of 'bad faith' that will justify a fee-shifting award,"[282] this court commonly employs the "glaring egregiousness" **[*61]** standard.[283] "The bad

---

[275] *See supra* note 85 and accompanying text.

[276] Dkt. 85, Def. Gilead Sciences, Inc.'s Pre-Trial Br. at 56-57 (requesting that inspection be subject to a mutually-agreeable form of confidentiality order, a Delaware forum selection provision applicable to any future litigated that uses the fruits of Plaintiffs' inspection, an incorporation condition like that entered in *Yahoo*!, and Gilead's ability to assert that certain documents are privileged or nonresponsive).

[277] Def.'s Answering Br. at 60.

[278] *See* Pls.' Opening Br. at 62-63.

[279] ***Shawe v. Elting, 157 A.3d 142, 149 (Del. 2017)*** (citing *Montgomery Cellular Hldg. Co. v. Dobler, 880 A.2d 206, 227 (Del. 2005))*.

[280] *Montgomery Cellular, 880 A.2d at 227* (internal quotation marks omitted); *see also* *Martin v. Harbor Diversified, Inc., 2020 Del. Ch. LEXIS 47, 2020 WL 568971, at *1 (Del. Ch. Feb. 5, 2020)* ("Shifting fees for bad faith is not, properly speaking, an exception to the American Rule on fees; it is a method for reducing and appropriately allocating the costs of vexatious behavior sufficiently serious that justice requires such mitigation.").

[281] *Compare* *In re SS&C Techs., Inc. S'holders Litig., 948 A.2d 1140, 1149-52 (Del. Ch. 2008)* (applying the bad faith exception to the American Rule and shifting fees because plaintiffs' counsel brought a motion to withdraw on notice in bad faith and made a series of misstatements in filings "that tended to misrepresent or downplay the facts"), *with* *Hardy v. Hardy, 2014 Del. Ch. LEXIS 135, 2014 WL 3736331, at *17 (Del. Ch. July 29, 2014)* (applying the bad faith exception to the American Rule to pre-litigation conduct and holding that the exception can apply "where the pre-litigation conduct of the losing party was so egregious as to justify an award of attorneys' fees" (quoting *Estate of Carpenter v. Dinneen, 2008 Del. Ch. LEXIS 40, 2008 WL 2950764 (Del. Ch. Mar. 26, 2008)))*.

[282] *Montgomery Cellular, 880 A.2d at 227*.

[283] *See, e.g.,* ***RBC Cap. Mkts., LLC v. Jervis, 129 A.3d 816, 879 (Del. 2015)*** (affirming this court's determination under the "glaring egregiousness" standard to shift fees); *Isr. Disc. Bank of N.Y. v. First State Depository Co., LLC, 2013 Del. Ch. LEXIS 136, 2013 WL 2326875, at *28-29 (Del. Ch. May 29, 2013)* (applying the "glaring egregiousness" standard in assessing potential fee shifting); *eBay* *Domestic Hldgs., Inc. v.*

faith exception is applied in 'extraordinary circumstances,'"[284] and it "is not lightly invoked,"[285] but this court has shifted fees in *Section 220* actions where a party's conduct rose to the level of bad faith.[286]

Delaware courts have urged stockholders to use the "tools at hand" and pursue *Section 220* inspections before filing derivative lawsuits for decades,[287] and this court has seen a rise in *Section 220* enforcement actions in recent years.[288] The regrettable reaction by defendant corporations has been massive resistance. As one academic article commented, "defendants have turned books and records litigation into a surrogate proceeding to litigate the possible merits of the suit where they place obstacles in the plaintiffs' way to obstruct them from employing it as a quick and easy pre-filing discovery tool."[289] These obstacles increase the investment required from stockholder plaintiffs and their counsel when pursuing *Section 220* inspections.

It seems that defendants like Gilead think that there are no real downsides to overly aggressive defense campaigns at the *Section 220* phase. Although aggressively defending **[*62]** a *Section 220* action will result in higher defense costs during that phase, the approach can undermine follow-on derivative claims if successful, thereby lowering net costs for defendants. Even if the approach is unsuccessful in thwarting inspection, the work product created in building legal defenses to follow-on derivative claims can be repurposed in the context of the derivative suit. And the risk of reputational harm to defendants resulting from a decision detailing possible corporate wrongdoing rendered under a plaintiff-friendly *Section 220* appears to lack the deterrent effect one might expect it to have.

Scholars have recommended fee shifting as one means of recalibrating the risks of *Section 220* litigation.[290] This proposition finds support in prior decisions of this court and the Model Business Corporation Act.[291]

Fee shifting may be appropriate here. Gilead exemplified the trend of overly aggressive litigation strategies by blocking legitimate discovery, misrepresenting the record, and taking positions for no apparent purpose other than obstructing the exercise of Plaintiffs' statutory rights. Gilead's **[*63]** pre-litigation failure to provide any Plaintiff with even a single document despite the ample evidence of a credible basis and the obvious responsiveness of certain categories of documents amplifies the court's concerns.

For these reasons, Plaintiffs are granted leave to move for fee-shifting.

Newmark, 16 A.3d 1, 47-48 (Del. Ch. 2010) (same); *In re Smith Trust, 1999 Del. Ch. LEXIS 152, 1999 WL 596274, at *2-4 (Del. Ch. July 23, 1999)* (same).

[284] *E.g.*, ***Shawe, 157 A.3d at 150-51***; *Montgomery Cellular, 880 A.2d at 227*; *accord. Dover Hist. Soc., 902 A.2d at 1092*; *Henry v. Phixios Holdings, Inc., 2017 Del. Ch. LEXIS 119, 2017 WL 2928034, at *14 (Del. Ch. July 10, 2017)* (Montgomery-Reeves, V.C.).

[285] *Ravenswood Inv. Co., L.P. v. Winmill & Co., 2014 Del. Ch. LEXIS 93, 2014 WL 2445776, at *4 (Del. Ch. May 30, 2014)* (quoting *Beck v. Atl. Coast PLC, 868 A.2d 840, 851 (Del. Ch. 2005))*.

[286] *See, e.g.*, *Carlson v. Hallinan, 925 A.2d 506, 545-46 (Del. Ch. 2006)*; *McGowan v. Empress Ent., Inc., 791 A.2d 1, 3-8 (Del. Ch. 2000)*; *Technicorp Int'l II, Inc. v. Johnston, 2000 Del. Ch. LEXIS 81, 2000 WL 713750, at *44 (Del. Ch. May 31, 2000)*.

[287] *See supra* note 169.

[288] *See* Edward B. Micheletti, et al., *Recent Trends in Books-and-Records Litigation*, 38 Del. Law. 18, 18 (2020) ("[T]he frequency of stockholder demands to inspect corporate books and records has increased . . . ."); *Cox et al., supra note 6 at 2123, 2146-47* (comparing the number of *Section 220* actions filed from 1981 to 1994 with those filed from 2004 to 2018 and finding a thirteen-fold increase).

[289] *Cox et al., supra note 6 at 2150*.

---

[290] *See* *id. at 2151* ("Delaware should give serious consideration to awarding plaintiffs their attorneys' fees in cases where the defendants make untoward efforts to delay the resolution of these summary cases."); Randall Thomas, *Improving Shareholder Monitoring of Corporate Management by Expanding Statutory Access to Information, 38 Ariz. L. Rev. 331, 335 (1996)* (arguing that for *Section 220* to facilitate effective stockholder monitoring, it must be significantly streamlined, including shifting attorneys' fees to deter frivolous refusals to produce information).

[291] *See supra* note 286; Model Business Corporation Act § 16.04(c) ("If the court orders inspection and copying of the records demanded, it shall also order the corporation to pay the shareholder's costs (including reasonable counsel fees) incurred to obtain the order unless the corporation proves that it refused inspection in good faith because it had a reasonable basis for doubt about the right of the shareholder to inspect the records demanded.").

III. CONCLUSION

For the foregoing reasons, judgment is entered in favor of Plaintiffs. The parties shall confer regarding conditions on inspection and concerning a form of order memorializing the scope of Gilead's production. Plaintiffs may seek leave to move for fee-shifting.

Pettry v. Gilead Scis., Inc.

Court of Chancery of Delaware

July 22, 2021, Decided

C.A. No. 2020-0132-KSJM, C.A. No. 2020-0138-KSJM, C.A. No. 2020-0155-KSJM, C.A. No. 2020-0173-KSJM

Reporter
2021 Del. Ch. LEXIS 156 *; 2021 WL 3087027

Deborah Pettry and Gail Friedt v. Gilead Sciences, Inc.;Richard C. Collins v. Gilead Sciences, Inc.;Hollywood Police Officers' Retirement System v. Gilead, Sciences, Inc.;Anthony Ramirez v. Gilead Sciences, Inc.

Notice: THIS OPINION HAS NOT BEEN RELEASED FOR PUBLICATION. UNTIL RELEASED, IT IS SUBJECT TO REVISION OR WITHDRAWAL.

Prior History: *Pettry v. Gilead Scis., Inc., 2020 Del. Ch. LEXIS 347, 2020 WL 6870461 (Del. Ch., Nov. 24, 2020)*

Counsel: **[*1]** Blake A. Bennett, Esquire, Cooch and Taylor, P.A., Wilmington, DE.

Gregory V. Varallo, Esquire, Bernstein Litowitz Berger & Grossmann LLP, Wilmington, DE.

Kurt M. Heyman, Esquire, Gillian L. Andrews, Esquire, Heyman Enerio Gattuso & Hirzel LLP, Wilmington, DE.

Brian C. Ralston, Esquire, Aaron R. Sims, Esquire, Potter Anderson & Corroon LLP, Wilmington, DE.

Judges: Kathaleen St. Jude McCormick, Chancellor.

Opinion by: Kathaleen St. Jude McCormick

Opinion

This letter resolves Plaintiffs' Motion for an Award of Attorneys' Fees and Expenses. The Post-Trial Memorandum Opinion in this matter (the "Memorandum Opinion") supplies the factual background germane to this letter decision.[1]

Delaware courts follow the American Rule that each party is expected to pay its own attorneys' fees regardless of the outcome of the litigation. This court, however, retains the ability to shift fees when faced with vexatious litigation conduct "to deter abusive litigation and to protect the integrity of the judicial process."[2] This court may award fees "in its discretion . . . 'where equity requires.'"[3] This court has used fee-shifting as "a method for reducing and appropriately allocating the costs of vexatious behavior sufficiently serious that **[*2]** justice requires such mitigation."[4] This exception is frequently referred to as the "bad faith" exception to the American rule, although the exception itself is perhaps more expansive, and there is "no single, comprehensive definition of 'bad faith' that will justify a fee-shifting award."[5] To capture the sorts of vexatious activities that the bad-faith exception is intended to address, this court employs the "glaring egregiousness" standard.[6]

---

1 *See* C.A. No. 2020-0173-KSJM, Docket ("Dkt.") 108 ("Mem. Op."). Defined terms used in this Order have the same meaning ascribed to them in the Memorandum Opinion.

2 *Montgomery Cellular Hldg. Co. v. Dobler, 880 A.2d 206, 227 (Del. 2005)*.

3 *Scion Breckenridge Managing Member, LLC v. ASB Allegiance Real Estate Fund, 68 A.3d 665, 687 (Del. 2013)* (quoting *Burge v. Fidelity Bond & Mortg. Co., 648 A.2d 414, 421 (Del. 1994)*).

4 *Martin v. Harbor Diversified, Inc., 2020 Del. Ch. LEXIS 47, 2020 WL 568971, at *1 (Del. Ch. Feb. 5, 2020)*.

5 *Montgomery Cellular, 880 A.2d at 227*.

6 *See, e.g.,* ***RBC Cap. Mkts., LLC v. Jervis, 129 A.3d 816, 879 (Del. 2015)*** (affirming this court's determination to shift fees under the "glaring egregiousness" standard); *Isr. Disc. Bank of N.Y. v. First State Depository Co., 2013 Del. Ch. LEXIS 136, 2013 WL 2326875, at *28-29 (Del. Ch. May 29, 2013)* (applying the "glaring egregiousness" standard in assessing potential fee shifting); *eBay Domestic Hldgs., Inc. v. Newmark, 16 A.3d 1, 47-48 (Del. Ch. 2010)* (same); *In re Charles Wm. Smith Tr., 1999 Del. Ch. LEXIS 152, 1999 WL*

Delaware courts have shifted fees for glaringly egregious conduct, such as forcing a plaintiff to file suit to "secure a clearly defined and established right,"[7] "unnecessarily prolong[ing] or delay[ing] litigation, falsif[ying] records, or knowingly assert[ing] frivolous claims."[8]

Although there is a fine line between glaringly egregious conduct and an aggressive litigation position, Gilead crossed the line in this case.

After Gilead declined to produce a single document to any of the five Plaintiffs thereby forcing them to commence litigation, Gilead took a series of positions during litigation that, when viewed collectively, were glaringly egregious.

Gilead argued that Plaintiffs had not met the credible basis requirement to investigate **[*3]** wrongdoing—a requirement that imposes "the lowest possible burden of proof"[9]—even though Plaintiffs had ample support for their proposition.[10]

Gilead claimed that Plaintiffs were not entitled to inspection because any follow-on claims challenging the wrongdoing at issue would be dismissed, ignoring that "[t]he stockholder need not demonstrate that the alleged mismanagement or wrongdoing is actionable" in order to be entitled to inspection.[11] In developing this argument, Gilead also misrepresented the record.[12]

Gilead pursued at trial a *Wilkinson* defense as to each Plaintiff, although deposition testimony revealed that all Plaintiffs "were knowledgeable about the basis for their Demands" and requested the books and records as an exercise of their statutory rights as stockholders.[13]

Gilead took aggressive positions in discovery, although the "purpose and nature of Section 220 proceedings" are better served when "managed expeditiously."[14]

Perhaps one of these positions, standing alone, could be forgiven as merely an aggressive defense. Perhaps not. I do not need to make that difficult call because, collectively, these positions rise to the level of glaringly egregious litigation conduct.

While Gilead **[*4]** admits that it vigorously defended the lawsuit, it contends that it did so on the "good-faith belief that the case law and factual record developed through discovery supported its arguments."[15] Gilead further argues that to obtain fee shifting, Plaintiffs "must show by *clear evidence* that Gilead acted in *subjective* bad faith that rose to the level of *glaring egregiousness*."[16]

Gilead overstates the law on this point. Although Delaware courts have described the bad faith standard as "subjective," this court has shifted fees based on litigation conduct without launching a fact-intensive

596274, at *2-4 (Del. Ch. July 23, 1999) (same).

[7] McGowan v. Empress Ent., Inc., 791 A.2d 1, 4 (Del. Ch. 2000) ("If McGowan had a clearly established legal right to inspect Empress's books and records, and Empress's conduct forced him to bring this action to secure that right, then the defendant can be found to have acted in bad faith and be ordered to pay the plaintiff's legal fees and expenses."); *accord.* Donnelly v. Keryx Biopharmaceuticals, Inc., 2019 Del. Ch. LEXIS 1328, 2019 WL 5446015, at *6 (Del. Ch. Oct. 24, 2019); Norman v. US MobilComm, Inc., 2006 Del. Ch. LEXIS 81, 2006 WL 1229115, at *4 (Del. Ch. Apr. 28, 2006).

[8] RBC Cap. Mkts., LLC v. Educ. Loan Tr. IV, 2016 Del. Super. LEXIS 93, 2016 WL 703852, at *3 (Del. Super. Feb. 17, 2016) (quoting Johnston v. Arbitrium (Cayman Islands) Handels AG, 720 A.2d 542, 546 (Del. 1998)); ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC, 2013 Del. Ch. LEXIS 236, 2013 WL 5152295, at *10 (Del. Ch. Sept. 16, 2013) (quoting Beck v. Atl. Coast PLC, 868 A.2d 840, 851 (Del. Ch. 2005)); In re SS & C Techs., Inc. S'holders Litig., 948 A.2d 1140, 1150 (Del. Ch. 2008) (quoting Johnston, 720 A.2d at 546).

[9] Seinfeld v. Verizon Comm'ns, Inc., 909 A.2d 117, 123 (Del. 2006).

[10] *See* Mem. Op. at 25-33 (explaining that Plaintiffs' support included an ongoing, multi-billion dollar antitrust lawsuit, including a 134-page complaint; a motion to dismiss that lawsuit with 38 exhibits; a decision of the federal court denying the motion to dismiss; pleadings accompanying mass tort claims by over 15,000 plaintiffs in multiple jurisdictions; a lawsuit by the DOJ alleging patent infringement and a subsequent ruling by the Patent Trial and Appeals Board; DOJ investigations into False Claims Act violations, including accompanying subpoenas and a related federal litigation; and congressional testimony).

[11] *See* AmerisourceBergen Co. v. Lebanon Cnty. Emps. Ret. Fund, 243 A.3d 417, 437 (Del. 2020).

[12] Mem. Op. at 45-47 (detailing Gilead's various misrepresentations of the record).

[13] *Id.* at 34.

[14] *See* AmerisourceBergen, 243 A.3d at 437.

[15] Dkt. 121 ¶ 2

[16] *Id.* (emphasis in original).

investigation into the offending party's state of mind.[17] Moreover, where this court shifts fees to curb and correct for overly vexatious litigation behavior, a showing of glaringly egregious litigation conduct is enough. To the extent that a finding of bad faith is necessary, then the court can infer bad faith based on the litigation conduct alone. In this case, such an inference is appropriate.

For the foregoing reasons, Plaintiffs' Motion for an Award of Attorneys' Fees and Expenses is GRANTED.

IT IS SO ORDERED.

Sincerely,

/s/ Kathaleen St. Jude McCormick

Kathaleen St. Jude McCormick

Chancellor

End of Document

[17] *See, e.g., McGowan, 791 A.2d at 4* (holding that the defendant "acted in subjective bad faith by failing to honor its promises to produce its books and records, and later by opposing [the plaintiff's] *§ 220* action to enforce his legal right to inspect those books and records," despite there being no record of the defendant's state of mind).

Richman v. Goldman Sachs Group, Inc.

United States District Court for the Southern District of New York

June 21, 2012, Decided; June 21, 2012, Filed

10 Civ. 3461 (PAC)

Reporter

868 F. Supp. 2d 261 *; 2012 U.S. Dist. LEXIS 86556 **; Fed. Sec. L. Rep. (CCH) P96,926; 2012 WL 2362539

Ilene Richman, Individually and on behalf of all others similarly situated, Plaintiffs -against- Goldman Sachs Group, Inc, et al., Defendants.

Subsequent History: Reconsideration denied by, Adhered to *In re Goldman Sachs Group, Inc. Sec. Litig., 2014 U.S. Dist. LEXIS 85683 (S.D.N.Y., June 23, 2014)*

Prior History: *Richman v. Goldman Sachs Group, Inc., 274 F.R.D. 473, 2011 U.S. Dist. LEXIS 64016 (S.D.N.Y., Mar. 25, 2011)*

Counsel: **[**1]** For Pension Funds, Lead Plaintiff: Christopher J. Keller, LEAD ATTORNEY, Labaton Sucharow, LLP, New York, NY.

For Arkansas Teachers Retirement System, Lead Plaintiff: Craig Anthony Martin, James W. Johnson, Lawrence Alan Sucharow, Louis Gottlieb, Thomas A. Dubbs, LEAD ATTORNEYS, Labaton Sucharow, LLP, New York, NY.

For West Virginia Investment Management Board, Lead Plaintiff: Mark W. Carbone, PRO HAC VICE, Carbone & Blaydes, PLLC, Charleston, WV; Robert R. Henssler, Jr., PRO HAC VICE, Robbins Geller Rudman & Dowd LLP (SFran.), San Francisco, CA.

For Plumbers and Pipefitters Pension Group, Lead Plaintiff: Robert R. Henssler, Jr., PRO HAC VICE, Robbins Geller Rudman & Dowd LLP (SFran.), San Francisco, CA.

For Ilene Richman, Individually and on behalf of all others similarly situated, Plaintiff: Samuel Howard Rudman, LEAD ATTORNEY, David Avi Rosenfeld, Robbins Geller Rudman & Dowd LLP(LI), Melville, NY; Eric I. Niehaus, Jonah H. Goldstein, Spencer A. Burkholz, PRO HAC VICE, Catherine J. Kowalewski, Robbins Geller Rudman & Dowd LLP (San Diego), San Diego, CA; Danielle S. Myers, Darren J. Robbins, PRO HAC VICE, Robbins Geller Rudman & Dowd LLP, (SANDIEGO) San Diego, CA; David C. Walton, **[**2]** Lerach, Coughlin, Stoia, Geller, Rudman & Robbins, L.L.P., San Diego, CA; Kenneth A. Elan, Kenneth A. Elan, Esq, New York, NY; Mark W. Carbone, PRO HAC VICE, Carbone & Blaydes, PLLC, Charleston, WV; Robert R. Henssler, Jr., PRO HAC VICE, Robbins Geller Rudman & Dowd LLP (SFran.), San Francisco, CA.

For pl Pablo Elizondo, Plaintiff: Danielle S. Myers, PROHAC VICE, Robbins Geller Rudman & Dowd LLP (SANDIEGO), San Diego, CA; Eric I. Niehaus, Jonah H. Goldstein, Spencer A. Burkholz, PRO HAC VICE, Robbins Geller Rudman & Dowd LLP (San Diego), San Diego, CA; Kenneth A. Elan, Kenneth A. Elan, Esq, New York, NY; Mark W. Carbone, PRO HAC VICE, Carbone & Blaydes, PLLC, Charleston, WV; Robert R. Henssler, Jr. PRO HAC VICE, Robbins Geller Rudman & Dowd LLP (SFran.), San Francisco, CA.

For Howard Sorkin, Individually, Howard Sorkin, On behalf of all others similarly situated, Consolidated Plaintiffs: Samuel Howard Rudman, LEAD ATTORNEY, Robbins Geller Rudman & Dowd LLP(LI), Melville, NY.

For Tikva Bochner, On behalf of herself and all others similarly situated, Consolidated Plaintiff: James Abram Harrod, III, Wolf Popper LLP, New York, NY.

For DR. Ehsan Afshani, Consolidated Plaintiff: Christopher **[**3]** Lovell, Fred Taylor Isquith, Victor E. Stewart, Lovell Stewart Halebian Jacobson LLP, New York, NY; Edward H. Glenn, Jr., Jacob H. Zamansky, Kevin Dugald Galbraith, Zamansky & Associates, L.L.C., New York, NY.

For Louis Gold, Individually, Louis Gold, On behalf of all others similarly situated, Consolidated Plaintiffs: Charles A. Germershausen, PRO HAC VICE, James Stuart Notis, Gardy & Notis, LLP, Englewood Cliffs, NJ.

For Thomas Draft, individually and on behalf of all others similarly situated, Consolidated Plaintiff: Evan J. Smith, Brodsky & Smith, L.L.C., Mineola, NY.

For Tikva Bochner, Movant: Marian Rosner, Wolf

Popper LLP, New York, NY.

For Montana Board of Investments, Movant: Jay W. Eisenhofer, LEAD ATTORNEY, Grant & Eisenhofer P.A. (NY), New York, NY; Gerald H. Silk, Bernstein Litowitz Berger & Grossmann LLP, New York, NY; Regina Marie Calcaterra, Barrack, Rodos & Bacine(NYC), New York, NY; Sean M. Handler, Kessler Topaz Meltzer & Check, LLP (PA), Radnor, PA.

For Metzler Investment GmbH, Movant: Jay W. Eisenhofer, LEAD ATTORNEY, Grant & Eisenhofer P.A. (NY), New York, NY; Gerald H. Silk, Bernstein Litowitz Berger & Grossmann LLP, New York, NY; Sean M. Handler, Kessler Topaz Meltzer **[**4]** & Check, LLP (PA), Radnor, PA.

For Sampension KP Livsforsikring A/S, Movant: Jay W. Eisenhofer, LEAD ATTORNEY, Grant & Eisenhofer P.A. (NY), New York, NY; Gerald H. Silk, Bernstein Litowitz Berger & Grossmann LLP, New York, NY.

For Goldman Sachs Group, Inc., Lloyd C. Blankfein, David A. Viniar, Gary D. Cohn, Defendants: Benjamin Robert Walker, Richard Howard Klapper, Theodore Edelman, Sullivan & Cromwell, LLP(NYC), New York, NY; David Maxwell Rein, Sullivan & Cromwell LLP, New York, NY.

Judges: PAUL A. CROTTY, United States District Judge.

Opinion by: PAUL A. CROTTY

Opinion

[*269] OPINION & ORDER

HONORABLE PAUL A. CROTTY, United States District Judge:

Plaintiffs in this class action allege that Goldman Sachs & Co. ("Goldman"), Lloyd C. Blankfein, David A. Viniar, and Gary D. Cohn (the "Individual Defendants," and collectively with Goldman, the "Defendants") violated § 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder (Count One); and § 20(a) of the Exchange Act (Count II). Plaintiffs, who are purchasers of Goldman's common stock during the period February 5, 2007 through June 10, 2010, claim that Defendants made material misstatements and omissions regarding: (1) Goldman's receipt of "Wells Notices" from the **[**5]** Securities and Exchange Commission ("SEC") relating to Goldman's role in the synthetic collateralized debt obligation ("CDO"), titled ABACUS 2007 AC-1 ("Abacus"); and (2) Goldman's conflicts of interest that arose from its role in the Abacus, Hudson Mezzanine Funding 2006-1 ("Hudson"), The Anderson Mezzanine Funding 2007-1 ("Anderson"), and Timberwolf I CDO transactions.

Defendants move, pursuant to Fed. R. Civ. P. 9(b) and 12(b)(6), to dismiss the Consolidated Class Action Complaint (the "Complaint"). For the following reasons, Defendants' motion with respect to the failure to disclose the Wells Notices is GRANTED, and otherwise DENIED.

BACKGROUND

I. Abacus and the SEC Investigation

On April 26, 2007, the Abacus synthetic CDO transaction closed.[1] Goldman served as the underwriter or placement agent, the lead manager, and the protection buyer for the Abacus transaction. (Compl. ¶ 50 & n.3.) Plaintiffs claim that "the Abacus transaction [ ] was designed from the outset by [Goldman] to allow a favored client to benefit at the expense of Goldman's other clients." (Id. ¶ 147.) Specifically, Plaintiffs claim that Goldman allowed Paulson & Co., a hedge fund client, to "play[ ] an active and **[**6]** determinative role in the selection process," and knew that Paulson was picking assets that it "believed would perform poorly or fail." (Id. ¶¶ 53, 64.) Indeed, "Paulson had agreed to pay Goldman a higher fee if Goldman could provide Paulson with CDS contracts containing premium payments below a certain level." (Id. ¶ 77.) Rather than disclose Paulson's role in the asset selection process, Goldman **[*270]** "falsely identified ACA [Management

[1] In a typical CDO, a special purpose vehicle ("SPV") issues notes and uses the proceeds to acquire a portfolio of assets, such as residential mortgage-backed securities ("RMBS"). The SPV makes payments to noteholders from the income generated by the underlying assets. In a synthetic CDO, the SPV contains a CDO and **[**7]** credit default swap ("CDS"). The SPV obtains derivative exposure to a "reference" portfolio—which may be RMBS or CDOs—by entering into a CDS, pursuant to which counterparties agree to make periodic payments to the SPV in exchange for commitment by the SPV to make payments to the counterparties in the event that the reference securities experience adverse credit events. (See Compl. ¶ 50 & n.3.)

LLC] as the only portfolio selection agent for the CDO." (Id. ¶¶ 59-66.) Goldman hid Paulson's role, because it "expect[ed] to leverage ACA's credibility and franchise to help distribute this Transaction." (Id. ¶ 61 (quoting a Goldman internal memorandum)). The Abacus transaction performed poorly, as Paulson intended; the investors lost approximately $1 billion, and Paulson, holding the sole short position, profited by this amount. (Id. ¶ 81.)

In August 2008, the SEC notified Goldman that it had commenced an investigation into Abacus and served Goldman with a subpoena. (Compl. ¶ 88.) Goldman disclosed in its SEC filings that it had "received requests for information from various governmental agencies and self-regulatory organizations relating to subprime mortgages, and securitizations, collateralized debt obligations and synthetic products relating to subprime mortgages" and that Goldman was "cooperating with the requests." (Id. ¶¶ 129, 130.) On July 29, 2009, the SEC issued a Wells Notice to Goldman, notifying it that the SEC's Enforcement Division staff "intends to recommend an enforcement action" and providing Goldman with "an opportunity to respond concerning the recommendation." (Id. ¶ 90.) On September 10 and 25, 2009, Goldman **[**8]** provided written Wells submissions to the SEC. (Id. ¶ 91.) Goldman thereafter met with the SEC on numerous occasions. (Id. ¶ 91.) Plaintiffs claim that by failing to disclose its receipt of a Wells Notice, Goldman "hid its improper conduct of betting against" its clients, and caused its stock to trade at artificially inflated levels. (Id. ¶¶ 49, 99.)

On September 28, 2009 and January 29, 2010, the SEC issued Wells Notices to Fabrice Tourre and Jonathan Egol, two Goldman employees involved in the Abacus transaction. (Id. ¶¶ 93, 94.) On April 16, 2010, the SEC filed a complaint against Goldman and Tourre—but not Egol—alleging securities fraud violations. (Id. ¶ 83.) As a result, Goldman's stock dropped from $184.27 to $160.70 per share, a drop of approximately 13%. (Id. ¶ 99.)

On July 14, 2010, Goldman reached a $550 million settlement with the SEC, in which Goldman acknowledged that its marketing material was incomplete and that it had made a mistake:

> [T]he marketing material for the ABACUS 2001-AC1 transaction contained incomplete information. In particular, it was a mistake for the Goldman marketing materials to state that the reference portfolio was "selected by" ACA Management LLC **[**9]** without disclosing the role of Paulson & Co. Inc. in the portfolio selection process and that Paulson's economic interests were adverse to CDO investors.

(Id. ¶ 87.)

On November 9, 2010, the Financial Industry Regulatory Authority ("FINRA") announced that it fined Goldman $650,000 for failing to disclose, within 30 days, that Tourre and Egol had received Wells Notices, in violation of National Association of Securities Dealers' ("NASD") Conduct Rule 3010 (which became FINRA Rule 2010, when FINRA succeeded NASD). (Id. ¶¶ 100-102.) In settling with FINRA, Goldman admitted that it violated these rules. (Id. ¶¶ 101, 102.)

II. Hudson

Hudson was a synthetic CDO that commenced on or around December 5, 2006, which Goldman packaged and sold. (Id. ¶¶ 148, 164.) Plaintiffs allege that Goldman had "clear conflicts of interest" in the Hudson transaction because it knew that the reference assets were poor quality mortgage related securities which were **[*271]** likely to lose value, and yet, sold these products to its clients at higher prices than Goldman believed they were worth, while betting against those very securities, "thereby allowing the Company to reap billions in profits at their clients direct expense." **[**10]** (Id. ¶ 148.) Goldman had told investors that it "has aligned incentives with the Hudson program by investing in a portion of equity," without disclosing that it also held 100% of the short position at the same time. (Id. ¶¶ 165, 171, 177.) Goldman's incentive from holding $6 million in equity was substantially outweighed by its $2 billion short position. (Id. ¶ 171.) Further, Goldman had not disclosed that the assets had been taken directly from Goldman's inventory, and had been priced by Goldman's own personnel. (Id. ¶¶ 174, 177.)

III. Anderson

Anderson was a synthetic CDO transaction that closed on March 20, 2007, for which Goldman served as the sole credit protection buyer and acted as an intermediary between the CDO and various broker-dealers. (Compl. ¶¶ 190, 191, 202.) Goldman was the source of 28 of the 61 CDS contracts that made up Anderson, and held a 40% short position. (Id. ¶¶ 189-191.) Plaintiffs allege that Goldman developed misleading talking points for its sales force, which did not adequately disclose the asset selection process and touted that Goldman would hold up to 50% of the equity tranche in the CDO, which was worth $21 million, without mentioning its $135 million **[**11]** short position. (Id. ¶¶ 204-207).

IV. Timberwolf I

Timberwolf I is a hybrid CDO squared transaction,[2] which closed in March 2007, that Goldman constructed, underwrote, and sold. (Id. ¶ 213.) In its marketing booklet, Goldman stated that it was purchasing 50% of the equity tranche, but failed to disclose that it was the largest source of assets and held a 36% short position in the CDO. (Id. ¶¶ 214, 216.) Goldman aggressively sold Timberwolf I without explaining its pricing methodology. (Id. ¶ 255.) Plaintiffs allege that Goldman knew it was selling poorly quality assets at inflated prices, and profited from its short position. (Id. ¶¶ 264-67.)

LEGAL STANDARDS

Since Plaintiffs bring claims for security fraud, they must meet heightened pleading requirements of *Fed. R. Civ. P. 9(b)*, and the Private Securities Litigation Reform Act of 1995 ("PSLRA"). *ATSI Commc'ns v. Shaar Fund, Ltd., 493 F.3d 87, 99 (2d Cir.2007)*; see also *15 U.S.C. § 78u-4(b)(1)*.

Section 10(b) of the Exchange Act prohibits any person from using or employing "any manipulative or deceptive device or contrivance in contravention" of SEC rules. *15 U.S.C. § 78j(b)*. *Rule 10b-5*, **[**12]** promulgated under Section 10(b), prohibits "any device, scheme, or artifice to defraud" and "any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading . . . ." *17 C.F.R. § 240.10b-5*.

To state a claim in a private action under section 10(b) and *Rule 10b-5*, a plaintiff must prove: "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission [or transaction causation]; (5) **[*272]** economic loss; and (6) loss causation." *Stoneridge Inv. Partners, L.L.C. v. Scientific—Atlanta, Inc., 552 U.S. 148, 157, 128 S. Ct. 761, 169 L. Ed. 2d 627 (2008)*.

Defendants argue that the Complaint should be dismissed because: (1) Plaintiff failed to plead an actionable misstatement or omission; (2) Plaintiffs failed to allege facts giving rise to a strong inference of scienter; and (3) Plaintiffs failed to adequately allege loss causation.

ANALYSIS

I. Goldman's Failure to Disclose Its Receipt of Wells Notices

A. Disclosure Requirements and The Wells Notice Process

Under *Section 13* of the Exchange Act, Regulation **[**13]** S-K Item 103, a company is required to "[d]escribe briefly any material pending legal proceedings . . . known to be contemplated by governmental authorities." *17 C.F.R. § 229.103*. *Section 240.12b-20* "supplements Regulation S—K by requiring a person who has provided such information in 'a statement or report ... [to] add[ ] such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading.'" *United States v. Yeaman, 987 F.Supp. 373, 381 (E.D.Pa. 1997)*.

The SEC provides a target of an investigation with a Wells Notice "whenever the Enforcement Division staff decides, even preliminarily, to recommend charges." *In re Initial Public Offering Sec. Litig., No. 21 MC 92(SAS), 2003 U.S. Dist. LEXIS 23102, 2004 WL 60290, at *1 (S.D.N.Y. Dec. 24, 2003)*. The party at risk of an enforcement action is then entitled, under SEC rules, to make a "Wells submission" to the SEC, "presenting arguments why the Commissioners should reject the [Enforcement Division] staff's recommendation for enforcement." *WHX Corp. v. S.E.C., 362 F.3d 854, 860, 360 U.S. App. D.C. 412 (D.C. Cir. 2004)* (citing *17 C.F.R. § 202.5(c)*). A party's entitlement to make a Wells submission **[**14]** is "obviously based on recognition that staff advice is not authoritative." Id. Indeed, "[t]he Wells process was implemented so that the Commission would have the opportunity to hear a defendant's arguments before deciding whether to go forward with enforcement proceedings." *In re Initial Public Offering, 2003 U.S. Dist. LEXIS 23102, 2004 WL 60290, at *1*. Accordingly, receipt of a Wells Notice does not necessarily indicate that charges will be filed.

[2] A CDO squared is backed by a pool of CDO tranches.

"An investigation on its own is not a 'pending legal proceeding' until it reaches a stage when the agency or prosecutorial authority makes known that it is contemplating filing suit or bringing charges." ABA Disclosure Obligations under the Federal Securities Laws in Government Investigations—Part II.C.; Regulation S-K, Item 103: Disclosure of "Legal Proceedings," *64 Bus. Law. 973 (2009)*. A Wells Notice may be considered an indication that the staff of a government agency is considering making a recommendation, id., but that is well short of litigation. Further, Plaintiffs conceded at oral argument that no court has ever held that a company's failure to disclose receipt of a Wells Notice constitutes an actionable omission under § 10(b) or *Rule 10b-5*. (May 21, 2012 **[**15]** Oral Arg. Tr. 22:17-22.)

In addition to Regulation S-K, Item 103, FINRA Rule 2010, and NASD Conduct Rule 3010 explicitly require financial firms to report an employee's receipt of a Wells Notice to FINRA within 30 days. (Compl. ¶ 100.)

In this case, the Defendants disclosed, as early as January 27, 2009, that there were governmental investigations into, inter alia, Goldman's synthetic CDO **[*273]** practices.[3] Goldman never disclosed the Wells Notices that it and its employees received on July 29, 2009, September 28, 2009, and January 29, 2010. (Compl. ¶¶ 90-94, 129.)

An omission is actionable where **[**16]** (1) the omitted fact is material; and (2) the omission is (a) "in contravention of an affirmative legal disclosure obligation"; or (b) needed "to prevent existing disclosures from being misleading." *In re Morgan Stanley Info. Fund Sec. Litig., 592 F.3d 347, 360 (2d Cir. 2010)*. Plaintiffs argue (1) that Defendants had to disclose their receipt of Wells Notices in order to prevent their prior disclosures about government investigations from being misleading, and (2) that Defendants had an affirmative legal obligation to disclose their receipt of Wells Notices under Regulation S-K, Item 103, FINRA and NASD Rules.

B. A Duty to Be Accurate and Complete in Making Disclosures

Plaintiffs' primary argument is that Defendants' disclosures about governmental investigations triggered a duty to disclose Goldman's subsequent receipt of Wells Notices. Specifically, Plaintiffs argue that by failing to disclose that the government inquiries resulted in Wells Notices, Defendants misled the public into "erroneously" concluding that "no significant developments had occurred which made the investigation more likely to result in formal charges." (Pl. Opp. 6.)

When a corporation chooses to speak—even where **[**17]** it lacks a duty to speak—it has a "duty to be both accurate and complete." *Caiola v. Citibank, N.A., 295 F.3d 312, 331 (2d Cir. 2002)*. A corporation, however, "only [has to reveal] such [facts], if any, that are needed so that what was revealed would not be so incomplete as to mislead." *In re Bristol Myers Squibb Co. Sec. Litig., 586 F.Supp.2d 148, 160 (S.D.N.Y. 2008)* (citation omitted). The federal securities laws "do not require a company to accuse itself of wrongdoing." *In re Citigroup, Inc. Sec. Litig., 330 F.Supp.2d 367, 377 (S.D.N.Y. 2004)* (citing *In re Am. Express Co. Shareholder Litig., 840 F.Supp. 260, 269-70 (S.D.N.Y. 1993))*; see also *Ciresi v. Citicorp, 782 F.Supp. 819, 823 (S.D.N.Y. 1991)* (dismissing Exchange Act claims in part because "the law does not impose a duty to disclose uncharged, unadjudicated wrongdoing or mismanagement"). Moreover, "defendants [a]re not bound to predict as the 'imminent' or 'likely' outcome of the investigations that indictments of [the company] and its chief officer[s] would follow, with financial disaster in their train." *Ballan v. Wilfred Am. Educ. Corp., 720 F.Supp. 241, 248 (E.D.N.Y. 1989)*.

In In re Citigroup, plaintiffs' 10(b) claims premised **[**18]** on Citigroup's failure to disclose "litigation risks associated with its Enron-related, analysis/investment banking and reporting activities" were dismissed because "Citigroup was not required to make disclosures predicting such litigation"; plaintiffs did not allege that litigation "was substantially certain to occur"; and the SEC filings at issue contained some "discuss[ion of] pending litigation." *330 F.Supp.2d at 377*. Similarly, **[*274]** here, Plaintiffs do not allege that litigation was substantially certain to occur, and concede that Defendants provided some notice about ongoing

[3] Plaintiffs' Complaint cites to the 2009 10-K concerning "requests for information from various governmental agencies" regarding, inter alia, synthetic CDOs. (Compl. ¶ 129.) Both parties refer to this statement as notice of governmental "investigations." (See e.g., Pl. Opp. 4.) Defendants attached SEC filings going back to at least January 27, 2009 that contain an identical disclosure. (See Walker Decl. Ex. J.) While these materials were not attached to the Complaint, the Court can take judicial notice of SEC filings. See *Finn v. Barney, No. 11-1270-CV, 471 Fed. Appx. 30, 2012 U.S. App. LEXIS 6185, 2012 WL 1003656, at *1 (2d Cir. Mar. 27, 2012)*.

governmental investigations in their SEC disclosures. Indeed, Plaintiffs cannot claim that a Wells Notice indicated that litigation was "substantially certain to occur" because Jonathan Egol, a Goldman employee, received a Wells Notice regarding the Abacus transaction and ultimately was not sued by the SEC. While Goldman and Tourre were sued, the Defendants were not obligated to predict and/or disclose their predictions regarding the likelihood of suit. See *Ballan, 720 F.Supp. at 248*.

Moreover, revealing one fact about a subject does not trigger a duty to reveal all facts on the subject, so long as "what was revealed **[**19]** would not be so incomplete as to mislead." *In re Bristol Myers, 586 F.Supp.2d at 160* (quoting *Backman v. Polaroid Corp., 910 F.2d 10, 16 (1st Cir. 1990))*. Plaintiffs have not shown that Defendants were required to disclose their receipt of Wells Notice to prevent their prior disclosures from being inaccurate or incomplete, as their receipt of Wells Notices indicated that the governmental investigations were indeed ongoing. While Plaintiffs claim to want to know about the Wells Notices, "a corporation is not required to disclose a fact merely because a reasonable investor would very much like to know that fact." *In re Time Warner Sec. Litig, 9 F.3d 259, 267 (2d Cir. 1993)*. At best, a Wells Notice indicates not litigation but only the desire of the Enforcement staff to move forward, which it has no power to effectuate. This contingency need not be disclosed.

Plaintiffs also argue that Defendants' statements in response to a December 24, 2009 New York Times Article (the "Article") triggered a duty to disclose the Wells Notices. The Article, which mentioned other investment companies but focused on Goldman, stated that the SEC, Congress, and FINRA are scrutinizing "[h]ow these disastrously **[**20]** performing [synthetic CDO] securities were devised." (Walker Decl. Ex. O at 1.)[4] In response, Goldman released a one-page press release addressing answers to questions the Times had asked prior to publication, but which had not been included in the Article. Goldman explained how synthetic CDOs worked and why they were created. (Compl. ¶ 124.) Goldman's response did not address or mention the existence of governmental investigations. Accordingly, Goldman's press release contained nothing concerning the investigations that could be considered inaccurate or incomplete.

In sum, Plaintiffs have not shown that Defendants' nondisclosure of their receipt of Wells Notices made their prior disclosures about ongoing governmental investigations materially misleading; or that Defendants breached their duty to be accurate and complete in making their disclosures.

C. A Regulatory Duty To Disclose

Plaintiffs also argue that Defendants had an affirmative legal obligation to disclose their receipt of Wells Notices under Regulation S-K, Item 103, **[**21]** FINRA and NASD Rules. There is nothing in Regulation S-K, Item 103 which mandates disclosure of Wells Notices. Item 103 does not explicitly require disclosure of a Wells Notices, and no court has ever held that this regulation creates an implicit duty to disclose receipt of a Wells Notice. When the regulatory investigation matures to the point where litigation is apparent **[*275]** and substantially certain to occur, then 10(b) disclosure is mandated, as discussed above. Until then, disclosure is not required. Moreover, even if Goldman had such a duty here, "[i]t is far from certain that the requirement that there be a duty to disclose under *Rule 10b-5* may be satisfied by importing the disclosure duties from [an] S—K [regulation]." *In re Canandaigua Sec. Litig., 944 F.Supp. 1202, 1210 (S.D.N.Y. 1996)* (addressing S-K regulation 303).

With respect to FINRA Rule 2010 and NASD Conduct Rule 3010, there is no dispute that Goldman was bound by and violated these regulations by failing to disclose Tourre and Egol's receipt of Wells Notices within 30 days. (Compl. ¶¶ 100-103.) Courts, however, have cautioned against allowing securities fraud claims to be predicated solely on violations of NASD rules[5] **[**22]** because such "rules do not confer private rights of action." *Weinraub v. Glen Rauch Sec., Inc., 399 F.Supp.2d 454, 462 (S.D.N.Y. 2005)*; *Tucker v. Janney Montgomery Scott, Inc., No. 96 Civ. 1823(LLS), 1997 U.S. Dist. LEXIS 3856, 1997 WL 151509, at *3 (S.D.N.Y. Apr. 1, 1997)*; see also *GMS Grp., LLC v. Benderson, 326 F.3d 75, 81-82 (2d Cir. 2003)* ("arguably there is no right of action simply for a violation of NASD rules.").[6]

---

[4] Since Plaintiffs obviously relied on this Article in drafting their Complaint, the Court can consider it here. *Roth v. Jennings, 489 F.3d 499, 509 (2d Cir. 2007)*

[5] This is applicable to FINRA rules, since FINRA is NASD's successor.

[6] A violation of Item 103 or NASD rules may nonetheless be

Plaintiffs have not shown that Goldman had a regulatory duty, upon which a Section 10(b) or Rule 10b-5 claim can be based, to disclose its receipt of Wells Notices. Accordingly, Plaintiffs' claim premised on Defendants' failure to disclose receipt of Wells Notices fails.

D. Scienter

While there was no duty to disclose, even if there was such a duty, Plaintiffs' claim would still fail because Plaintiffs have not adequately alleged scienter.

"The **[**23]** requisite state of mind, or scienter, in an action under section 10(b) and Rule 10b-5 is 'an intent to deceive, manipulate or defraud.'" In re GeoPharma, Inc. Sec. Litig., 411 F.Supp.2d 434, 441 (S.D.N.Y. 2006) (quoting Ganino v. Citizens Utils. Corp., 228 F.3d 154, 168 (2d Cir.2000)). Moreover, to satisfy Rule 9(b), a plaintiff must allege "facts that give rise to a strong inference of fraudulent intent." Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1128 (2d Cir. 1994). A plaintiff claiming fraud can plead scienter "either (a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness." Lerner v. Fleet Bank, N.A., 459 F.3d 273, 290-91 (2d Cir. 2006).

While Plaintiffs failed to raise a strong inference of motive and opportunity,[7] "they could raise a strong inference **[*276]** of scienter under the 'strong circumstantial evidence [of conscious misbehavior or recklessness]' prong, 'though the strength of the circumstantial allegations must be correspondingly greater' if there is no motive." ECA, Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co., 553 F.3d 187, 198-99 (2d Cir. 2009) **[**24]** (quoting Kalnit v. Eichler, 264 F.3d 131, 143-44 (2d Cir. 2001). Recklessness sufficient to establish scienter involves conduct that is "highly unreasonable and . . . represents an extreme departure from the standards of ordinary care." Chill v. Gen. Elec. Co., 101 F.3d 263, 269 (2d Cir.1996) (quoting Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 47 (2d Cir.1978)). A strong inference of scienter may arise where a plaintiff alleges, inter alia, defendants "'knew facts or had access to information suggesting that their public statements were not accurate'; or [ ] 'failed to check information they had a duty to monitor.'" Novak v. Kasaks, 216 F.3d 300, 311 (2d Cir. 2000).

Plaintiffs argue that Defendants knew of the Wells Notices and admitted that their failure to disclose Tourre and Egol's receipt of Wells Notices violated FINRA and NASD rules. As previously indicated, Defendants' failure to disclose receipt of Wells Notices did not make their prior and ongoing disclosures inaccurate. Thus, Defendants "failure to disclose [their receipt of Wells Notices], by itself, can only constitute recklessness if there was an obvious duty to disclose that information." In re GeoPharma, 411 F.Supp.2d at 446 (citing Kalnit, 264 F.3d at 143-44)). The requirement that the duty be "obvious" ensures that fraudulent intent will not be imputed to a company every time a public statement lacks **[**26]** detail. See Bragger v. Trinity Capital Enter. Corp., No. 92 Civ. 2124(LMM), 1994 U.S. Dist. LEXIS 2605, 1994 WL 75239, at *4 (S.D.N.Y. Mar. 7, 1994).

Plaintiffs failed to show that Defendants had an obvious duty to disclose their receipt of Wells Notices. Regulation S-K, Item 103 and FINRA and NASD Rules do not create an obvious duty to disclose, sufficient for Section10(b) and Rule 10b-5 purposes; no court has ever held otherwise. Since "the duty to disclose . . . was not so clear," Defendants' "recklessness cannot be inferred from the failure to disclose." Kalnit, 264 F.3d at 143 (holding that since "this case does not present facts indicating a clear duty to disclose, plaintiff's scienter allegations do not provide *strong* evidence of conscious misbehavior or recklessness."); see also In re GeoPharma, 411 F.Supp.2d at 446-47 (holding that defendants had no "obvious duty to disclose [the contents of an] FDA letter" given "what defendants *did* disclose" in their press release).

relevant to a 10(b) and 10b-5 analysis. See GMS Grp., 326 F.3d 75, 82 (NASD "violations may be considered relevant for purposes of § 10(b) unsuitability claims"); Clark v. John Lamula Investors, Inc., 583 F.2d 594, 601 (2d Cir. 1978).

[7] Plaintiffs argue (in a footnote) that Defendants "had a motive to maintain [Goldman's] appearance of financial health . . . ." (Pl. Opp. 20-21 n.17 (quoting RMED Intern., Inc. v. Sloan's Supermarkets, Inc., 878 F.Supp. 16, 19 (S.D.N.Y. 1995).) In RMED Intern., the court found that Defendants had a motive to hide the existence of an FTC investigation in order to "maintain [Defendant's] appearance of financial health to both its existing shareholders and its potential investors." Id. This argument is made in Plaintiffs' **[**25]** opposition brief, but their Complaint does not allege that Defendants omitted any mention of Wells Notices in order to maintain the appearance of financial health. Even if Plaintiffs had made such an allegation, the Second Circuit has since held: "Motives that are common to most corporate officers, such as the desire for the corporation to appear profitable and the desire to keep stock prices high . . . do not constitute 'motive' for purposes of this inquiry." ECA, 553 F.3d at 198.

In sum, Plaintiffs failed to satisfy both the duty and scienter requirements to state a Section 10(b) and *Rule 10b-5* claim. Accordingly, Defendants' motion to dismiss Plaintiffs' claims premised on Defendants' failure to disclose their receipt **[**27]** of Wells Notices is GRANTED.

II. Goldman's Alleged Conflicts of Interest

Plaintiffs claim that Goldman made material misstatements and omissions concerning Goldman's business practices and conflicts of interest, which are actionable in light of Goldman's misstatements and fraudulent conduct in the Abacus, Hudson, Anderson, and Timberwolf I **[*277]** CDO transactions. Plaintiffs are Goldman's own shareholders—not investors in the Abacus, Hudson, Anderson, and Timberwolf I CDO transactions. Accordingly, to state a claim, Plaintiffs have to show that Goldman made material misstatements and omissions with the intent to defraud its own shareholders. See *In re Sadia, S.A. Sec. Litig., 643 F.Supp.2d 521, 532 (S.D.N.Y. 2009)* (distinguishing acts that deceive a company's *own* shareholders, which can give rise to shareholders' securities fraud claims, from those that deceive investors in the securities of other companies, which are not actionable when raised by the company's own shareholders).

A. Actionable Misstatements and Omissions

Plaintiffs claim that Goldman's conduct in the Abacus, Hudson, Anderson, and Timberwolf I CDO transactions made the following disclosures materially misleading:

- "[W]e increasingly **[**28]** have to address potential conflicts of interest, including situations where our services to a particular client or our own proprietary investments or other interests conflict, or are perceived to conflict, with the interest of another client . . . ." (Compl. ¶ 134 (Form 10-K));
- "We have extensive procedures and controls that are designed to . . . address conflicts of interest" (Compl. ¶¶ 134, 154 (Form 10-K));
- "Our clients' interests always come first. Our experience shows that if we serve our clients well, our own success will follow." (Compl. ¶ 154 (Goldman Annual Report));
- "We are dedicated to complying fully with the letter and spirit of the laws, rules and ethical principles that govern us. Our continued success depends upon unswerving adherence to this standard." (Compl. ¶ 154 (Goldman Annual Report));
- "Integrity and honesty are at the heart of our business" (Compl. ¶ 289 (Goldman Annual Report));
- "Most importantly, and the basic reason for our success, is our extraordinary focus on our clients" (Compl. ¶ 154 (Viniar's Statements on Goldman's Investor Conference Call));
- "Our reputation is one of our most important assets" (Compl. ¶ 154 (Form 10-K)).

Defendants argue that **[**29]** these statements are non-actionable statements of opinion, puffery, or mere allegations of corporate mismanagement (Def. Br. 20-21); and that Goldman's conflict of interest disclosures foreclose liability (Def. Reply Br. 8-10).[8]

"Expressions of puffery and corporate optimism do not give rise to securities violations." *Rombach v. Chang, 355 F.3d 164, 174 (2d Cir. 2004)* (citation omitted). "Likewise, allegations of corporate mismanagement without an element of deception or manipulation are not actionable." *Lapin v. Goldman Sachs Grp., Inc., 506 F.Supp.2d 221, 239 (S.D.N.Y. 2006)* (citing *In re Citigroup, Inc. Sec. Litig., 330 F. Supp.2d 367, 375-76 (S.D.N.Y. 2004))*. "The important limitation on these principles is that optimistic statements may be actionable upon a showing that the defendants did not genuinely or reasonably believe the positive opinions they touted **[**30]** (i.e., the opinion was **[*278]** without a basis in fact or the speakers were aware of facts undermining the positive statements), or that the opinions imply certainty." Id. (citing cases). Moreover, by putting the "topic of the cause of its financial success at issue, [a company] then [ ] is 'obligated to disclose information concerning the source of its success, since reasonable investors would find that such information would significantly alter the mix of available information." *In re Van der Moolen Holding N.V. Sec. Litig., 405 F.Supp.2d 388, 400-01 (S.D.N.Y. 2005)* (quoting *In re Providian Fin. Corp. Secs. Litig., 152 F.Supp.2d 814, 824-25 (E.D.Pa. 2001)*.

Additionally, disclaimers do not always shield a defendant from liability. For example, "[c]autionary words about future risk cannot insulate from liability the failure to disclose that the risk has transpired." *Rombach, 355 F.3d at 173*. Indeed, "under certain

[8] Goldman's arguments in this respect are Orwellian. Words such as "honesty," "integrity," and "fair dealing" apparently do not mean what they say; they do not set standards; they are mere shibboleths. If Goldman's claim of "honesty" and "integrity" are simply puffery, the world of finance may be in more trouble than we recognize.

circumstances, cautionary statements can give rise to Section 10(b) liability." In re Van der Moolen, 405 F.Supp.2d at 400. "[T]he disclosure required by the securities laws is measured not by literal truth, but by the ability of the material to accurately inform rather than mislead **[**31]** prospective buyers." McMahan v. Wherehouse Entm't, Inc., 900 F.2d 576, 579 (2d Cir. 1990).

With respect to the Abacus transaction, Plaintiffs argue that Goldman's conduct "involved both client conflicts and outright fraud." (Pl. Opp. 15). Plaintiffs allege that Goldman knowingly allowed Paulson to select the assets for the Abacus CDO, and knew that Paulson was selecting assets that it believed would perform poorly or fail. (See, e.g., Compl. ¶¶ 59-66.) To compound this absence of transparency, Goldman hid Paulson's role, and disclosed only ACA's role in the asset selection process, in order to "leverage ACA's credibility and franchise to help distribute this Transaction." (Id.) Plaintiffs have thus plausibly alleged that Goldman made a material omission regarding Paulson's role in the asset selection process when it spoke about this topic. See Caiola v. Citibank, N.A., 295 F.3d 312, 331 (2d Cir. 2002) (holding that corporations have a "duty to be both accurate and complete" in their disclosures). Investors on the long side of this offering, the ratings agencies, and ACA were kept in the dark.

Goldman's assertion that it "neither admitted, nor denied" that its Abacus disclosures were **[**32]** fraudulent is eviscerated by its concession that "it was a mistake for the Goldman marketing materials to state that the reference portfolio was 'selected by' ACA Management LLC without disclosing the role of Paulson & Co. Inc. in the portfolio selection process and that Paulson's economic interests were adverse to CDO investors." (Id. ¶ 144.) Goldman paid a $550 Million settlement to the SEC—the largest SEC penalty in history—because of the "mistake" it acknowledged. (Id.) In the SEC action, District Court Judge Barbara S. Jones found Tourre's conduct fraudulent because: "having allegedly affirmatively represented Paulson had a particular investment interest in ABACUS—that it was long—in order to be both accurate and complete, Goldman and Tourre had a duty to disclose Paulson had a different investment interest—that it was short . . . [because it was] a fact that, if disclosed, would significantly alter the 'total mix' of available information." S.E.C. v. Goldman Sachs & Co., 790 F.Supp.2d 147, 162-63 (S.D.N.Y. 2011) (internal citations and quotations omitted).

In the Hudson, Anderson, and Timberwolf I CDO transactions Goldman affirmatively represented that it held a long position **[**33]** in the equity tranches, without disclosing its substantial short positions. Specifically, in the Hudson transaction, **[*279]** Goldman stated that it had "aligned incentives" with investors by "investing in a portion of equity," which amounted to $6 Million, without disclosing that it also held 100% of the short position at the same time, which amounted to $2 Billion. (Compl. ¶¶ 148, 164, 165, 171, 174, 177.)[9] Goldman's talking points in the Anderson transaction touted that Goldman would hold up to 50% of the equity tranche, which would be worth up to $21 Million, without mentioning its $135 Million short position. (Id. ¶¶ 204-207). Goldman's marketing booklet for the Timberwolf I transaction stated that Goldman was purchasing 50% of the equity tranche, without disclosing that it was the largest source of assets and held a 36% short position in the CDO. (Id. ¶¶ 214, 216.) Thus, as with the Abacus transaction, Plaintiffs have plausibly alleged that Goldman made material omissions in the Hudson, Anderson, and Timberwolf I transactions because "having allegedly affirmatively represented [Goldman] had a particular investment interest in [these synthetic CDOs]—that it was long—in order to be both **[**34]** accurate and complete, Goldman . . . had a duty to disclose [it] had a [greater] investment interest [from its] short [position]. . . . [because that was] a fact that, if disclosed, would significantly alter the 'total mix' of available information." S.E.C. v. Goldman Sachs & Co., 790 F.Supp.2d at 162-163.

Plaintiffs **[**35]** plausibly allege that Goldman's material omissions in the Abacus, Hudson, Anderson, and Timberwolf I transactions: (1) made its disclosures, to its own shareholders, concerning its business practices

[9] Goldman's statements in the Hudson transaction were made before the beginning of the class period. (Compl. ¶¶ 148, 164, 165, 171, 174, 177.) While a defendant can be found "liable only for those statements made during the class period," In re IBM Sec. Litig., 163 F.3d 102, 107 (2d Cir. 1998), a prior misstatement does not require dismissal, if the prior statement is "relevant in determining whether defendants had a duty to make a corrective disclosure during the Class Period." In Re Quintel Entm't Sec. Litig., 72 F. Supp. 2d 283, 290-291 (S.D.N.Y. 1999). Here, it was Goldman's subsequent statements regarding its business practices and conflicts of interest, which were made during the relevant time period, that are alleged to be material misstatements when viewed in light of Goldman's previous conduct in the Hudson transaction. Accordingly, the Court need not dismiss such conduct.

materially misleading; and (2) conflicted with its shareholders' interests, because fraudulent conduct hurts a company's share price, and concealing such conduct caused Goldman's stock to trade at artificially high prices, as discussed below. Given Goldman's fraudulent acts, it could not have genuinely believed that its statements about complying with the letter and spirit of the law—and that its continued success depends upon it, valuing its reputation, and its ability to address "potential" conflict of interests were accurate and complete. See *Lapin, 506 F.Supp.2d at 240* (upholding securities law claims where the complaint "alleges that Goldman knew about the pervasive conflicts and the effect they had on its research reports and buy recommendations, allegedly one of its core competencies, yet, they allegedly failed to disclose such material information to its investors."); see also *In re Sadia, S.A. Sec. Litig., 643 F.Supp.2d at 532* (upholding securities law claims where plaintiffs **[**36]** alleged that defendants materially misstated in their Sarbanes-Oxley certifications that there was not "any fraud" at the company, while "knowingly conceal[ing] that the Company had entered into substantial high-risk currency hedging contracts in violation of its internal hedging policy.")

Goldman must not be allowed to pass off its repeated assertions that it complies with the letter and spirit of the **[*280]** law, values its reputation, and is able to address "potential" conflicts of interest as mere puffery or statements of opinion. Assuming the truth of Plaintiffs' allegations, they involve "misrepresentations of existing facts." *Freudenberg v. E*Trade Financial Corp., 712 F.Supp.2d 171, 190 (S.D.N.Y. 2010)* (finding "statements touting risk management [that] were . . . juxtaposed against detailed factual descriptions of the Company's woefully inadequate or non-existent credit risk procedures" were actionable misstatements) (quoting *Novak, 216 F.3d at 315*). Moreover, Goldman's allegedly manipulative, deceitful, and fraudulent conduct in hiding Paulson's role and investment position in Abacus transaction, and in hiding its own investment position in Hudson, Anderson, and Timberwolf I transactions **[**37]** takes Plaintiffs' claim beyond that of mere mismanagement. See *Lapin, 506 F.Supp.2d at 240* ("Goldman also misconstrues Plaintiff's allegations as merely stating it mismanaged its research business by allowing conflicts to proliferate[,] . . . . [when the complaint] actually alleges that Goldman knew about the pervasive conflicts and the effect they had on its research reports and buy recommendations, allegedly one of its core competencies, yet, they allegedly failed to disclose such material information to its investors."); see also *Freudenberg, 712 F.Supp.2d at 193* ("Because Plaintiffs allege that Defendants intentionally misled the public, rather than simply making bad business decisions, Plaintiffs have pled more than mere mismanagement.").

Defendants also argue that the above statements were not material. A complaint, however, "may not properly be dismissed . . . on the ground that the alleged misstatements or omissions are not material unless they are so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance." *ECA, 553 F.3d at 197* (quoting *Ganino, 228 F.3d at 162*). Plaintiffs have sufficiently alleged that Goldman's **[**38]** misstatements in the Abacus, Hudson, Anderson, and Timberwolf I transactions were material. See *S.E.C. v. Goldman Sachs, 790 F.Supp.2d at 162-63* (finding that Paulson's role was "a fact that, if disclosed, would significantly alter the 'total mix' of available information."). Accepting Plaintiffs allegations as true at this juncture, as the Court must, the Court cannot say that Goldman's statements that it complies with the letter and spirit of the law and that its success depends on such compliance, its ability to address "potential" conflict of interests, and valuing its reputation, would be so obviously unimportant to a reasonable investor. See generally, *Lapin, 506 F.Supp.2d at 240-41* ("[I]t defies logic to suggest that, for example, an investor would not reasonably rely on a statement, contained in . . . a list of Goldman's business principles, that recognized Goldman's dedication to complying with the letter and spirit of the laws and that Goldman's success depended on such adherence."); *In re Citigroup Inc. Sec. Litig., 753 F.Supp.2d 206, 236 (S.D.N.Y. 2010)*.

Accordingly, Plaintiffs have sufficiently alleged that Goldman made material misstatements about its business practices **[**39]** and conflicts of interest, viewed in light of its role and conduct in the Abacus, Hudson, Anderson and Timberwolf I transactions.

B. Scienter

A strong inference of scienter can arise where defendants "knew facts or had access to information suggesting that their public statements were not accurate." *Novak, 216 F.3d at 311*.

[*281] With respect to Abacus, Goldman certainly knew that Paulson played an active role in the asset selection process. How else could Goldman admit that it was a "mistake" not to have disclosed such information. Goldman knew that Paulson's interests were adverse to investors as "Paulson had agreed to pay Goldman a higher fee if Goldman could provide Paulson with CDS contracts containing premium payments below a certain level." (Id. ¶ 77.) Goldman approached and enlisted ACA without disclosing Paulson's intended role as the sole short party. (Id. ¶ 61.) Goldman "expressed hope that ACA's involvement would improve sales" and "expect[ed] to leverage ACA's credibility and franchise to help distribute this transaction." (Id.) Rather than disclose Paulson's role or adverse interests, however, Goldman concealed its actions and put forward ACA as the sole asset selector. (Id. ¶ **[**40]** 66.) Plaintiffs have thus plausibly created a strong inference of scienter with respect to Goldman's knowledge of its material misstatements and omissions in the Abacus transaction. See *S.E.C. v. Goldman Sachs & Co., 790 F.Supp.2d at 163*.

With respect to the Hudson, Anderson, and Timberwolf I CDOs, Plaintiffs have plausibly alleged that Goldman knew that its statements about holding long positions and having aligned interest with investors were inaccurate due to its substantial short positions. Indeed, Plaintiffs have referenced a number of internal Goldman communications showing that Goldman believed that the "[s]ubprime environment" was "bad and getting worse," and wanted to make a "structured exit" by "trying to close everything down, but stay on the short side."[10] (Compl. ¶¶ 195, 202.) Goldman concealed its efforts to shut "everything down" and "stay on the short side" in the Hudson, Anderson, and Timberwolf I CDOs by claiming to have aligned interest with investors and disclosing only its long position.

Meanwhile, Goldman repeatedly reassured its own shareholders that it was complying with the letter and spirit of the law and that its "continued success depends upon unswerving adherence to this standard"; and that it had procedures in place to address "potential conflicts of interest." (Compl. ¶¶ 134, 154). Given Goldman's practice of making material misrepresentations to third party investors regarding its short position, or Paulson's short position, Goldman knew or should have known that its statements about complying with the letter and spirit of the law, and its disclaimers regarding "potential" conflicts of interest were inaccurate and incomplete. See *Lapin, 506 F.Supp.2d at 241-42* ; *In re Citigroup Inc. Sec. Litig., 753 F.Supp.2d 206, 238 (S.D.N.Y. 2010)* **[**42]** (finding Plaintiffs adequately alleged scienter by showing that "Citigroup was taking significant steps internally to address increasing risk in its CDO portfolio but at the same time it was continuing to mislead investors about the significant risk those assets posed."). Accepting Plaintiffs allegations as true, there is a strong inference of scienter with respect to Goldman's conduct **[*282]** in the Hudson, Anderson and Timberwolf I transactions.

C. Loss Causation

Allegations of loss causation are not subject to the heightened pleading requirements of *Rule 9(b)* and the PSLRA. Rather, a "short and plain statement"—the standard of *Rule 8(a)*—"is all that is necessary at this stage of the litigation." *CompuDyne Corp. v. Shane, 453 F.Supp.2d 807, 828 (S.D.N.Y. 2006)*.

To survive a motion to dismiss, a plaintiff need only allege either: "(i) facts sufficient to support an inference that it was a defendant's fraud — rather than other salient factors —that proximately caused plaintiff's loss," *Lentell v. Merrill Lynch & Co., Inc, 396 F.3d 161, 177 (2d Cir. 2005)*, or (ii) "facts that would allow a factfinder to ascribe some rough proportion of the whole loss to . . . [the defendant's fraud]." *Lattanzio v. Deloitte & Touche LLP, 476 F.3d 147, 158 (2d Cir. 2007)*. **[**43]** "[L]oss causation has to do with the relationship between the plaintiff's investment loss and the information misstated or concealed by the defendant. If that relationship is sufficiently direct, loss causation is established, but if the connection is attenuated, or if the plaintiff fails to demonstrate a causal connection between the content of the alleged misstatements or omissions and the harm actually suffered, a fraud claim will not lie." *Lentell, 396 F.3d at 174* (quotations and citations omitted).

A decline in stock price following a public announcement of "bad news" does not, by itself, demonstrate loss causation. See *Leykin v. AT & T Corp., 423 F.Supp.2d 229, 245 (S.D.N.Y. 2006)*. A plaintiff may, however, "successfully allege loss causation by . . . alleging that the market reacted

---

[10] "When the defendant is a corporate entity, the law imputes the state of mind of the employees or agents who made the statement(s) to the corporation." *In re Vivendi Universal, S.A. Sec. Litig., 765 F. Supp. 2d 512, 543 (S.D.N.Y. 2011)* **[**41]** (citing *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc., 531 F.3d 190, 195 (2d Cir. 2008)* ("To prove liability against a corporation, of course, a plaintiff must prove that an agent of the corporation committed a culpable act with the requisite scienter, and that the act (and accompanying mental state) are attributable to the corporation.")). Accordingly, the scienter reflected in Goldman's Mortgage Department Head's statements can be attributed to Goldman.

negatively to a 'corrective disclosure,' which revealed an alleged misstatement's falsity or disclosed that allegedly material information had been omitted." In re Merrill Lynch & Co. Research Reports & Sec. Litig., No. 02 Civ. 9690(JFK), 2008 U.S. Dist. LEXIS 44344, 2008 WL 2324111, at *5 (S.D.N.Y. June 4, 2008). "[A] corrective disclosure need not take the form of a single announcement, but rather, can occur through a series **[**44]** of disclosing events." In re Bristol Myers Squibb Co. Sec. Litig., 586 F.Supp.2d 148, 165 (S.D.N.Y. 2008) (citing cases).

Plaintiffs claim to have purchased Goldman stock at inflated values because they purchased stock before Goldman's practice of making material misstatements and omissions came to light. (Compl. ¶ 329.) They claim that Goldman's misstatements and conflicts of interest came to light on: (1) April 16, 2010, when the SEC filed fraud charges related to the Abacus transaction, which caused Goldman's stock to drop from $184.27 per share to $160.70 per share (a 13% drop); (2) April 25-26, 2010, when the Senate released Goldman's internal emails reflecting its practice of betting against the securities it sold to investors, which caused a stock drop from $157.40 per share to $152.03 per share (a 3% drop); and (3) June 10, 2010, when the SEC announced it was investigating the Hudson CDO transaction, which caused a stock drop from $136.80 per share to $133.77 per share (a 2% drop). (Compl. ¶¶ 329-35.)

While Defendants argue that the lawsuits and investigations themselves cause the stock decline, these suits and investigations can more appropriately be seen as a series of "corrective **[**45]** disclosures," because they revealed Goldman's material misstatements—and indeed pattern of making misstatements—and its conflicts of interest. See In re Bristol Myers, 586 F.Supp.2d at 164 (finding that a "disclosure of the Justice Department investigation" **[*283]** was "more akin to a corrective disclosure" because it revealed that Defendants had not complied with their obligation to present accurate information to regulators which resulted in the investigation). Plaintiffs' allegations are thus sufficient at this juncture to show that Goldman's misstatements and omissions caused, or at least contributed to, Plaintiffs' losses. See id. at 164-66; see also Emergent Capital Inv. Mgmt., LLC v. Stonepath Grp., Inc., 343 F.3d 189, 197 (2d Cir. 2003) (viewing the facts most favorably to plaintiff and finding allegations that defendants artificially inflated the stock before "dumping" their own was adequate to allege loss causation).

III. Individual Defendants

For the Individual Defendants "to be liable for securities fraud, these defendants must also be responsible for [Goldman's] misleading statements and omissions." In re Citigroup Inc. Sec. Litig., 753 F.Supp.2d 206, 239 (S.D.N.Y. 2010). Each of **[**46]** the Individual Defendants is alleged to have helped prepare the SEC filings at issue. (Compl. ¶ 38-40, 154.)

To show scienter, Plaintiffs allege that each of the Individual Defendants had knowledge of Goldman's synthetic CDO operations. Specifically, Plaintiffs allege that in February 2007—before the Abacus, Anderson, and Timberwolf I CDOs closed, Blankfein reviewed the Mortgage Department's efforts to reduce its subprime RMBS positions and asked about: "losses stemming from residual positions in old deals. Could/should we have cleaned up these books before and are we doing enough right now to sell off cats and dogs in other books throughout the division." (Compl. ¶ 194.) Viniar and Cohn were the recipients of the email from Goldman's Mortgage Department Head stating that Goldman was trying to make a "structured exit" from the subprime market by "trying to close everything down, but stay on the short side." (Compl. ¶ 202.) Cohn and Viniar were alerted to Hudson's sales efforts, and how the CDO assets were valued. (Compl.¶181.) Viniar was also alerted to how the CDOs were valued in general, Goldman's sales efforts with respect to CDOs, and even chaired multiple meetings on the CDO transactions **[**47]** at issue. (Compl. ¶¶ 181, 233.) "Although plaintiffs do not allege with specificity the matters discussed at these meetings, their mere existence is indicative of scienter: That defendants engaged in meetings concerning [Goldman's] CDO risks is inconsistent with the company's public statements" that they held equity positions and had interests that were aligned with the purchasers of the synthetic CDOs. In re Citigroup, 753 F.Supp.2d at 238-239 (S.D.N.Y. 2010).

These allegations, taken as true, show that each Individual Defendant actively monitored the status of Goldman's subprime assets and subprime deals during the relevant time, and that each knew that Goldman was trying to purge these assets from its books and stay on the short side. These allegations create a strong inference that the Individual Defendants knew that Goldman was making material misstatements in the Abacus, Hudson, Anderson, and Timberwolf I CDOs, when it sold poor quality assets to investors without disclosing its or Paulson's substantial short positions.

Given such knowledge, the Individual Defendants were in a position to know that Goldman's statements about complying with the letter and spirit of the law, valuing **[**48]** its reputation, and disclaimers regarding "potential" conflicts of interest were inaccurate and incomplete.

IV. Section 20 Claims

To maintain a claim for control person liability pursuant to *Section 20(a)*, a **[*284]** plaintiff must "allege facts showing (1) 'a primary violation by the controlled person,' (2) 'control of the primary violator by the targeted defendant,' and (3) that the 'controlling person was in some meaningful sense a culpable participant in the fraud perpetrated.'" *In re Citigroup, 753 F.Supp.2d at 248* (quoting *In re Beacon Assocs. Litig., 745 F.Supp.2d at 411, 2010 WL 3895582, at *17)*.

The Individual Defendants do not contest their control person status; rather they argue that Plaintiffs have not alleged a primary violation by a controlled person. For the reasons above, however, Plaintiffs have plausibly alleged § 10(b) and 10b-5 claims against Goldman. Moreover, for the reasons above, Plaintiffs have adequately alleged culpable participation with respect to the Individual Defendants, because "[a]llegations sufficient to plead scienter for the purposes of primary liability pursuant to Section 10(b) 'necessarily satisfy' the culpable participation pleading requirement for Section 20(a) **[**49]** claims." Id. Accordingly, Defendants' motion to dismiss Count Two is denied.

CONCLUSION

In conclusion, Defendants' motion to dismiss is GRANTED with respect to Plaintiffs' claim relating to Defendants' failure to disclose their receipt of Wells Notices, and DENIED in all other respects. The Clerk of Court is directed to terminate this motion.

Dated: New York, New York

June 21, 2012

SO ORDERED

/s/ Paul A. Crotty

PAUL A. CROTTY

United States District Judge

End of Document

Ruggieri v. Ventalume Window & Door Prods.

Supreme Court of Rhode Island

May 12, 1971

No Number in Original

Reporter

108 R.I. 514 *; 277 A.2d 296 **; 1971 R.I. LEXIS 1298 ***

Luigi Ruggieri, Jr. v. Ventalume Window & Door Products, Inc. et al.

Prior History: **[***1]** CIVIL ACTION for damages for injuries resulting from collision of motor vehicles, before Supreme Court on appeal of defendants from the grant of plaintiff's motion for a new trial by Giannini, J., of Superior Court, limited to the question of damages, heard and appeal sustained in part and case remitted to Superior Court with direction relative to additurs.

Counsel: *Monti and Monti, Francis A. Monti, A. David Tammelleo*, for plaintiff.

Gunning, LaFazia, Gnys & Selya, Bruce M. Selya, John E. Martinelli, for defendants.

Judges: Roberts, C. J., Paolino, Powers, Joslin and Kelleher, JJ.

Opinion by: JOSLIN

Opinion

[*515] **[**296]** In this civil action for damages for injuries allegedly sustained as a result of a collision between an automobile owned and operated by the plaintiff and a truck owned by the corporate defendant and operated by the individual defendant a jury in the Superior Court reurned a verdict against each defendant for $ 502.40. Thereupon, the plaintiff moved for a new trial principally upon the ground that the verdicts were grossly inadequate. His motion was granted and a new trial was ordered solely on the question of damages. The defendants appealed.

In pursuing **[***2]** their appeal defendants do not suggest that on any reasonable view of the evidence the jury in finding for plaintiff could justifiably have fixed his damages at an amount as low as $ 502.40. Neither do they question the necessity for a new trial. Instead, they point to the disparity between the amount of the verdict and the evidence as to the damages sustained, and argue that the disproportion between the two is so substantial that it creates a "strong suspicion" that the awards were the result of a compromise on the question of liability. In that kind of a situation, their argument continues, fairness to both parties dictates that the submission to another jury should be on all of the factual issues in the case, rather than on the question of damages alone.

We recognize that a verdict which compromises the question of liability calls for an unconditional new trial, *Maklar v. Greene, 106 R. I. 405, 261 A.2d 15*; *Fitzgerald v. **[**297]** Rendene, 98 R. I. 239, 201 A.2d 137*; *Colantonio v. Ellinwood, 96 R. I. 226, 190 A.2d 584*; *Loughran v. McKenna, 60 R. I. 453, 199 A. 302*; *Sayegh v. Davis, 46 R. I. 375, 128 A. 573*. What is critical here **[***3]** initially, however, is not the rule, but whether defendants who did not urge the trial justice to apply it can now advance it on appeal as a ground for reversal. The general rule, of course, is that save in exceptional cases questions not raised, passed upon, and preserved **[*516]** for review at the trial court level will not be noted on appeal. *Hawkins v. Smith, 105 R. I. 669, 679, 254 A.2d 747, 753*; *Romeo v. Cranston Redevelopment Agency, 105 R. I. 661, 668, 254 A.2d 426, 436*; *Hill v. Ogrodnik, 83 R. I. 138, 145-46, 113 A.2d 734, 739*. That principle operates to bar a party who has not moved for a new trial in the trial court from attacking a verdict on review on the ground that it is against the evidence or the law. *Gramolini v. Marzalkowski, 102 R. I. 85, 88, 228 A.2d 537, 538*; *Foster v. DeAndrade, 88 R. I. 442, 444, 149 A.2d 713, 715*; *James v. R. I. Auditorium, Inc., 60 R. I. 405, 415, 199 A. 293, 298*; *Dolbashian v. R. I. Hospital Trust Co., 53 R. I. 462, 167 A. 262*. We see no reason why the same principle should not apply here where defendants did not move for a new trial or elect some other procedure to obtain a ruling **[***4]** on the issue they now urge, but instead, apparently content with the jury's verdict, sat idly by while plaintiff challenged their verdicts on the ground of inadequacy. Now, after the trial justice has responded to plaintiff's claim that the awards were inadequate and granted him a new trial solely on the question of damages, defendants ask us to decide the case in their favor on the basis of an issue which they neither raised before the trial court nor properly preserved for review in this court. To permit this would sanction a departure from what has long been deemed a prerequisite to appellate review in this state and that cannot be countenanced. Any suggestions in *Maklar* v. *Greene, Fitzgerald* v. *Rendene* or *Loughran* v. *McKenna*, all *supra*, that this is one of those exceptional cases where an issue may be raised initially before this court are gratuitous and should not be considered precedential.

The defendants also argue that the trial justice should not have limited the new trial to damages without first affording them an opportunity to file additurs. Here they are on sounder ground than in their initial argument. The **[*517]** controlling statute **[***5]** is *G. L. 1956 (1969 Reenactment) § 9-23-1* which in pertinent part reads:

> "A verdict shall not be set aside as excessive, *or inadequate*, by the supreme or superior court until the prevailing party has been given an opportunity to remit so much thereof as the court adjudges excessive, *or the losing party consents to such additur as the court may order*." (Italics ours.)

Until the italicized language was added to this enactment by P. L. 1940, chap. 946, sec. 1, it applied only to remittiturs and was construed as requiring a trial justice who found a verdict excessive to condition his order for a new trial upon a remittitur of the excess. *Reynolds v. Davis, 54 R. I. 185, 171 A. 925*; *Finnegan v. United Electric Ry., 52 R. I. 296, 160 A. 784*. There is nothing in the legislation as amended in 1940 which suggests or even hints at a different construction when the inadequacy, rather than the excessiveness, of the damages is the reason for the granting of the new trial. The plaintiff, arguing to the contrary, focuses on the word "may" in the language providing for an additur. The word "may" as used there, however, obviously refers to the amount which the **[***6]** trial justice decides to order as the additur, rather than to whether he is required or merely permitted to fix an additur. With respect to additurs, just as with respect to remittiturs, the legislative mandate to a trial justice is clear. When he is satisfied that the damages awarded are grossly excessive or inadequate, he must, before ordering a new trial because of the verdict's excessiveness or inadequacy, afford the plaintiff an opportunity to file a remittitur **[**298]** or extend to the defendant the right to consent to an additur. 1 Kent, *R. I. Civ. Prac*. § 59.4 at 440.

The plaintiff refers to *Clark v. New York, N.H. & H.R.R., 33 R. I. 83, 80 A. 406*; *Loughran v. McKenna, supra*, and argues that in neither of those cases was the order granting a new trial on the question of damages alone conditioned **[*518]** upon affording the losing party an opportunity to consent to an additur. The procedure followed in those cases is of no assistance to plaintiff, however, for those decisions predated the 1940 amendatory legislation mandating an additur when the inadequacy of the damages is the reason for the new trial.

The defendants' appeal is sustained in **[***7]** part and the case is remitted to the Superior Court with direction to the trial justice before whom it was heard to condition his order granting a new trial upon affording the defendants an opportunity to consent to such additurs as he may order.

End of Document

Sandys v. Pincus

Supreme Court of Delaware

October 13, 2016, Submitted; December 5, 2016, Decided

No. 157, 2016

Reporter
152 A.3d 124 *; 2016 Del. LEXIS 627 **

THOMAS SANDYS, Derivatively on Behalf of ZYNGA INC., Plaintiff below, Appellant, v. MARK J. PINCUS, REGINALD D. DAVIS, CADIR B. LEE, JOHN SCHAPPERT, DAVID M. WEHNER, MARK VRANESH, WILLIAM GORDON, REID HOFFMAN, JEFFREY KATZENBERG, STANLEY J. MERESMAN, SUNIL PAUL and OWEN VAN NATTA, Defendants below, Appellees, and ZYNGA INC., a Delaware Corporation, Nominal Defendant below, Appellee.

Subsequent History: Case Closed December 21, 2016.

Prior History: [1]** Court Below: Court of Chancery of the State of Delaware. C.A. No. 9512-CB.

Sandys v. Pincus, 2016 Del. Ch. LEXIS 43 (Del. Ch., Feb. 29, 2016)

Disposition: REVERSED.

Counsel: Norman M. Monhait, Esquire, P. Bradford deLeeuw, Esquire, Rosenthal, Monhait & Goddess, P.A., Wilmington, Delaware; Jeffrey S. Abraham, Esquire, (Argued), Philip T. Taylor, Esquire, Abraham, Fruchter & Twersky, LLP, New York, New York, Attorneys for Plaintiff-Below, Appellant, Thomas Sandys.

Elena C. Norman, Esquire, Nicholas J. Rohrer, Esquire, Paul J. Loughman, Esquire, Young Conaway Stargatt & Taylor LLP, Wilmington, Delaware; Jordan Eth, Esquire, Anna Erickson White, Esquire, (Argued), Morrison & Foerster LLP, San Francisco, California, Attorneys for Defendants-Below, Appellees, Mark J. Pincus, Reginald D. Davis, Cadir B. Lee, John Schappert, David M. Wehner, Mark Vranesh, and Owen Van Natta, and Zynga Inc.

Bradley D. Sorrels, Esquire, Jessica A Montellese, Esquire, Wilson Sonsini Goodrich & Rosati, P.C., Wilmington, Delaware; Steven M. Schatz, Esquire, (Argued), Nina (Nicki) Locker, Esquire, Benjamin M. Crosson, Esquire, Wilson Sonsini Goodrich & Rosati, P.C., Palo Alto, California, Attorneys for Defendants-Below, Appellees, William Gordon, Reid Hoffman, Jeffrey Katzenberg, Stanley J. Meresman, and **[**2]** Sunil Paul.

Judges: Before STRINE, Chief Justice; HOLLAND, VALIHURA, VAUGHN, and SEITZ, Justices, constituting the Court en Banc.

Opinion by: STRINE

Opinion

[*126] STRINE, Chief Justice, for the Majority:

I.

This appeal in a derivative suit brought by a stockholder of Zynga, Inc. turns on whether the Court of Chancery correctly found that a majority of the Zynga board could impartially consider a demand and thus correctly dismissed the complaint for failure to plead demand excusal under *Court of Chancery Rule 23.1*. This case again highlights the wisdom of the representative plaintiff bar heeding the repeated admonitions of this Court and the Court of Chancery to make a diligent pre-suit investigation into the board's independence so that a complaint can be filed satisfying the burden to plead particularized facts supporting demand excusal. Here, the derivative plaintiff's lack of diligence compounded the already difficult task that the Court of Chancery faces when making close calls about pleading stage independence. Fortunately for the derivative plaintiff, however, he was able to plead particularized facts regarding three directors that create a reasonable doubt that these directors can impartially consider a demand.

First, the plaintiff pled a **[**3]** powerful and unusual fact about one director's relationship to Zynga's former CEO and controlling stockholder which creates a reasonable doubt that she can impartially consider a demand adverse to his interests. That fact is that the controlling stockholder and the director and her husband co-own an unusual asset, an airplane, which is suggestive of an extremely intimate personal friendship between their families. Second, the plaintiff pled that two other directors are partners at a prominent venture capital firm and that they and their firm not only control 9.2% of Zynga's equity as a result of being early-stage investors, but have other interlocking relationships with the controller and another selling stockholder outside of Zynga. Although it is true that entrepreneurs like the controller need access to venture capital, it is also true that venture capitalists compete to fund the best entrepreneurs and that these relationships can generate ongoing economic opportunities. There is nothing wrong with that, as that is how commerce often proceeds, but these relationships can give rise to human motivations compromising the participants' ability to act impartially toward each other on **[**4]** a matter of material importance. Perhaps for that reason, the Zynga board itself determined that these two directors did not qualify as independent under the NASDAQ rules, which have a bottom line standard that a director is not independent if she has "a relationship which, in the opinion of the Company's board of directors, would interfere with the exercise of independent judgment . . . ."[1] Although the plaintiff's lack of diligence made the determination as to these directors perhaps closer than necessary, in our view, the combination of these facts creates a pleading stage reasonable doubt as to the ability of these directors to act independently on a demand adverse to the controller's interests. When these three directors are considered incapable of impartially considering a demand, a majority of the nine member Zynga board is compromised for *Rule 23.1* purposes and demand is excused. Thus, the dismissal of the complaint is reversed.

II.

The plaintiff alleges two derivative claims, each centering on allegations that certain top managers and directors at Zynga—including its former CEO, Chairman, **[*127]** and controlling stockholder Mark Pincus—were given an exemption to the company's standing rule preventing **[**5]** sales by insiders until three days after an earnings announcement. According to the plaintiff, top Zynga insiders sold 20.3 million shares of stock for $236.7 million as part of a secondary offering before Zynga's April 26, 2012 earnings announcement, an announcement that the plaintiff contends involved information that placed downward pressure on Zynga's stock price.[2] The plaintiff alleges that these insiders sold their shares at $12.00 per share and that, immediately after the earnings announcement, the market price dropped 9.6% to $8.52. Three months later, following the release of additional negative information, which the plaintiff alleges was known by Zynga management and the board when it granted the exemption, Zynga's market price declined to $3.18, a decrease of 73.5% from the $12.00 per share offering price. In this suit, the plaintiff alleges that the insiders who participated in the sale breached their fiduciary duties by misusing confidential information when they sold their shares while in possession of adverse, material non-public information and also asserts a duty of loyalty claim against the directors who approved the sale.

The defendants moved to dismiss this action **[**6]** under *Court of Chancery Rule 23.1* for plaintiff's failure to make a pre-suit demand on the board.[3] The Court of Chancery's decision turned on its evaluation of the pleading stage independence of the Zynga board at the time the complaint was filed,[4] which was comprised of the following nine directors: Mark Pincus, Reid Hoffman, Jeffrey Katzenberg, Stanley J. Meresman, William Gordon, John Doerr, Ellen Siminoff, Sunil Paul, and Don Mattrick. In addressing demand excusal, the Court of Chancery applied the standard set forth in this Court's

[1] NASDAQ Marketplace Rule 5605(a)(2).

[2] These shares were sold as part of a secondary public offering that increased Zynga's public float, which at that time consisted of fewer than 150 million shares, compared to approximately 688 million shares held by Zynga directors, officers, employees, former employees, and other pre-IPO investors. Appellee's Answering Br. at 7.

[3] *See* *Ct. Ch. R. 23.1* ("The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort.").

[4] *Rales v. Blasband, 634 A.2d 927, 934 (Del. 1993)* (noting that demand futility is assessed at the time the complaint is filed).

decision in *Rales v. Blasband*[5] to determine if at least five of Zynga's nine directors were independent for pleading stage purposes. The Court of Chancery first determined that the two directors who participated in the transaction, Pincus and Hoffman, were interested in the transaction, and therefore could not impartially consider a demand.[6] The Court of Chancery then examined the independence of directors Katzenberg, **[*128]** Meresman, Gordon, Doerr, and Siminoff. The Court of Chancery found that all five of these directors were independent and thus, that demand was not excused. The Court of Chancery did not analyze the independence of directors Paul and Mattrick. But, the Court of Chancery **[**7]** did include a footnote stating that it "would reach the same conclusion regarding Paul, who did not participate in the Secondary Offering or even vote to approve it."[7] At the time of the complaint, Mattrick had replaced Pincus as CEO. The remaining seven directors were outsiders.

The Court of Chancery properly determined that directors Pincus and Hoffman were interested in the transaction. Furthermore, Mattrick is Zynga's CEO. Zynga's controlling stockholder, Pincus, is interested in the transaction under attack, and therefore, Mattrick cannot be considered independent. Thus, the question for us is whether the plaintiff pled particularized facts that create a reasonable doubt about the independence of two of the **[**8]** remaining six Zynga directors.[8] If the plaintiff convinces us that he did, then we must reverse the Court of Chancery's dismissal under Rule 23.1. We review this question *de novo*.[9]

On appeal, neither party contests the applicability of the *Rales* standard employed by the Court of Chancery. Therefore, we use it in our analysis to determine whether the Court of Chancery erred in finding that a majority of the board was independent for pleading stage purposes. To plead demand excusal under *Rales*, the plaintiff must plead particularized factual allegations that "create a reasonable doubt that, as of the time the complaint [was] filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."[10] At the pleading stage, a lack of independence turns on "whether the plaintiffs have pled facts from which the director's ability to act impartially on a matter important to the interested party can be doubted because that director may feel either subject to the interested party's dominion or beholden to that interested party."[11] "Our law requires that all the pled facts regarding a director's relationship to the interested party be considered **[**9]** in full context in making the, admittedly imprecise, pleading stage determination of independence."[12] "[A]lthough the plaintiff is bound to plead particularized facts in pleading a derivative complaint, so too is the court bound to draw all inferences from those particularized facts in favor of the plaintiff, not the defendant, when dismissal of a derivative complaint is sought."[13]

For many years, this Court and the Court of Chancery have advised derivative plaintiffs to take seriously their obligations to plead particularized facts justifying demand excusal.[14] This case presents the unusual

---

[5] *Id.*

[6] Although the defendants assert that the Court of Chancery did not reach this conclusion, we disagree. The Court of Chancery conducted a simple analysis finding Pincus and Hoffman interested in the transaction when it stated:

> Because Hoffman and Pincus are the only members of the Demand Board who sold shares in the Secondary Offering and received a benefit from the alleged wrongdoing, they are the only members of the Demand Board who face potential liability under *Brophy*. Consequently, the other seven directors on the Demand Board are not interested in Count I for purposes of the *Rales* test, and I need only to determine whether plaintiff has created a reasonable doubt about their independence.

*Sandys v. Pincus, 2016 Del. Ch. LEXIS 43, 2016 WL 769999, at *7 (Del. Ch. Feb. 29, 2016)*.

[7] *2016 Del. Ch. LEXIS 43, [WL] at *14 n.70*.

[8] The plaintiff does not dispute the Court of Chancery's finding that directors Katzenberg and Meresman are independent.

[9] ***Del. Cty. Emps. Ret. Fund v. Sanchez, 124 A.3d 1017, 1021 (Del. 2015)***; *Beam v. Stewart, 845 A.2d 1040, 1048 (Del. 2004)*.

[10] *Rales, 634 A.2d at 934*.

[11] ***Sanchez, 124 A.3d at 1024 n.25***.

[12] ***Id. at 1022***.

[13] *Id.*

[14] *See, e.g., Rales, 634 A.2d at 934 n.10*; *Brehm v. Eisner, 746 A.2d 244, 266-67 (Del. 2000)*; *Guttman v. Huang, 823 A.2d 492, 504 (Del. Ch. 2003)*; *Ash v. McCall, 2000 Del. Ch. LEXIS 144, 2000 WL 1370341, at *15 n.56 (Del. Ch. Sept. 15, 2000)*.

situation where a plaintiff who **[*129]** sought books and records to plead his complaint somehow only asked for records relating to the transaction he sought to redress and did not seek any books and records bearing on the independence of the board.[15] Furthermore, although purporting to be a fitting representative for investors in a technology company, the plaintiff appears to have forgotten that one of the most obvious tools at hand is the rich body of information that now can be obtained by conducting an internet search.[16] As a result of the plaintiff's failure, he made the task of the Court of Chancery more difficult **[**10]** than was necessary and hazarded an adverse result for those he seeks to represent. Despite that failure, the plaintiff did plead some particularized facts and we are bound to draw all reasonable inferences from those facts in the plaintiff's favor in determining whether dismissal was appropriately granted.[17]

A.

In conducting this analysis, we first focus on director Ellen Siminoff. The Court of Chancery found that Siminoff was independent even though she and her husband co-own a private airplane[18] with Pincus.[19] In his complaint, the plaintiff pled that "Siminoff and her husband have an existing business relationship with defendant Pincus as co-owners of a private airplane,"[20] and in his briefing in the Court of Chancery, the plaintiff characterized Siminoff as a "close family friend" of Pincus,[21] which the Court of Chancery took into account as if it was a pled fact.[22] Had the plaintiff been more thorough in his research by using all of the "tools at hand,"[23] including the tool provided by the **[*130]** company whose name has become a verb—or another internet search engine—he likely would have discovered more information about Siminoff's relationship with Pincus. Not only was **[**11]** the plaintiff's research cursory, the plaintiff did not focus on the most likely inference from the co-ownership of the private airplane between Pincus and Siminoff—which is not that the private airplane was a business venture—but that it signaled an extremely close, personal bond between Pincus and Siminoff, and between their families. Thus, the Court of Chancery was stuck with the limited factual allegations made by the plaintiff and, citing our decision in *Beam v. Stewart*,[24] the Court of Chancery determined that these allegations of friendship and shared ownership of an asset were not enough to create a reasonable pleading stage inference that Siminoff could not act impartially in considering a demand implicating

---

[15] Verified Complaint Pursuant to 8 Del. C. § 220, *Sandys v. Zynga Inc.*, C.A. No. 8450-ML (Del. Ch.).

[16] Of course, as with any source of information, including a traditional library, the internet should be used with care. Ultimately, any fact pleading has to be based on a source that provides a good faith basis for asserting a fact. Thus, as with any search, an internet search will only have utility if it generates information of a reliable nature. But with that key caveat in mind, we can take judicial notice that internet searches can generate articles in reputable newspapers and journals, postings on official company websites, and information on university websites that can be the source of reliable information.

[17] ***Sanchez, 124 A.3d at 1022***.

[18] During oral arguments, there was a question raised by the Court over whether this was an airplane or a jet. The plaintiff's lawyer proceeded to characterize it as a jet during his rebuttal. But, Zynga's Proxy Statement and the plaintiff's complaint both state "private airplane," and therefore we call it an airplane. Regardless of whether it is an airplane or a jet, we reach the same conclusion.

[19] Zynga, Inc. Definitive Proxy Statement (Form 14A), at 1 (Apr. 25, 2013) (noting that Ms. Siminoff, her spouse, and Mr. Pincus "co-own a small private airplane, which was not used for Company travel").

[20] App. to Appellant's Opening Br. at A071 (Verified Shareholder Derivative Complaint).

[21] *Id.* at A145.

[22] *Sandys, 2016 Del. Ch. LEXIS 43, 2016 WL 769999, at *8*.

[23] *See, e.g.,* *Rales v. Blasband, 634 A.2d 927, 935 n.10 (1993)*. This Court noted that although derivative plaintiffs may believe it is difficult to meet the particularization requirement in their pleadings:

> [They] have many avenues available to obtain information bearing on the subject of their claims. For example, there is a variety of public sources from which the details of a corporate act may be discovered, including the media and governmental agencies such as the Securities and Exchange Commission. In addition, a stockholder who has met the procedural requirements and has shown a specific proper purpose may use the summary procedure embodied in 8 Del. C. § 220 to **[**12]** investigate the possibility of corporate wrongdoing.

Id.

[24] *845 A.2d 1040 (Del. 2004)*.

Pincus.[25]

Although we acknowledge the difficult position that the Court of Chancery was placed in, we reach a different conclusion. The Siminoff and Pincus families own an airplane together. Although the plaintiff made some strained arguments below, it made one argument in relation to this unusual fact that does create a pleading stage inference that Siminoff cannot act independently of Pincus. That argument is that owning an airplane together is not a common thing, and suggests that the Pincus and Siminoff families are extremely close to each other and are among each other's most important and intimate friends. Co-ownership of a private plane involves a partnership in a personal asset that is not only very expensive, but that also requires close cooperation in use, which is suggestive of detailed planning indicative of a continuing, close personal friendship. In fact, it is suggestive of the type of very close personal relationship that, like family ties, one would expect to heavily influence a human's ability to exercise impartial judgment.[26] As we noted recently, although a plaintiff has a pleading stage burden that is elevated in the demand **[**13]** excusal context, that standard does not require a plaintiff to plead a detailed calendar of social interaction to prove that directors have a very substantial personal relationship rendering them unable to act independently of each other.[27] A plaintiff is only required to plead facts supporting an inference[28]—or in the words of *Rales*, "create a reasonable doubt"[29]—that a director cannot act impartially. Here, the facts support an inference that Siminoff would not be able to act impartially when deciding whether to move forward with a suit implicating a very close friend with **[*131]** whom she and her husband co-own a private plane.

B.

We next turn to the plaintiff's argument that he created a reasonable doubt that two other directors—William Gordon and John Doerr—are not independent for pleading stage purposes. In his complaint, the plaintiff included the following facts pertaining to Gordon and Doerr: both are partners at Kleiner Perkins Caufield & Byers,[30] which controls approximately 9.2% of Zynga's equity;[31] and, Kleiner Perkins is also invested in One Kings Lane, a company that Pincus's wife co-founded.[32] Not only that, defendant Reid Hoffman—an outside director of Zynga who was one **[**14]** of the directors and officers given an exemption to sell in the secondary offering—and Kleiner Perkins both have investments in Shopkick, Inc., and Hoffman serves on that company's board along with yet another partner at Kleiner Perkins.[33] These relationships, suggest the plaintiff, indicate that Gordon and Doerr have a mutually beneficial network of ongoing business relations with Pincus and Hoffman that they are not likely to risk by causing Zynga to sue them. Amplifying this argument, says the plaintiff, is the voice of Gordon's and Doerr's fellow Zynga directors who did not consider them to be independent directors. According to its own public disclosures, the Zynga board determined that Gordon and Doerr do not qualify as independent directors under the NASDAQ Listing Rules.[34] Importantly, however, Zynga did not disclose why its board made this determination,[35] and the plaintiff failed to request this

---

[25] *Sandys, 2016 Del. Ch. LEXIS 43, 2016 WL 769999, at *8*.

[26] *See In re MFW S'holders Litig., 67 A.3d 496, 509 n.37 (Del. Ch. 2013), aff'd sub nom. Kahn v. M & F Worldwide Corp., 88 A.3d 635 (Del. 2014)* (noting that if a friendship "was one where the parties had served as each other's maids of honor, had been each other's college roommates, shared a beach house with their families each summer for a decade, and are as thick as blood relations, that context would be different from parties who occasionally had dinner over the years, go to some of the same parties and gatherings annually, and call themselves "friends'"); ***Del. Cty. Emps. Ret. Fund v. Sanchez, 124 A.3d 1017, 1022 (Del. 2015)*** (finding that a director was not independent for pleading stage purposes because the director had a friendship of over 50 years with an interested party and the director's primary employment was as an executive of a company over which the interested party had substantial influence).

[27] ***124 A.3d at 1020-22***.

[28] ***Id. at 1019***.

[29] *Rales, 634 A.2d at 934*.

[30] App. to Appellant's Opening Br. at A071 (Verified Shareholder Derivative Complaint).

[31] *Id.* at A020.

[32] *Id.* at A072.

[33] *Id.*

[34] *Id.*

[35] Zynga, Inc. Definitive Proxy Statement (Form 14A), at 1 (Apr. 25, 2013).

information in its books and records demand.[36]

Despite these factual allegations, the Court of Chancery found that Gordon and Doerr were independent for pleading stage purposes because the plaintiff failed to specifically allege why Gordon and Doerr lack independence **[**15]** under the NASDAQ rules, and the other circumstances pled by the plaintiff were "insufficient to question their independence under Delaware law."[37] In so ruling, the Court of Chancery seemed to place heavy weight on the presumptive independence of directors under our law.[38] But, to have a derivative suit dismissed on demand excusal grounds because of the presumptive independence of directors whose own colleagues will not accord them the appellation of independence creates cognitive dissonance that our jurisprudence should not ignore.

We agree with the Court of Chancery that the Delaware independence standard is context specific and does not perfectly marry with the standards of the stock exchange in all cases,[39] but the criteria NASDAQ has articulated as bearing on independence are relevant under Delaware law and likely influenced by our law.[40] The **[*132]** NASDAQ rules outline the following list of relationships that automatically preclude a finding of independence:

> **(A)** a director who is, or at any time during the past three years was, employed by the Company;
>
> **(B)** a director who accepted or who has a Family Member who accepted any compensation from the Company in excess of $120,000 during any period **[**16]** of twelve consecutive months within the three years preceding the determination of independence, other than the following:
>
> > **(i)** compensation for board or board committee service;
> >
> > **(ii)** compensation paid to a Family Member who is an employee (other than an Executive Officer) of the Company; or
> >
> > **(iii)** benefits under a tax-qualified retirement plan, or non-discretionary compensation.
>
> Provided, however, that in addition to the requirements contained in this paragraph (B), audit committee members are also subject to additional, more stringent requirements under Rule 5605(c)(2).
>
> **(C)** a director who is a Family Member of an individual who is, or at any time during the past three years was, employed by the Company as an Executive Officer;
>
> **(D)** a director who is, or has a Family Member who is, a partner in, or a controlling Shareholder or an Executive Officer of, any organization to which the Company made, or from which the Company received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues for that year, or $200,000, whichever is more, other than the following:
>
> > **(i)** payments arising solely from investments in the Company's securities; **[**17]** or
> >
> > **(ii)** payments under non-discretionary charitable contribution matching programs.
>
> **(E)** a director of the Company who is, or has a Family Member who is, employed as an Executive Officer of another entity where at any time during the past three years any of the Executive Officers of the Company serve on the compensation committee of such other entity; or
>
> **(F)** a director who is, or has a Family Member who is, a current partner of the Company's outside auditor, or was a partner or employee of the Company's outside auditor who worked on the Company's audit at any time during any of the past three years.
>
> **(G)** in the case of an investment company, in lieu of paragraphs (A)-(F), a director who is an "interested person" of the Company as defined in Section 2(a)(19) of the Investment Company Act of 1940,

[36] Verified Complaint Pursuant to 8 Del. C. § 220, *Sandys v. Zynga Inc.*, C.A. No. 8450-ML (Del. Ch.).

[37] *Sandys, 2016 Del. Ch. LEXIS 43, 2016 WL 769999, at *10*.

[38] *Id.*

[39] *2016 Del. Ch. LEXIS 43, [WL] at *9*.

[40] *See In re MFW S'holders Litig., 67 A.3d at 510* (noting that stock exchange rules governing director independence "were influenced by experience in Delaware and other states and were the subject of intensive study by expert parties" and "[t]hey cover many of the key factors that tend to bear on independence . . . and they are a useful source for this court to consider when assessing an argument that a director lacks independence").

> other than in his or her capacity as a member of the board of directors or any board committee.[41]

Most importantly, under the NASDAQ rules there is a fundamental determination that a board must make to classify a director as independent, a determination **[*133]** that is also relevant under our law. The bottom line under the NASDAQ rules is that a director is not independent if she has a "relationship which, in the opinion of the Company's board **[**18]** of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director."[42] The NASDAQ rules' focus on whether directors can act independently of the company or its managers has important relevance to whether they are independent for purposes of Delaware law. Our law is based on the sensible intuition that deference ought to be given to the business judgment of directors whose interests are aligned with those of the company's stockholders.[43] Precisely because of that deference, if our law is to have integrity, Delaware must be cautious about according deference to directors unable to act with objectivity. To consider directors independent on a *Rule 23.1* motion generates understandable skepticism in a high-salience context where that determination can short-circuit a merits determination of a fiduciary duty claim.

We presume that the Zynga board did not lightly classify Gordon and Doerr as having a "relationship which, in the opinion of the Company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director."[44] And, although we do not know the exact reason the board made **[**19]** this determination,[45] we do know this. In the case of a company like Zynga, which has a controlling stockholder, Pincus, who wields 61% of the voting power, if a director cannot be presumed capable of acting independently because the director derives material benefits from her relationship with the company that could weigh on her mind in considering an issue before the board, she necessarily cannot be presumed capable of acting independently of the company's controlling stockholder. That a director sits on a controlled company board is not, and cannot of course, be determinative of director independence at the pleading stage, as that would make the question of independence tautological. But, our courts cannot blind themselves to that reality when considering whether a director on a controlled company board has other ties to the controller beyond her relationship at the controlled company.

As to this reality, we consider it likely that the other facts pled by the plaintiff were taken into account by the Zynga board in determining that Gordon and Doerr were not independent directors. These facts include that: Gordon and Doerr are partners at Kleiner Perkins, which controls 9.2% of Zynga's **[**20]** equity; Kleiner Perkins is also invested in One Kings Lane, a company co-founded by Pincus's wife; and, Hoffman and Kleiner Perkins are both invested in Shopkick, and Hoffman serves on its board with another **[*134]** Kleiner Perkins partner. Of course, the defendants now argue that the relationships among these directors flowed all in one direction and that it is Pincus who is likely beholden to Gordon, Doerr, and Kleiner Perkins for financing. But, the reality is that firms like Kleiner Perkins compete with others to finance talented entrepreneurs like Pincus, and networks arise of repeat players who cut each other into beneficial roles in various situations. There is, of course, nothing at all wrong with that. In fact, it is crucial to commerce and most human relations. But, precisely because of the importance of a mutually beneficial ongoing business relationship, it is reasonable to expect that sort of relationship might have a material effect on the parties' ability to act adversely toward each other. Causing a lawsuit to be brought against another person is no small matter, and is the sort of thing that might plausibly endanger a relationship. When, as here, pled facts suggest such a **[**21]** relationship exists and the company's own board has determined that the directors whose ability to consider a demand impartially is in

[41] NASDAQ Marketplace Rule 5605(a)(2).

[42] *Id.*

[43] *See* *Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)* ("The business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors under *Section 141(a)*. 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.").

[44] NASDAQ Marketplace Rule 5605(a)(2).

[45] The Proxy Statement states that "the Board has affirmatively determined that Messrs. Hoffman, Katzenberg, Meresman and Paul and Ms. Siminoff do not have any relationships that would interfere with the exercise of independent judgment in carrying out the responsibilities of a director and that each of these directors is "independent,"' without further explanation as to why the excluded directors were found to be non-independent. Zynga, Inc. Definitive Proxy Statement (Form 14A), at 1 (Apr. 25, 2013).

question cannot be considered independent, a reasonable doubt exists under *Rales*.

Finally, consistent with our prior admonition, why the Zynga board determined that Gordon and Doerr are non-independent is precisely the sort of issue for which the use of a targeted request for books and records would have been helpful to the plaintiff, and thereby to both the Court of Chancery and us. The plaintiff's lack of diligence put the Court of Chancery in a compromised and unfair position to make an important determination regarding these directors' pleading stage independence. That is regrettable, and the plaintiff is fortunate that his failure to do a pre-suit investigation has not resulted in dismissal.

III.

Because we have determined that the plaintiff has met his pleading stage burden to create a reasonable doubt that a majority of the Zynga board could act impartially in considering a demand implicating Zynga's CEO and controlling stockholder, we reverse the Court of Chancery's dismissal under *Rule 23.1* and remand the matter for further proceedings consistent with **[**22]** this opinion.[46]

Dissent by: VALIHURA

Dissent

VALIHURA, Justice, dissenting:

In a thoughtful forty-two page opinion, the Chancellor determined that the plaintiff had failed to demonstrate that demand would have been futile with respect to the claims in the Complaint. For the reasons set forth herein, I would affirm his well-reasoned decision.

This is a close case, and the plaintiff did not aid his cause in failing to direct a books and records request to the issues bearing on the board's independence.[1] Demand **[*135]** futility required the plaintiff to demonstrate that five of the nine directors were interested or lacked independence. In my view, the Court of Chancery correctly determined that directors Katzenberg, Meresman, Gordon, and Doerr were independent. Plaintiff raises no challenge in this Court as to the independence of directors Katzenberg and Meresman.[2] Although the trial court did not separately analyze director Paul, it did state in a footnote that it "would reach the same conclusion regarding Paul, who did not participate in the Secondary Offering or even vote to approve it."[3] Because I would conclude that directors Katzenberg, Meresman, Gordon, Doerr, Siminoff, and Paul were independent, I would affirm the **[**23]** Court of Chancery's determination that the plaintiff's complaint failed to create a reasonable doubt that at least five of the nine directors were disinterested or independent for pleading stage purposes.

The plaintiff's arguments as to Gordon and Doerr's alleged lack of independence arise from their positions as partners at Kleiner Perkins Caufield & Byers ("Kleiner Perkins"). The plaintiff alleged that Kleiner Perkins has (i) invested alongside Hoffman in a company co-founded by Pincus's wife; (ii) invested in a company of

---

[46] As indicated, on appeal, the parties raised numerous other issues, including an argument to dismiss the claims against certain defendants under *Court of Chancery Rule 12(b)(6)* based on this Court's decision in *In re Cornerstone Therapeutics Inc., Stockholder Litig., 115 A.3d 1173 (Del. 2015)*. Although the defendants ask us to reach these questions now, we consider that imprudent and believe that it is important for our Court of Chancery, which is the expert in these cases, to consider these issues in the first instance.

[1] To his credit, his counsel was candid about this at oral argument before this Court. *See* Oral Argument at 5:23, *Sandys v. Pincus*, No. 157, 2016 (Del. Oct. 19, 2016) [hereinafter "Oral Argument"], *https://livestream.com/DelawareSupremeCourt/events/6511893/videos/139287026* ("Your Honor, at the time we started the process, a majority of the board had been sellers in the Secondary Offering, so it didn't seem quite as critical at that point in time. I guess with the benefit of hindsight if I had to do it again we would have sought that.").

[2] The Verified Shareholder Derivative Complaint (the "Complaint") contains no allegations regarding Katzenberg's relationship with Hoffman or Pincus. The Complaint's only allegation regarding Meresman's independence is that both he and Hoffman serve on LinkedIn's board. Verified S'holder Derivative Compl. at A71 ¶ 117(i), *Sandys v. Pincus* (Del. Ch. Apr. 4, 2014) [hereinafter "Compl. at A__"], *available at* A12-78. Directors Siminoff and Doerr joined the Board after the events at issue in this action and are not named as defendants; and directors Gordon, Katzenberg, Meresman, and Paul are outside directors who were on the Board during the events at issue, but did not sell any stock in the Secondary Offering.

[3] *Sandys v. Pincus, 2016 Del. Ch. LEXIS 43, 2016 WL 769999, at *14 n.70 (Del. Ch. Feb. 29, 2016)*.

which Hoffman is a director; and (iii) completed two financings with Hoffman's venture capital firm.[4] As the Court of Chancery recognized, the plaintiff failed to plead any facts about the size, profits, or materiality to Gordon and Doerr of these investments or interests. Absent more, the relationships among these venture capitalists and entrepreneurs, as alleged, are not sufficient to raise a reasonable doubt as to Gordon and Doerr's independence. Thus, I agree with the Chancellor's view that their relationships and overlapping investments do not rise to the level of creating a reasonable doubt as to their independence. **[**24]**

As to Gordon's and Doerr's designation as "not independent" under the NASDAQ rules, the Court of Chancery correctly observed that independence under the NASDAQ rules is relevant to our analysis here but not dispositive.[5] The plaintiff candidly acknowledged that he failed to allege why Gordon and Doerr lack independence under NASDAQ rules.[6] As the trial court **[*136]** observed, "neither the proxy statement nor the plaintiff specifies the reason for this[,]"[7] and so it is not clear whether Gordon and Doerr's "non-independent" designation was due to a relationship with Zynga, Pincus, or another executive. It is not difficult to come up with a scenario where a director might be deemed "not independent" under the NASDAQ rules, or NYSE rules, yet deemed independent for demand futility purposes.[8] A request pursuant to *8 Del. C. § 220* should have been targeted to this point, as plaintiff concedes.[9]

In the demand futility context, directors are presumed independent,[10] and it is the plaintiff's burden to plead facts "with particularity" showing that a demand on the board would have been futile.[11] Given this burden of proof, the presumption of independence, and the lack **[**25]** of any explanation as to why Gordon and Doerr were identified as "not independent" for NASDAQ purposes, I do not believe that plaintiffs are entitled to an inference that Gordon and Doerr lack independence for purposes of the fact-specific demand futility determination here. This is particularly true given that the allegations concerning Gordon and Doerr's interlocking business relationships fall short of suggesting that they are of a "bias-producing" nature.

As to director Paul, the plaintiff argues that Paul lacked independence from Pincus because they co-founded a company over twenty years ago and Pincus serves in an advisory role and is an investor in Paul's company, SideCar.[12] There are no allegations that demonstrate the materiality or magnitude of the present business relationship, which the plaintiff conceded could have been "[s]omewhere between 10 cents and $10 billion."[13]

---

[4] Compl. at A20 ¶¶ 17-18, A68 ¶¶ 114(c), (f), A71 ¶ 117(g), A72 ¶¶ 117(j-k). The Chancellor appropriately declined to consider other information regarding certain officers' investments in Kleiner Perkins funds. The plaintiff had raised this information in briefing and in an affidavit containing an excerpt from a public filing that was not incorporated by reference into or attached to the Complaint.

[5] *See, e.g., In re MFW S'holders Litig., 67 A.3d 496, 510 (Del. Ch. 2013)* ("[T]he fact that directors qualify as independent under the NYSE rules does not mean that they are necessarily independent under our law in particular circumstances." (citing *In re Oracle Corp. Derivative Litig., 824 A.2d 917, 941 n.62 (Del. Ch. 2003))*), *aff'd*, *88 A.3d 635 (Del. 2014)*.

[6] *See* Oral Argument at 12:13.

[7] *Sandys, 2016 Del. Ch. LEXIS 43, 2016 WL 769999, at *9*.

[8] *See, e.g., Teamsters Union 25 Health Servs. & Ins. Plan v. Baiera, 119 A.3d 44, 61 (Del. Ch. 2015)* (comparing the bright-line test for independence set forth in the NYSE rules with the "case-by-case fact specific inquiry based on well-pled factual allegations" required by Delaware law). In *Baiera*, the Court of Chancery concluded that, "[g]iven the peculiarities of the NYSE Rules, the fact that [the director] was not designated as "independent' under the NYSE Rules in Orbitz's April 2013 proxy statement carries little weight." *Id. at 62*. The court then found that "the factual allegations concerning [that director's] former relationship with Travelport [were] insufficient in [its] view to cast reasonable doubt on his presumed independence under Delaware law." *Id.*

[9] *See* Oral Argument at 14:00 ("We alleged certain business relationships. It's true we didn't go through the 220 for that one and that was a deficiency in our process. And I guess I fall on my sword for that one.").

[10] *Beam v. Stewart, 845 A.2d 1040, 1048-49 (Del. 2004)* ("The key principle upon which this area of our jurisprudence is based is that the directors are entitled to a *presumption* that they were faithful to their fiduciary duties. In the context of presuit demand, the burden is upon the plaintiff in a derivative action to overcome that presumption." (emphasis in original) (citations omitted)).

[11] *Del. Ch. Ct. R. 23.1*; *see also Brehm v. Eisner, 746 A.2d 244, 254 (Del. 2000)* ("*Rule 23.1* is not satisfied by conclusory statements or mere notice pleading.").

[12] Compl. at A71 ¶ 117(f).

[13] Transcript of Oral Argument on Defs.' Mots. to Dismiss &

He also did not dispute the trial court's statement that the company Paul and Pincus co-founded was sold approximately 15 years ago.[14] Thus, based upon my review of the record,[15] I would **[*137]** conclude that these allegations are insufficient to plead a lack of independence.

Although I would not need to reach issues concerning Siminoff's independence had my view prevailed, I believe that a few points are worth making. The sum total of the allegations as to Siminoff's alleged lack of independence appear in paragraph 117(h) of the Complaint, which states that "Siminoff and her husband have an existing *business relationship* with defendant Pincus as co-owners of a private airplane and, therefore, Siminoff would not initiate litigation against her *business partner* defendant Pincus as it would substantially and irreparably harm their ongoing *business relationship*."[16]

Before the trial court, both parties referred to statements in Zynga's public filings with the Securities and Exchange Commission, although the Complaint did not expressly incorporate these statements by reference.[17] In briefing on the defendants' motion to dismiss or stay, the defendants attached a proxy statement in which Zynga disclosed the "relationship between Ms. Siminoff and her spouse and Mr. Pincus, who co-own a small private airplane, which was not used for Company travel."[18] The Chancellor also acknowledged an unsupported reference in the plaintiff's brief describing Siminoff as a "close personal **[**27]** friend" of Pincus. At oral argument on the defendants' motion to dismiss, the Chancellor offered counsel for Sandys an opportunity to expand on the nature of the relationship, but counsel was unable to do so.[19]

Given the plaintiff's failure to allege any specific facts as to the materiality of the co-owned asset (apparently a small plane, not a jet),[20] whether there were other owners, or the nature of the Siminoff/Pincus relationship,[21] I am sympathetic to the Chancellor's view that "Plaintiff's allegations concerning co-ownership of an asset and friendship do not reveal a sufficiently **[*138]** deep personal connection to Pincus so as to raise a reasonable doubt about Siminoff's independence from Pincus."[22] Given the plaintiff's burden, the Chancellor's decision to err on the dismissal side of this fault line is not unreasonable.

The Majority states that "the most likely inference" to draw from co-ownership of the small plane is "not that the private airplane was a *business venture*" but that there was "an extremely close, personal bond between Pincus and Siminoff" and that "the Pincus and Siminoff families are **[**28]** extremely close to each other and are among each other's most important and intimate

Stay at A410-411 (Tr. 49:23-50:6), *Sandys v. Pincus*, No. 9512-CB (Del. Ch. Nov. 17, 2015), *available at* A362-435.

[14] *Id.* at A410 (Tr. 49:19-22).

[15] Beam, 845 A.2d at 1048 ("This Court reviews *de novo* ***[**26]*** a decision of the Court of Chancery to dismiss a derivative suit under Rule 23.1[,]" and "[t]he scope of this Court's review is plenary." (italics added) (citations omitted)).

[16] Compl. at A71 ¶ 117(h) (emphasis added).

[17] *E.g.*, Zynga Inc., Definitive Proxy Statement (Form 14A) (Apr. 25, 2013), *excerpt available at* B210-21; Zynga Inc., Prospectus (Mar. 29, 2012), *excerpt available at* B125-60.

[18] Zynga Inc., Definitive Proxy Statement (Form 14A), at 1 (Apr. 25, 2013), *excerpt available at* B210-21.

[19] Transcript of Oral Argument on Defs.' Mots. to Dismiss & Stay at A410 (Tr. 49:7-16).

[20] Zynga Inc., Definitive Proxy Statement (Form 14A), at 1 (Apr. 25, 2013), *excerpt available at* B210-21. Plaintiff's counsel referred to the plane as a "jet" during argument before this Court. *See* Oral Argument at 42:35 ("Your Honor I know you faulted Plaintiff for not doing a more complete books and records, but in the context of this case Defendants placed into the record many of the facts in the form of a proxy statement and a registration statement. And in the argument down below I did invite the Chancellor to look at all the facts in the registration statement and the proxy and both sides cited to those facts. So -- that it's a plane or a jet, the fact that it is a jet is properly before the Court just based upon the Defendants putting that document before the Court, to the extent there is a difference between a plane and a jet."). The proxy statement does not refer to the plane as a "jet," as the Majority acknowledges. *See* Majority Op. at 8 n.18. At oral argument, when asked whether the plane is a $40,000 Piper Cub or a $40 million Gulfstream jet, counsel for plaintiff merely responded that he never considered that the plane could be a smaller plane "given the positions of these individuals" and that he thought "it's reasonable to infer that a private plane is a relatively weighty purchase and a weighty investment." Oral Argument at 10:00.

[21] *See* Compl. at A71 ¶ 117(h).

[22] *Sandys, 2016 Del. Ch. LEXIS 43, 2016 WL 769999, at *8*.

friends."[23] I respectfully disagree given that the plaintiff has chosen to plead only a *business relationship*. Nothing more is alleged, let alone facts suggesting that kind of familial loyalty and intimate friendship.

To render a director unable to consider demand, a relationship must be of a "bias-producing nature."[24] In *Beam*, this Court reaffirmed that a *reasonable* inference cannot be made that a particular friendship raises a reasonable doubt "without specific factual allegations to support such a conclusion."[25] In *Beam*, this Court affirmed dismissal of a complaint that had pled that certain directors were a "longtime personal friend," a "longstanding friend[,]" and had a "longstanding personal relationship with defendant Stewart."[26] Given this plaintiff's decision to allege the existence of a business relationship only, he is left to argue that co-ownership of a small airplane is simply the kind of fact that, in and of itself, creates a reasonable doubt as to Siminoff's independence from Pincus. This is a close call. Although it may be reasonable to infer some kind of collaborative relationship given the **[**29]** nature of the asset, I do not believe the bare allegation in the Complaint rises to the level of creating a reasonable doubt as to Siminoff's ability to carry out her fiduciary duties, to properly consider a demand, and to put at risk her reputation by disregarding her duties.

Thus, this case stands in contrast to *Sanchez*,[27] for example, where the plaintiff pled that the director had a fifty-year friendship with the interested party, that the director's primary employment (and that of his brother) was as an executive of a company over which the interested party had substantial influence, and the director made thirty to forty percent of his annual income from his directorship.[28] Here, the bare reference to a "close friendship" appears only as an unsupported assertion in a brief.[29] This unsupported and unverified reference should not be considered and should not serve as a basis upon which to draw any inferences. For me, this is not a mere technicality. Court of Chancery Rule 3(aa) requires that all complaints "be verified."[30] This means that every pleading **[*139]** "shall be under oath or affirmation by the party filing such pleading that the matter contained therein insofar as it concerns the party's act and deed is true, and **[**30]** so far as relates to the act and deed of any other person, is believed by the party to be true."[31] Unverified and unsupported statements in a brief should not be considered as if they were pleaded facts.

In *Sanchez*, we warned that, "[i]t is not fair to the defendants, to the Court of Chancery, or to this Court, nor is it proper under the rules of either court, for the plaintiffs to put facts outside the complaint before us."[32] We further cautioned that "this approach hazards dismissal with prejudice on the basis of a record the plaintiffs had the fair chance to shape and that omitted facts they could have, but failed to, plead."[33] Here, the plaintiff failed to heed that warning and unnecessarily complicated the task of both courts in exercising their best efforts to reach a just result.[34] Even assuming that

[23] Majority Op. at 9-10 (emphasis added).

[24] Beam, 845 A.2d at 1050.

[25] *Id.* (quoting Beam v. Stewart, 833 A.2d 961, 979 (Del. Ch. 2003)) (internal quotation marks omitted).

[26] Id. at 1045-47.

[27] ***Del. Cnty. Emps. Ret. Fund v. Sanchez, 124 A.3d 1017 (Del. 2015)***.

[28] ***Id. at 1020-21***.

[29] Brief of Pl. in Opp'n to Defs.' Mots. to Stay or Dismiss at A145, *Sandys v. Pincus*, No. 9512-CB (Del. Ch. Apr. 17, 2015), *available at* A82-150.

[30] Del. Ct. Ch. R. 3(aa).

[31] *Id.*

[32] ***Sanchez, 124 A.3d at 1021 n.14***.

[33] *Id.*

[34] Finally, regarding the Majority's repeated suggestions (both in its Opinion and at oral argument) that plaintiffs should search the internet for facts in fashioning a complaint, *see, e.g.*, Oral Argument at 6:05, 14:00, 21:10, although perhaps useful on some level, internet searches likely are not, in most cases, an adequate substitute for demands made pursuant to 8 Del. C. § 220—particularly in terms of the reliability and trustworthiness of information discovered. Of course, a court cannot engage in independent fact-finding, on the internet or otherwise, and the Majority is correct that the Court of Chancery was stuck with the limited factual allegations made by the plaintiff—and so is this Court. The Majority suggests that, had the plaintiff undertaken an internet search, "he likely would have discovered more information about Siminoff's relationship with Pincus." Majority Op. at 9; *see also* Oral Argument at 21:30. But the Majority never identifies what information likely would have been discovered. Whatever it may be, it can have no bearing on our disposition since the record on appeal before us consists of "the original papers and

our law cannot "ignore the social nature of humans[,]"[35] there is no equity here in asking the reviewing courts to speculate that the pleaded Siminoff/Pincus business relationship is of such a nature to render her beholden to him or so under his influence that her directorial discretion is sterilized.

Accordingly, because I would affirm the **[**31]** Court of Chancery's decision, I respectfully dissent.

End of Document

---

exhibits" only. *Del. Sup. Ct. R. 9(a)*; *see* *Tribbitt v. Tribbitt, 963 A.2d 1128, 1131 (Del. 2008)* (observing that, "while a judge may take judicial notice of a fact outside the record, that fact must not be subject to reasonable dispute and the parties must be given prior notice and an opportunity to challenge judicial notice of that fact" (citations omitted)); *Barks v. Herzberg, 206 A.2d 507, 509, 58 Del. 162, 8 Storey 162 (Del. 1965)*; *Del. R. Evid. 201(e)* ("A party is entitled upon timely request to an opportunity to be heard as to the propriety of taking judicial notice and the tenor of the matter noticed. In the absence of prior notification, the request may be made after judicial notice has been taken.").

[35] *Oracle, 824 A.2d at 938*.

Stone v. Ritter

Supreme Court of Delaware

October 5, 2006, Submitted ; November 6, 2006, Decided

No. 93, 2006

Reporter

911 A.2d 362 *; 2006 Del. LEXIS 597 **

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.

Prior History: **[**1]** Court Below -- Court of Chancery of the State of Delaware, in and for New Castle County. C.A. No. 1570-N.

Disposition: AFFIRMED.

Counsel: Brian D. Long, Esquire (argued) and Seth D. Rigrodsky, Esquire, of Rigrodsky & Long, P.A., Wilmington, Delaware, for appellants.

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

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

Opinion by: HOLLAND

Opinion

[*364] **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. **[**2]** 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] **[**3]** 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

---

[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 Del. Ch. LEXIS 33, 2006 WL 391931, at *5 (Del. Ch.)*; *Guttman v. Huang, 823 A.2d 492, 506 (Del. Ch. 2003)*.

"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 **[**4]** 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 **[**5]** Activity Reports" ("SARs"), as required by the federal Bank Secrecy Act ("BSA") [4] **[**6]** 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 **[**7]** 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

[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)*.

although in 2000 "at least one" AmSouth employee suspected that Hamric was involved in a possibly illegal scheme, AmSouth failed to file SARs in **[**8]** 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 **[**9]** 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

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 **[**10]** 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]

[11]** 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]

---

[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

[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.

[**13] *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, **[**14]** 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 **[**15]** 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 **[**16]**

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., 41 Del. Ch. 78, 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.

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] **[**17]** 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 **[**18]** 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' **[**19]** claim for relief.

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

---

[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.

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 **[**20]** to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty.

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 **[**21]** 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]

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 **[**22]** 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

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 **[**23]** 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 **[**24]** under Rule 23.1. [37]

Reasonable Reporting System Existed

---

[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. Haung, 823 A.2d at 506*.

[36] *Stone v. Ritter, 2006 Del. Ch. LEXIS 20, C.A. No. 1570-N (Del. Ch. 2006)* (Letter Opinion).

[37] *Beam ex rel. Martha Stewart Living Omnimedia Inc. v. Stewart, 845 A.2d 1040, 1048 (Del. 2004)*.

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 **[**25]** 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 **[**26]** 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 **[**27]** 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

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 **[**28]** 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

---

[38] *Del. Code Ann. tit. 8, 220* (2006).

[39] *In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d at 968*.

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 **[**29]** 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 **[**30]** an oversight claim seeking to hold the directors personally liable for such failures by the employees.

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.

[**31] *Conclusion*

The judgment of the Court of Chancery is affirmed.

End of Document

[40] *Id. at 967*.

[41] *Id. at 971*.

[42] *Id*. (emphasis in original).

[43] *Id. at 967-68, 971*.

UFCW & Participating Food Indus. Empls Tri-State Pension Fund v. Zuckerberg

Court of Chancery of Delaware, New Castle

July 29, 2020, Submitted; October 26, 2020, Decided

C.A. No. 2018-0671-JTL

Reporter

250 A.3d 862 *; 2020 Del. Ch. LEXIS 319 **; 2020 WL 6266162

UNITED FOOD AND COMMERCIAL WORKERS UNION AND PARTICIPATING FOOD INDUSTRY EMPLOYERS TRI-STATE PENSION FUND, Plaintiff, v. MARK ZUCKERBERG, MARC ANDREESSEN, PETER THIEL, REED HASTINGS, ERSKINE B. BOWLES, and SUSAN D. DESMOND-HELLMANN, Defendants, and FACEBOOK, INC., Nominal Defendant.

Subsequent History: Affirmed by *United Food & Commer. Workers Union v. Zuckerberg, 2021 Del. LEXIS 298 (Del., Sept. 23, 2021)*

Counsel: **[**1]** P. Bradford deLeeuw, DELEEUW LAW LLC, Wilmington, Delaware; Robert C. Schubert, SCHUBERT JONCKHEER & KOLBE LLP, San Francisco, California; James E. Miller, SHEPHERD FINKELMAN MILLER & SHAH, LLP, Chester, Connecticut; Attorneys for Plaintiff.

Kevin R. Shannon, Berton W. Ashman, Jr., Tyler J. Leavengood, POTTER ANDERSON & CORROON LLP, Wilmington, Delaware; William Savitt, Ryan A. McLeod, Anitha Reddy, Cecilia A. Glass, WACHTELL, LIPTON, ROSEN & KATZ, New York, New York; Attorneys for Defendants Marc L. Andreessen, Erskine B. Bowles, Susan D. Desmond-Hellmann, Reed Hastings, and Peter A. Thiel.

Raymond J. DiCamillo, Kevin M. Gallagher, Megan E. O'Connor, RICHARDS, LAYTON & FINGER, P.A, Wilmington, Delaware; George M. Garvey, Laura Lin, MUNGER, TOLLES & OLSON LLP, Los Angeles, California; Attorneys for Defendant Mark Zuckerberg.

David E. Ross, Garrett B. Moritz, R. Garrett Rice, ROSS ARONSTAM & MORITZ LLP, Wilmington, Delaware; George M. Garvey, Laura Lin, MUNGER, TOLLES & OLSON LLP, Los Angeles, California; Attorneys for Nominal Defendant Facebook, Inc.

Judges: LASTER, V.C.

Opinion by: LASTER

Opinion

[*869] LASTER, V.C.

Defendant Mark Zuckerberg is the founder, CEO, chairman of the board, and controlling stockholder of nominal **[**2]** defendant Facebook, Inc. At Zuckerberg's request, the Facebook board of directors (the "Board") pursued a reclassification of Facebook's shares. The transaction involved authorizing a new class of non-voting stock, then issuing two shares of non-voting stock to each existing stockholder. The effect of the reclassification would be to shift two-thirds of Facebook's economic value into the non-voting stock. The chief beneficiary was Zuckerberg, who would be able to transfer the bulk of his economic ownership in Facebook without giving up voting control.

Various stockholder plaintiffs filed lawsuits and sought a permanent injunction blocking the reclassification. Facebook agreed not to implement the reclassification until after a ruling on its merits. Just before trial, at Zuckerberg's request, the Board withdrew the reclassification. That decision gave the plaintiffs everything they sought to achieve, rendering that litigation moot.

The plaintiff in this litigation filed a derivative action against Zuckerberg and certain members of the Board who approved the reclassification. The plaintiff maintains that the pursuit of the reclassification constituted a breach of duty and that Facebook **[**3]** was harmed as a result. As damages, the plaintiff seeks to recover $21.8 million that Facebook expended pursuing the reclassification and defending the transaction until the eve of trial, plus $68.7 million that

Facebook paid the prior plaintiffs as a fee award. The plaintiff alleges that Facebook has suffered other damages, including reputational harm, in an amount to be proven at trial.

The defendants moved to dismiss this derivative action under *Rule 23.1* on the grounds that the plaintiff failed to demand that the Board pursue the litigation and did not establish that demand was futile. This decision grants the defendants' motion.

I. FACTUAL BACKGROUND

The facts are drawn from the amended complaint and the documents that it incorporates by reference. At this stage of the proceeding, the complaint's allegations are assumed to be true, and the plaintiff receives the benefit of all reasonable inferences.

A. Facebook

Facebook is a publicly traded Delaware corporation with its principal place of business in Menlo Park, California. Facebook is a social networking platform that allows users to create profiles, upload photos and videos, send messages, and communicate with friends, family, and colleagues. **[**4]** Based on global reach and total active users, Facebook is the largest social media and networking service. As of December 31, 2018, Facebook had 2.32 billion monthly users.

Facebook is one of the ten largest companies in the world by market capitalization. Shares of Facebook's Class A common stock trade on the Nasdaq under the symbol "FB." Facebook is a "controlled company" under applicable Nasdaq rules. Compl. ¶ 11. Zuckerberg controls Facebook, having founded the company in 2004 and served as its CEO and as a director since then. Since 2012, Zuckerberg has served as chair of the Board.

When the events giving rise to this litigation began, Zuckerberg beneficially owned shares that carried 53.8% of Facebook's outstanding voting power, but **[*870]** which reflected economic ownership of only 14.8%. Zuckerberg exercised disproportionate voting power because of Facebook's dual-class capital structure. Facebook's certificate of incorporation authorized two classes of common stock: (i) Class A common stock, which carried one vote per share, and (ii) Class B common stock, which carried ten votes per share. Zuckerberg owned around 4 million Class A shares and 419 million Class B shares. His Class B shares **[**5]** carried as much voting power as 4.19 billion Class A shares.

B. Zuckerberg Takes The Giving Pledge.

In December 2010, Zuckerberg took the Giving Pledge. Championed by Bill Gates and Warren Buffett, the Giving Pledge calls on wealthy business leaders to donate a majority of their wealth to philanthropic causes. Zuckerberg announced that he would begin his philanthropy early in life.

In March 2015, Zuckerberg developed a plan to complete the Giving Pledge by making annual donations of shares of Facebook stock worth $2-3 billion, eventually giving away 99% of his wealth. At some point, donations of this magnitude would cause Zuckerberg to lose control over Facebook.

Zuckerberg asked Facebook's general counsel to examine how soon the donations would undermine his voting control. The answer was quite soon. Zuckerberg only could donate shares worth approximately $3-4 billion before losing voting control.

To avoid this result, Facebook's general counsel recommended that Zuckerberg follow the "Google playbook." Facebook would authorize new shares of Class C common stock that would not have any voting rights, then distribute shares of Class C common stock to all its existing stockholders, including **[**6]** Zuckerberg. By doing so, Facebook would reallocate a portion of its economic value to the new non-voting shares. No existing stockholders would be harmed because each stockholder would receive a proportionate number of Class C shares. For Zuckerberg, however, the reallocation of a portion of his economic ownership to the non-voting Class C shares would allow him to transfer that portion without undermining his voting control.

Facebook's general counsel advised Zuckerberg that the reclassification required (i) an amendment to Facebook's certificate of incorporation, followed by (ii) a dividend of Class C shares. Both required Board approval, and the amendment required stockholder approval. Given the voting power of his holdings, Zuckerberg could approve the amendment at the stockholder level, so the only hurdle was Board approval. Facebook's general counsel recommended that the Board form a special committee to evaluate the transaction. Facebook's general counsel also advised that Google's reclassification led to stockholder litigation, which ended with a settlement valued at $522 million.

Zuckerberg liked the idea of a reclassification. He told Facebook's legal team to "start figuring **[**7]** out how to make this happen." *Id.* ¶ 22.

C. Zuckerberg Proposes The Reclassification.

In June 2015, Zuckerberg told the Board about the Giving Pledge and his plan to donate his Facebook shares. He explained that he wanted to consider the implications of reducing his stock ownership and how best to position Facebook moving forward.

Zuckerberg retained Simpson Thacher & Bartlett LLP and Goldman, Sachs & Co. to advise him on the reclassification. On **[*871]** August 20, 2015, Zuckerberg formally proposed to the Board that Facebook engage in a reclassification.

On August 22, 2015, the Board established a special committee to review, analyze, and negotiate the reclassification (the "Committee"). The Board also tasked the Committee with evaluating potential alternatives to a reclassification and making a formal recommendation to the Board. The members of the Committee were defendants Marc Andreessen, Erskine Bowles, and Susan Desmond-Hellmann.

The Board authorized the Committee to retain its own legal and financial advisors. At the recommendation of Facebook management, the Committee selected Wachtell, Lipton, Rosen & Katz LLP as its legal advisor. The Committee did not meet with Wachtell before hiring **[**8]** the firm. The Committee was supposed to prepare a formal charter delineating its duties and responsibilities, but it never did.

D. The Committee Negotiates With Zuckerberg.

Before meeting with the Committee, Wachtell contacted Simpson Thacher to discuss the terms of a reclassification. Simpson Thacher rejected as "non-starters" certain corporate governance concessions from the "Google playbook," including (i) a "stapling" provision that would have required Zuckerberg to sell a share of high-vote Class B stock each time he sold a share of non-voting Class C stock and (ii) a "true-up" payment to the Class A stockholders to compensate them for the dilution of their voting power. *See id.* ¶ 33.

On September 23, 2015, Wachtell met with the Committee for the first time. From the outset, the Committee anticipated that a reclassification would take place. Its deliberations focused less on whether to pursue a reclassification or propose an alternative and more on the details of the reclassification that Zuckerberg wanted.

On October 12, 2015, the Committee retained Evercore Partners as its financial advisor. As with Wachtell, the Committee did not meet with Evercore before retaining the firm. The **[**9]** lead banker from Evercore noted that they were hired "in the second inning," after the transaction was well underway. *Id.* ¶ 34 (internal quotation marks omitted).

At some point, Facebook retained Morgan Stanley & Co. LLC as its financial advisor. Simpson Thacher had previously spoken with Morgan Stanley about serving as Zuckerberg's personal financial advisor, and Morgan Stanley briefly acted in that role before Zuckerberg retained Goldman Sachs. As a result, Morgan Stanley knew about Zuckerberg's expectations for the reclassification, and Morgan Stanley used Simpson Thacher's work product when preparing its analyses of the reclassification.

On October 23, 2015, at the Committee's request, Wachtell spoke with Simpson Thacher about eight "Possible Concessions" from Zuckerberg:

• sunset provisions,

• an equal treatment provision,

• a non-competition covenant,

• acquisition protections,

• an independent nominating committee,

• conditioning the reclassification on the approval of Facebook's Class A stockholders,

• "stapling" provisions or other transfer restrictions, and

• a "true-up" payment to the Class A stockholders.

Wachtell already knew from its earlier communications with Simpson Thacher that **[**10]** Zuckerberg would not agree to the last two proposals. Zuckerberg now rejected **[*872]** the idea of a Class A vote. Zuckerberg agreed to consider the first five concessions.

On November 9, 2015, the Committee discussed the five concessions that Zuckerberg had agreed to consider. The Committee did not ask about the concessions that Zuckerberg had rejected; it simply accepted Zuckerberg's position. Evercore advised the Committee that Facebook's Class A stockholders were unlikely to approve the reclassification. Evercore did not provide any explanation, and the Committee did not ask why or otherwise explore the comment.

Although negotiations ostensibly had just begun, Zuckerberg was confident that the Board would approve a reclassification. He told Facebook's COO, Sheryl Sandberg, that there were "lots of details to work through, but at this point we're much more in the mode of making decisions and locking things down rather than broad consideration." *Id.* ¶ 39 (internal quotation marks omitted). On November 9, 2015, Zuckerberg publicly reaffirmed his Giving Pledge, noting that his "giving [was] just starting" and that he and his spouse planned to "expand" their giving. *Id.* ¶ 40 (internal quotation **[**11]** marks omitted).

The next day, Zuckerberg circulated a draft announcement that described his "new model of philanthropy" and involved donating 99% of his wealth during his lifetime. *Id.* He solicited comments from various Facebook personnel, including Desmond-Hellmann, one of the three members of the Committee. Zuckerberg told the other two members of Committee—Andreessen and Bowles—about his plan before he announced it. Both Andreessen and Bowles reacted enthusiastically. Andreessen told Zuckerberg that he was "very proud" of him, and Bowles told Zuckerberg that he was "proud to be a small part of your life." *Id.* Zuckerberg also told Warren Buffett and Bill and Melinda Gates about his plan. Melinda Gates forwarded her email conversation with Zuckerberg to Desmond-Hellmann, along with a smiley emoji. Zuckerberg later told the Board that he planned to announce that he and his spouse had committed "to give 99% of [their] FB shares during [their] lives with a focus on improving the world for the next generation." *Id.*

On November 11, 2015, Wachtell relayed the Committee's demands to Simpson Thacher. The demands largely hewed to the five concessions that Zuckerberg had agreed to consider. The **[**12]** Committee did not attempt to extract a cash payment or a greater number of Class C shares for the Class A stockholders. The Committee did not propose that the reclassification be conditioned on Class A stockholder approval. The Committee also did not ask for any type of restriction on Zuckerberg's ability to sell stock.

On December 1, 2015, Zuckerberg announced his Giving Pledge through a Facebook post. He simultaneously affirmed that he would "remain[] Facebook's CEO for many, many years to come." *Id.* ¶ 41 (internal quotation marks omitted). To do both, Zuckerberg needed the reclassification to become a reality. The announcement did not mention the reclassification, the Committee, or the need for the Committee and the Board to approve the reclassification. Zuckerberg did not seek Board approval before posting his announcement.

Over the next week, Zuckerberg's pledge received negative press. On December 6, 2015, Zuckerberg emailed Andreessen, writing, "This has been a crazy week. I want to thank you for all your support, and all you're doing to defend and spread what we're actually doing." *Id.* ¶ 43.

[*873] By January 27, 2016, the Committee largely had agreed to move forward with a reclassification. **[**13]** Over the next three months, the Committee and Zuckerberg negotiated various corporate governance provisions, focusing primarily on sunset provisions. The final slate of governance provisions permitted Zuckerberg to retain voting control of Facebook, even if he took years off to work for the government or redirected his focus to managing the charity that he and his wife had created.

E. Andreessen Back-Channels Information To Zuckerberg.

Throughout the negotiations over the reclassification, Andreessen regularly engaged in back-channel communications with Zuckerberg about what the Committee was doing. Andreessen and Zuckerberg exchanged text messages in which Andreessen described at least twelve different meetings during which the Committee deliberated over its negotiating positions. Andreessen shared with Zuckerberg details about what the Committee focused on, what questions the members would ask, and how each member felt about different governance issues. *Id.* ¶ 47.

For example, on February 11, 2016, the Board met to receive an update on the Committee's progress. An hour before the meeting, Andreessen sent a series of text messages to Zuckerberg. He told Zuckerberg, "Between us — re special **[**14]** board session. 1 new share class will happen. 2 everyone loves [your plan]." *Id.* ¶ 48 (internal quotation marks omitted). He added that the Committee "love[d] the intent." *Id.* He texted that the Committee was merely working "around the edges of the big things you want." *Id.* He told Zuckerberg that the Committee was working to "protect the company and you personally." *Id.* Later that day, Andreessen reassured Zuckerberg that "[a]ll [of the Committee's] feedback is to protect you and the company." *Id.* At other points, Andreessen acknowledged to Zuckerberg that several Facebook "senior staff think[] this is a big mistake" and that they "wish you would stop but don't want to challenge you." *Id.*

In addition to back-channeling information, Andreessen coached Zuckerberg before, during, and after calls with the Committee. For example, during a teleconference with the Committee on March 5, 2016, when Zuckerberg was pushing for the right to take an eight-year leave of absence, Andreessen coached Zuckerberg through the negotiations via text message. Throughout the meeting, Andreessen shared live updates with Zuckerberg. He told Zuckerberg when his arguments were falling flat: "This line of argument **[**15]** is not helping ☺." *Id.* ¶ 49 (internal quotation marks omitted). He told Zuckerberg when to back off: "The committee wants to do this. You don't need to question that." *Id.* And he encouraged Zuckerberg when his arguments were working: "NOW WE'RE COOKING WITH GAS." *Id.*

In another example, Zuckerberg was scheduled to talk to Desmond-Hellmann on March 11, 2016. The day before, Zuckerberg asked Andreessen, "Do you have any context before I talk to Sue tomorrow." *Id.* ¶ 47 (internal quotation marks omitted). Andreessen provided a detailed preview of the call.

These communications are only examples. Andreessen engaged in similar communications with Zuckerberg throughout the negotiations.

F. Facebook Moves Forward With The Reclassification.

On April 5, 2016, the Committee met to discuss the reclassification. Zuckerberg and an outside director, defendant Peter Thiel, attended. On April 13, 2016, the **[*874]** Committee voted to recommend the reclassification to the full Board.

Under the terms of the reclassification, Facebook would amend its charter to authorize the new Class C stock and to add certain corporate governance provisions. Facebook then would declare a dividend of two Class C shares of Facebook **[**16]** stock for each existing share of Class A and Class B stock. And Zuckerberg would enter into a "Founder Agreement" with Facebook conditioned on the reclassification becoming effective. *See id.* ¶ 56 (the "Reclassification").

Under the Founder Agreement, Zuckerberg agreed that if he ever owned less than 50.1% of the outstanding Class B shares, then he would retire Facebook's multi-class structure. Zuckerberg's also agreed that his high-vote shares would lose their additional voting rights if he left Facebook. But Zuckerberg could satisfy the condition that he remain at Facebook by serving as an "Approved Executive Officer," which only required that he serve as a vice president in charge of a principal business unit, division, or function. With the approval of the independent directors, that position could be part-time. The Founder Agreement permitted Zuckerberg to take a leave of absence to pursue government service and continue to maintain his voting control, as long as he retained at least 30% of the shares that he held on the effective date of the Reclassification.

Bowles was concerned about the government-service provision. In one of his back-channel text messages, Andreessen told Zuckerberg **[**17]** that Bowles regarded the provision as "an unforced error," which he "may grudgingly support [] at the end." *Id.* ¶ 58 (internal quotation marks omitted). Andreessen also told Zuckerberg that Bowles was "worried" that the government-service provision would be "the straw that breaks the camel's back on the optics of good governance" and "the thing people will point to on announcement and say 'what the f*ck are you guys doing agreeing to this.'" *Id.*

On April 14, 2016, the Board approved the Reclassification. Zuckerberg, Sandberg, and then-director Jan Koum abstained from the vote. *Id.*

G. Facebook Stockholders Challenge The Reclassification.

Facebook did not immediately announce the Reclassification. Facebook delayed the announcement until April 27, 2016, when Facebook publicly announced both the Reclassification and its best-ever quarterly earnings. An Evercore banker told Desmond-Hellmann, "Anytime FB announces earnings like that, no one will care about an equity recapitalization." *Id.* ¶ 59 (internal quotation marks omitted).

On April 29, 2016, Facebook stockholders filed a lawsuit in this court challenging the Reclassification. In subsequent days, another twelve cases were filed. The thirteen **[**18]** cases were consolidated. *See In re Facebook, Inc. Class C Reclassification Litig.*, C.A. No. 12286-VCL (the "Reclassification Action").

On June 20, 2016, Facebook held its annual stockholders meeting. Shares carrying 5.1 billion votes were voted in favor of the Reclassification, while shares carrying 1.5 billion votes were voted against. The shares voted in favor included Zuckerberg's holdings of 4 million Class A shares and 419 million Class B shares, which together constituted 4.7 billion votes. Excluding Zuckerberg's votes, the tally would have been around 453 million shares in favor and 1.5 billion shares against. Put differently, holders of more than 70% of the disinterested shares opposed the Reclassification.

[*875] The plaintiffs in the Reclassification Action sought injunctive relief blocking the consummation of the transaction. On June 24, 2016, the parties to the Reclassification Action agreed that Facebook would not implement the Reclassification while litigation was ongoing. On April 17, 2017, this court certified a class of stockholders comprising the holders of Facebook common stock other than Zuckerberg. Trial was scheduled to begin on September 26, 2017.

H. Facebook Abandons [**19] The Reclassification.

On September 21, 2017, five days before trial was set to begin, Zuckerberg asked the Board to abandon the Reclassification. The Board agreed, and the next day, Facebook issued a Form 8-K announcing the Board's decision. Facebook also announced that Zuckerberg still planned to fulfill the Giving Pledge by selling or donating between 35 and 75 million shares over the next eighteen months. Zuckerberg posted on Facebook about the abandoned Reclassification, explaining that he "knew it was going to be complicated and it wasn't a perfect solution." Compl. ¶ 62 (internal quotation marks omitted). He stated that he had come up with a "better" plan that would allow him to "fully fund" his philanthropy and "retain voting control of Facebook for 20 years or more." *Id.* Zuckerberg made clear that although Facebook had abandoned the Reclassification, he and his spouse still planned "to give away 99% of [their] Facebook shares during [their] lives." *Id.* He claimed that they "now plan[ned] to accelerate [their] work and sell more of those shares sooner." *Id.* Over the next sixteen months, Zuckerberg sold about 30.4 million shares for around $5.6 billion without losing control of **[**20]** Facebook. *See id.*

Because the plaintiffs in the Reclassification Action sought to block its implementation, the Board's withdrawal of the Reclassification gave them everything they wanted and rendered the Reclassification Action moot. By the time that the Board made its decision, Facebook had incurred approximately $21.8 million to pursue the Reclassification and defend the Reclassification Action. Then, as compensation for the benefits conferred by the Reclassification Action, Facebook agreed to pay a fee award of $68.7 million to plaintiffs' counsel.

I. This Litigation

On September 12, 2018, the plaintiff filed this derivative action. The complaint asserts a single count for breach of fiduciary duty. According to the complaint, the defendants "violated their fiduciary duties of care and loyalty" by pursuing and approving the Reclassification. *Id.* ¶ 110. The plaintiff further contends that the defendants "breached their fiduciary duties by failing to adequately evaluate Andreessen and Desmond-Hellmann's suitability to serve on the [Committee] . . . and then appointing these individuals to the [Committee]." *Id.* According to the complaint, Facebook is entitled to recover damages from the **[**21]** defendants for the "massive expenditures on financial advisors, experts, and attorneys retained by [Facebook] in connection with the Reclassification . . . , exposure to the Reclassification [Action] and the related litigation costs, and damage to Facebook's reputation and goodwill." *Id.* ¶ 111.

II. LEGAL ANALYSIS

When a corporation suffers harm, the board of directors is the institutional actor legally empowered under Delaware law to determine what, if any, remedial action the corporation should take, including pursuing litigation against the individuals involved. *See* [*8 Del. C. § 141(a)*]. "A cardinal precept of the General Corporation **[*876]** Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation." [*Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984)*].[1] "Directors of Delaware corporations derive

---

[1] In [*Brehm v. Eisner, 746 A.2d 244, 253-54 (Del. 2000)*], the Delaware Supreme Court overruled seven precedents, including [*Aronson*], to the extent that they reviewed a [*Rule 23.1*] decision by the Court of Chancery under an abuse of discretion standard or otherwise suggested deferential appellate review. [*Id. at 253 n.13*] (overruling in part on this

their managerial decision making power, which encompasses decisions whether to initiate, or refrain from entering, litigation, from 8 Del. C. § 141(a)." Zapata Corp. v. Maldonado, 430 A.2d 779, 782 (Del. 1981) (footnote omitted). Section 141(a) vests statutory authority in the board of directors to determine what action the corporation will take with its litigation assets, just as with other corporate assets. *See id.*

In a derivative suit, a stockholder seeks to displace **[**22]** the board's authority over a litigation asset and assert the corporation's claim. Aronson, 473 A.2d at 811. Unless the board of directors permits the stockholder to proceed, a stockholder only can pursue a cause of action belonging to the corporation if (i) the stockholder demanded that the directors pursue the corporate claim and they wrongfully refused to do so or (ii) demand is excused because the directors are incapable of making an impartial decision regarding the litigation. Ainscow v. Sanitary Co. of Am., 21 Del. Ch. 35, 180 A. 614, 615 (Del. Ch. 1935) (Wolcott, C.) (citing Sohland v. Baker, 15 Del. Ch. 431, 141 A. 277 (Del. 1927)).

The doctrines of demand refusal and demand excusal are substantive requirements of Delaware law. As a matter of procedure, Rule 23.1 imposes a pleading requirement on a plaintiff that seeks to assert a derivative claim so that the doctrines can be applied at the pleading stage. Rule 23.1 did not create the demand requirement; it is merely the "procedural embodiment of this substantive principle." Rales v. Blasband, 634 A.2d 927, 932 (Del. 1993); *accord* Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 96-97, 111 S. Ct. 1711, 114 L. Ed. 2d 152 (1991) (holding that the demand requirement underlying Rule 23.1 is substantive, and the Rule 23.1 pleading requirement is procedural).

Rule 23.1 requires that when a stockholder seeks to assert a derivative claim, the complaint must "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors **[**23]** or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort." Ct. Ch. R. 23.1(a). For a pleading to satisfy Rule 23.1, the plaintiff "must comply with stringent requirements of factual particularity that differ substantially from . . . permissive notice pleadings . . . ." Brehm, 746 A.2d at 254. Under the heightened pleading requirements of Rule 23.1, "conclusionary [sic] allegations of fact or law not supported by the allegations of specific fact may not be taken as true." Grobow, 539 A.2d at 187.

[*877] The requirement of factual particularity does not entitle a court to discredit or weigh the persuasiveness of well-pled allegations. "The well-pleaded factual allegations of the derivative complaint are accepted as true on such a motion." Rales, 634 A.2d at 931. "Plaintiffs are entitled to all reasonable factual inferences that logically flow from the particularized facts alleged . . . ." Brehm, 746 A.2d at 255. Rule 23.1 requires that a plaintiff allege specific facts, but "he need not plead evidence." Aronson, 473 A.2d at 816; *accord* Brehm, 746 A.2d at 254 ("[T]he pleader is not required to plead evidence . . . .").

The plaintiff in this case chose not to make a pre-suit demand. The operative question is therefore whether "demand is excused because the directors are incapable of making an impartial decision **[**24]** regarding whether to institute such litigation." Stone v. Ritter, 911 A.2d 362, 367 (Del. 2006). Subject to exceptions not applicable here, the demand futility analysis asks whether the board of directors as constituted when the lawsuit was filed could exercise disinterested and independent judgment regarding a demand. *See* In re infoUSA, Inc. S'holders Litig., 953 A.2d 963, 985 (Del. Ch. 2007). When determining whether the particularized allegations of the complaint support a reasonable inference that a director could not meet this standard, the court must consider the plaintiff's allegations "in their totality and not in isolation from each other." *Del. Cty. Emps. Ret. Fund v. Sanchez, 124 A.3d 1017, 1019 (Del. 2015)*. The question is whether the constellation of allegations, viewed holistically, creates a reasonable doubt about the director's ability to consider a demand objectively. *See* In re Oracle Corp. Derivative Litig., 2018 Del. Ch. LEXIS 92, 2018 WL 1381331, at *18 (Del. Ch. Mar. 19, 2018).

To determine whether a board of directors could

---

issue Scattered Corp. v. Chi. Stock Exch., 701 A.2d 70, 72-73 (Del. 1997); Grimes v. Donald, 673 A.2d 1207, 1217 n.15 (Del. 1996); Heineman v. Datapoint Corp., 611 A.2d 950, 952 (Del. 1992); Levine v. Smith, 591 A.2d 194, 207 (Del. 1991); Grobow v. Perot, 539 A.2d 180, 186 (Del. 1988); Pogostin v. Rice, 480 A.2d 619, 624-25 (Del. 1984); and Aronson, 473 A.2d at 814). The *Brehm* Court held that going forward, appellate review of a Rule 23.1 determination would be *de novo* and plenary. Brehm, 746 A.2d at 254. The seven partially overruled precedents otherwise remain good law. This decision does not rely on any of them for the standard of appellate review. Having described *Brehm*'s relationship to these cases, this decision omits their cumbersome subsequent history.

properly consider a demand, a court counts heads. *See* In re EZCORP Inc. Consulting Agreement Deriv. Litig., 2016 Del. Ch. LEXIS 14, 2016 WL 301245, at *34 (Del. Ch. Jan. 25, 2016). If the board lacks a majority of directors who could exercise independent and disinterested judgment regarding a demand, then demand is futile.[2]

A. The Standards For Evaluating Whether Directors Can Consider A Demand

The Delaware Supreme Court has established two tests for determining whether directors can exercise independent and disinterested judgment regarding **[**25]** a demand. *See* Wood v. Baum, 953 A.2d 136, 140 (Del. 2008). The *Aronson* decision announced the first test. The *Rales* decision announced the second test. Both tests remain authoritative, but the *Aronson* test has proved to be comparatively narrow and inflexible in its application, and its formulation has not fared well in the face of subsequent judicial developments. The *Rales* test, by contrast, has proved to be broad and flexible, and it encompasses the *Aronson* test as a special case.

[*878] 1. *Aronson*

In 1984, after many decades during which Rule 23.1 did not play a major role in stockholder derivative litigation, the Delaware Supreme Court issued its landmark decision in *Aronson*. A stockholder plaintiff alleged that a board of directors could not evaluate a demand to bring litigation to challenge an earlier board decision made by the very same directors. *See* Aronson, 473 A.2d at 814. Relying on established precedent, the plaintiff argued that the directors self-evidently could not consider a demand because they had approved the challenged transaction and been named as defendants. *See* id. at 814, 817. After acknowledging that earlier Delaware cases had taken that approach,[3] the Delaware Supreme Court rejected it, explaining, "Were that so, the demand requirements of our law would be **[**26]** meaningless, leaving the clear mandate of Chancery Rule 23.1 devoid of its purpose and substance." Id. at 814.

The high court instead held that the question of demand futility was "inextricably bound to issues of business judgment . . . ." Id. at 812. For the *Aronson* court, this observation meant that the analysis of demand futility turned on whether the business judgment rule protected the decision being challenged. *Id.* The Delaware Supreme Court framed the resulting test as follows:

> Our view is that in determining demand futility the Court of Chancery . . . 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. Hence, the Court of Chancery must make two inquiries, one into the independence and disinterestedness of the directors and the other into the substantive nature of the challenged transaction and the board's approval thereof.
>
> As to the latter inquiry the court does not assume that the transaction is a wrong to the corporation requiring corrective steps by the board. Rather, the alleged wrong **[**27]** is substantively reviewed against the factual background alleged in the

[2] Aronson, 473 A.2d at 812 (noting that if a board decision is "not approved by a majority consisting of the disinterested directors, then the business judgment rule has no application"); *see* Beam v. Stewart, 845 A.2d 1040, 1046 n.8 (Del. 2004) (noting that for demand futility purposes, a disinterested and independent majority is required, such that a board evenly divided between interested and disinterested directors could not exercise business judgment on a demand); Beneville v. York, 769 A.2d 80, 85-87 (Del. Ch. 2000) (holding that demand is futile if the board is split); Gentile v. Rossette, 2010 Del. Ch. LEXIS 123, 2010 WL 2171613, at *7 n.36 (Del. Ch. May 28, 2010) ("A board that is evenly divided between conflicted and non-conflicted members is not considered independent and disinterested.").

[3] *See* id. at 814 (citing McKee v. Rogers, 18 Del. Ch. 81, 156 A. 191, 193 (Del. Ch. 1931) (Wolcott, C.) ("It is manifest then that there can be no expectation that the corporation would sue [the defendant, who controlled the board], and if it did, it can hardly be said that the prosecution of the suit would be entrusted to proper hands."); Miller v. Loft, Inc., 17 Del. Ch. 301, 153 A. 861, 862 (Del. Ch. 1931) (Wolcott, C.) ("[I]f by reason of hostile interest or guilty participation in the wrongs complained of, the directors cannot be expected to institute suit, . . . no demand upon them to institute suit is [required]."); Fleer v. Frank H. Fleer Corp., 14 Del. Ch. 277, 125 A. 411, 414 (Del. Ch. 1924) (Wolcott, C.) ("Where the demand if made would be directed to the particular individuals who themselves are the alleged wrongdoers and who therefore would be invited to sue themselves, the rule is settled that a demand and refusal is not requisite.")). Other pre-*Aronson* precedents consistent with *McKee, Fleer*, and *Miller* could be cited.

> complaint. As to the former inquiry, directorial independence and disinterestedness, the court reviews the factual allegations to decide whether they raise a reasonable doubt, as a threshold matter, that the protections of the business judgment rule are available to the board. Certainly, if this is an "interested" director transaction, such that the business judgment rule is inapplicable to the board majority approving the transaction, then the inquiry ceases. In that event futility of demand has been established by any objective or subjective standard.

Id. at 814-15 (formatting added). "In sum," the Delaware Supreme Court concluded, "the entire review is factual in nature." *Id. at 815*. The trial court "must be satisfied **[*879]** that a plaintiff has alleged facts with particularity which, taken as true, support a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment. Only in that context is demand excused." *Id. at 815*.

The *Aronson* decision thus called for two separate inquiries, each of which assessed the standard of review that would govern the claim for breach of fiduciary duty challenging the underlying **[**28]** decision. The first *Aronson* inquiry asked whether a disinterested and independent majority of directors had made that decision, which is a prerequisite to the application of the business judgment rule. *Id. at 814*. If the particularized allegations of the complaint established that the board lacked a disinterested and independent majority, then the protections of the business judgment rule would not be available to the directors when defending their prior decision, and demand was futile. *Id.*

The second *Aronson* inquiry asked whether the challenged decision "was otherwise the product of a valid exercise of business judgment." *Id.* The *Aronson* court envisioned that if the business judgment rule did not apply for some reason other than the absence of a majority of disinterested and independent directors (the subject of the first *Aronson* inquiry), then demand also would be excused. In *Aronson*, that possibility was front and center because the plaintiffs alleged that the challenged transaction constituted waste. *See id. at 817*.[4] The Delaware Supreme Court was engaged contemporaneously in strengthening the duty of care,[5] and the *Aronson* decision stated that "to invoke the rule's protection directors have a duty to **[**29]** inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge **[*880]** of their duties." *473 A.2d at 812*. With the benefit of hindsight, it seems possible that the *Aronson* court also anticipated that entire fairness might apply based on a pled breach of the duty of care, as the Delaware Supreme Court subsequently held.[6]

---

[4] Historically, waste derived from the *ultra vires* doctrine and stood outside the business judgment rule. *See generally* Harwell Wells, *The Life (and Death?) of Corporate Waste*, *74 Wash. & Lee L. Rev. 1239, 1243-48 (2017)*. At the time of *Aronson*, a viable waste claim thus would not be subject to the business judgment rule because, by definition, the decision was so extreme as to be beyond the directors' authority. *See* *Alcott v. Hyman, 42 Del. Ch. 233, 208 A.2d 501, 507 (Del. 1965)*; *Gottlieb v. Heyden Chem. Corp., 33 Del. Ch. 177, 91 A.2d 57, 58 (Del. 1952)*. Evidencing the different legal framework, non-unanimous stockholder ratification could not validate an action that constituted waste. *See* *Michelson v. Duncan, 407 A.2d 211, 219 (Del. 1979)*. Contemporary Delaware decisions have brought waste within the fiduciary framework of the business judgment rule by re-conceiving of waste as a means of pleading that the directors acted in bad faith. *See, e.g.*, *White v. Panic, 783 A.2d 543, 554 n.36 (Del. 2001)* ("To prevail on a waste claim or a bad faith claim, the plaintiff must overcome the general presumption of good faith by showing that the board's decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation's best interests."); *CanCan Dev., LLC v. Manno, 2015 Del. Ch. LEXIS 144, 2015 WL 3400789, at *20 (Del. Ch. May 27, 2015)* (explaining that waste is "best understood as one means of establishing a breach of the duty of loyalty's subsidiary element of good faith"); *SEPTA v. AbbVie Inc., 2015 Del. Ch. LEXIS 110, 2015 WL 1753033, at *14 n.144 (Del. Ch. Apr. 15, 2015)* ("This Court has found that, doctrinally, waste is a subset of good faith under the umbrella of the duty of loyalty."), *aff'd*, ***132 A.3d 1 (Del. 2016)***.

[5] The duty of care was a subject of much discussion and debate at the time. *See* Henry Ridgely Horsey, *The Duty of Care Component of the Business Judgment Rule*, *19 Del. J. Corp. L. 971, 996-97 (1994)* (describing debates over duty of care that preceded *Aronson*). As part of its discussion of the duty of care, the *Aronson* court addressed an issue of first impression, stating that "under the business judgment rule director liability is predicated upon concepts of gross negligence." *473 A.2d at 812*. Eight months later, the Delaware Supreme Court issued *Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985)*, its landmark decision on the duty of care.

[6] *See* *Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 366-71 (Del. 1993)*. Justice Moore, the author of *Aronson*, also served

Addressing a situation in which the same directors who would consider a demand had made the challenged decision, the *Aronson* court viewed the standard of review that would apply to the challenged decision as outcome determinative for purposes of demand futility. If the business judgment rule governed the challenged decision, then the directors did not face a substantial risk of liability from the lawsuit, and the lawsuit could not disable the directors from exercising business judgment regarding the demand. But if the entire fairness test governed—either because the board **[**30]** lacked a disinterested and independent majority when making the challenged decision or for some other reason—then the *Aronson* court regarded that fact as sufficient to render demand excused.[7]

In using the standard of review for the challenged transaction as a proxy for the risk of director liability and hence the test for demand futility, *Aronson* was a creature of its time. Subsequent jurisprudential developments severed the linkage between these concepts. Under current law, the application of a standard of review that is more onerous than the business judgment rule does not render demand futile. Similarly, the availability of exculpation means that a standard of review that is more onerous than the business judgment rule may not result in a substantial likelihood of liability.

The most obvious place to look for any continuing link between the application of a standard of review more onerous than the business judgment rule and a consequence of rendering demand futile is in cases involving interested transactions with a controlling stockholder. Authored in 1984, *Aronson* predated by more than a decade two watershed decisions from the Delaware Supreme Court which held that the entire **[**31]** fairness test applies inherently and from the outset ("*ab initio*") to an interested transaction involving a controlling stockholder. *See* [*Kahn v. Tremont Corp., 694 A.2d 422, 428-29 (Del. 1997)*]; [*Kahn v. Lynch Commun. Sys., 638 A.2d 1110, 1115 (Del. 1994)*]. The *Aronson* court thus could not have taken into account the implications of automatic-entire-fairness review on the demand futility analysis, even though the decisions at issue in *Aronson* involved interested transactions with a 47% stockholder. *See* [*Aronson, 473 A.2d at 808*]. After *Tremont* and *Lynch*, a natural reading of *Aronson*'s second **[*881]** prong would suggest that demand becomes futile when entire fairness applies *ab initio*. Former Chief Justice Strine once said as much while serving as a member of this court. *See* [*Parfi Hldg. AB v. Mirror Image Internet, Inc., 794 A.2d 1211, 1231 n.47 (Del. Ch. 2001)*] ("The complaint pleads particularized facts that suggest that the entire fairness standard of review—rather than the business judgement [sic] rule—would apply to the Transactions and that the Transactions might not have been fair. As a result, the complaint satisfies the second prong of *Aronson*."). Case law, however, developed in a different direction, with this court holding that demand is not rendered futile under the second prong of *Aronson* simply because entire fairness applies *ab initio* to a transaction with a controlling stockholder.[8]

on the panel that decided *Technicolor*.

[7] *See* [*id. at 815*] ("Certainly, if this is an 'interested' director transaction, such that the business judgment rule is inapplicable to the board majority approving the transaction, then the inquiry ceases. In that event futility of demand has been established by any objective or subjective standard."); [*id. at 818*] ("Unless facts are alleged with particularity to overcome the presumptions of independence and a proper exercise of business judgment, in which case the directors could not be expected to sue themselves, a bare claim of this sort raises no legally cognizable issue under Delaware corporate law."); *id.* ("In sum, we conclude that the plaintiff has failed to allege facts with particularity indicating that the Meyers directors were tainted by interest, lacked independence, or took action contrary to Meyers' best interests in order to create a reasonable doubt as to the applicability of the business judgment rule. Only in the presence of such a reasonable doubt may a demand be deemed futile.").

[8] *See* [*In re BGC Partners, Inc. Derivative Litig., 2019 Del. Ch. LEXIS 1289, 2019 WL 4745121, at *7-8 (Del. Ch. Sept. 30, 2019)*]; ***[**32]*** [*Teamsters Union25 Health Servs. & Ins. Plan v. Baiera, 119 A.3d 44, 2015 WL 4192107, at *16 (Del. Ch. 2015)*]. Both decisions relied on the indisputable fact that *Aronson* did not regard a transaction with a controlling stockholder as triggering entire fairness *ab initio* and hence rendering demand futile. As noted, that omission was likely an artifact of the timing of that subsequent doctrinal innovation. Both decisions also relied on *Beam*, in which a stockholder plaintiff sought to establish that demand was futile under *Aronson*. The corporation in *Beam* had a controlling stockholder, but as the *Baiera* decision recognized, the claim in *Beam* did not challenge a self-interested transaction with the controlling stockholder. It was therefore not a situation in which entire fairness would apply *ab initio. See* [*Baiera, 119 A.3d 44, 2015 WL 4192107, at *16*]. The Delaware Supreme Court's decision in *Beam* thus does not provide insight into how the second prong of *Aronson* would operate after *Tremont* and *Lynch*. As discussed below, the question is no longer meaningful because of the manner in which [*Section 102(b)(7)*] now operates at the pleading stage, even when entire fairness applies *ab initio*.

The *Aronson* decision also pre-dated the Delaware Supreme Court's open recognition of enhanced scrutiny as a third and intermediate standard of review.[9] Because the sibling strains of enhanced scrutiny create additional scenarios where the business judgment rule does not apply, a natural reading of *Aronson*'s second prong would suggest that demand becomes futile when enhanced scrutiny applies. Here too, former Chief Justice Strine once said as much while serving as a member of this court, writing that if an enhanced scrutiny claim were assumed to be derivative, that characterization would not have any effect on a stockholder plaintiff's ability to sue because "[s]o long as the plaintiff states a claim implicating the heightened scrutiny required by *Unocal*, demand has been excused under the [*Aronson*] demand excusal test."[10] Once again, subsequent case **[*882]** law developed in a different direction, and authority now holds that demand is not futile simply because enhanced scrutiny applies. *See* Ryan v. Armstrong, 2017 Del. Ch. LEXIS 80, 2017 WL 2062902, at *13-14 (Del. Ch. May 15, 2017).

Perhaps most significantly, *Aronson* predated **[**33]** by two years the enactment of Section 102(b)(7) of the Delaware General Corporation Law, which authorizes the certificate of incorporation of a Delaware corporation to 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 as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.

8 Del. C. § 102(b)(7). Exculpatory provisions shield directors from personal liability for monetary damages, except as to the four identified categories. "The totality of these limitations or exceptions . . . is to . . . eliminate . . . director liability only for 'duty of care' violations. With respect to other culpable directorial actions, the conventional liability of directors for wrongful conduct remains intact." 1 David A. Drexler et al., Delaware Corporation Law and Practice, § 6.02[7], at 6-18 (2019).

The presence **[**34]** of an exculpatory provision has significant implications for the risk of liability faced by outside directors, even in a lawsuit challenging a self-dealing transaction involving a controlling stockholder for which entire fairness is the operative standard of review. When a corporation has an exculpatory provision and a self-dealing transaction has been determined to be unfair, "only the self-dealing director [is] subject to damages liability for the gap between a fair price and the deal price without an inquiry into his subjective state of mind." Venhill Ltd. P'ship v. Hillman,

[9] The development of enhanced scrutiny can be traced to *Zapata*, a decision issued in 1981, three years before *Aronson. See, e.g.,* Obeid v. Hogan, 2016 Del. Ch. LEXIS 86, 2016 WL 3356851, at *13 (Del. Ch. June 10, 2016). By 1984, it was not yet clear that enhanced scrutiny would emerge as a new standard of review. And rather than embracing and building on *Zapata*'s innovative approach, the *Aronson* court appears to have sought to calm the tempestuous response to *Zapata* by reassuring the business and legal community that the business judgment rule was alive and well. *See* EZCORP, 2016 Del. Ch. LEXIS 14, 2016 WL 301245, at *26-27 (describing scope of practitioner and academic response to *Zapata* and the aspects of *Aronson* that appear intended to respond to criticism of the earlier decision).

[10] In re Gaylord Container Corp. S'holders Litig., 747 A.2d 71, 81 (Del. Ch. 1999). As support, then-Vice Chancellor Strine cited the following precedents: Moran v. Household Int'l, Inc., 490 A.2d 1059, 1071 (Del. Ch. 1985) ("In my view, the plaintiffs' complaints, which set forth particularized facts alleging that the Rights Plan deters all hostile takeover attempts through its limitation on alienability of shares and the exercise of proxy rights, sufficiently pleads a primary purpose to retain control, and thus casts a reasonable doubt as to the disinterestedness and independence of the board at this stage of the proceedings."), *aff'd*, 500 A.2d 1346 (Del. 1985); Carmody v. Toll Bros., Inc., 723 A.2d 1180, 1189 (Del. Ch. 1998) ("Even if the claims were regarded as derivative, the complaint's entrenchment allegations are sufficient to excuse compliance with the demand requirement."); Wells Fargo & Co. v. First Interstate Bancorp, 1996 Del. Ch. LEXIS 3, 1996 WL 32169, at *8 (Del. Ch. Jan. 18, 1996) (Allen, C.) ("With respect to the entrenchment claim, it seems clear that factual allegations which, if true, are sufficient to shift the burden to defendants to meet the 'enhanced business judgment' test of *Unocal* are similarly sufficient to raise a reasonable doubt concerning the board's ability to make a binding business judgment, whether one focuses on a judgment to resist the Wells Fargo offer or on the hypothetical judgment that this board would make if asked to institute this law suit."); In re Chrysler Corp. S'holders Litig., 1992 Del. Ch. LEXIS 152, 1992 WL 181024, at *4-5 (Del. Ch. July 27, 1992) (holding that directors' decision to lower rights plan trigger created sufficient inference of entrenchment to excuse demand).

2008 Del. Ch. LEXIS 67, 2008 WL 2270488, at *22 (Del. Ch. June 3, 2008). For other directors,

> even the ones who might be deemed non-independent by status, the presence of the exculpatory charter provision . . . require[s] an examination of their state of mind, in order to determine whether they breached their duty of loyalty by approving the transaction in bad faith . . . , rather than in a good faith effort to benefit the corporation.

2008 Del. Ch. LEXIS 67, [WL] at *23. "In other words, their status [as non-independent directors] is only a fact relevant to the ultimate determination whether they complied with their fiduciary duties, it is not a status crime making them a guarantor of the fairness of the transaction." *Id.* Instead, "[t]he liability **[**35]** of **[*883]** the directors must be determined on an individual basis because the nature of their breach of duty (if any), and whether they are exculpated from liability for that breach, can vary for each director." In re Emerging Communs., Inc. S'holders Litig., 2004 Del. Ch. LEXIS 70, 2004 WL 1305745, at *38 (Del. Ch. May 3, 2004).

After the turning of the millennium, this court began to confront arguments that Section 102(b)(7) affected the analysis of the second prong of *Aronson*.[11] A line of decisions asserted that when a corporation had a Section 102(b)(7) provision, the second prong of *Aronson* would result in demand being futile only if the underlying transaction *both* was not protected by the business judgment rule *and* the plaintiff had pled particularized facts supporting a non-exculpated claim.[12] When these decisions grounded their analysis in *Aronson*, they relied on the Delaware Supreme Court's statement that

> the mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterestedness of directors, although in rare cases a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists.

Aronson, 473 A.2d at 815. A natural reading of this language does not suggest **[**36]** that it required a substantial likelihood of liability *in addition to* a standard of review more onerous than the business judgment rule. The passage rather equated a substantial likelihood of liability with the application of a standard more onerous than the business judgment rule. Hence, the quoted passage stated that there may be settings in which the business judgment rule does not apply "and a substantial **[*884]** likelihood of director liability *therefore* exists." *Id.* (emphasis added). The decisions that incorporated Section 102(b)(7) into the second prong of *Aronson* transmuted this language into a requirement that the business judgment rule not apply

---

[11] The first case to address this argument appears to have been this court's second pleading-stage decision in the *Disney* litigation, rendered after the Delaware Supreme Court affirmed the original dismissal but granted the plaintiffs leave to re-plead. *See* In re Walt Disney Co. Deriv. Litig. (Disney III), 825 A.2d 275 (Del. Ch. 2003). The *Disney III* opinion described "[t]he primary issue before the Court [as] whether plaintiffs' new complaint survives the Rule 23.1 motion to dismiss under the second prong of *Aronson v. Lewis*." Id. at 285-86. The court observed that the defendants had argued that the complaint alleged, at most, a breach of the duty of care, and that even if it stated a claim, "Disney's charter provision, based on 8 Del. C. § 102(b)(7), would apply and the individual directors would be protected from personal damages liability for any breach of their duty of care." Id. at 286. The court held that the complaint stated a claim for bad faith, but framed its holding as if Section 102(b)(7) operated to qualify the second prong of *Aronson*:

> A fair reading of the new complaint, in my opinion, gives rise to a reason to doubt whether the board's actions were taken honestly and in good faith, as required under the second prong of *Aronson*. Since acts or omissions **[**37]** not undertaken honestly and in good faith, or which involve intentional misconduct, do not fall within the protective ambit of § 102(b)(7), I cannot dismiss the complaint based on the exculpatory Disney charter provision.

Id. Subsequent cases have identified *Disney III* as the earliest case to introduce Section 102(b)(7) to the second prong of *Aronson. See, e.g.,* Lenois v. Lawal, 2017 Del. Ch. LEXIS 784, 2017 WL 5289611, at *14 (Del. Ch. Nov. 7, 2017); In re Goldman Sachs Grp., Inc. S'holder Litig., 2011 Del. Ch. LEXIS 151, 2011 WL 4826104, at *12 (Del. Ch. Oct. 12, 2011).

[12] *See* Goldman Sachs, 2011 Del. Ch. LEXIS 151, 2011 WL 4826104, at *12 (applying Section 102(b)(7) as an overlay to the second prong of *Aronson*; holding that as a result, the plaintiffs had to plead facts "amounting to bad faith" to satisfy the second prong); Guttman v. Huang, 823 A.2d 492, 501-02, 507 (Del. Ch. 2003) (same); In re Lear Corp. S'holder Litig., 967 A.2d 640, 652 (Del. Ch. 2008) (holding that for purposes of the second prong of *Aronson*, the presence of an exculpatory provision "requires the plaintiffs to plead particularized facts supporting an inference that the directors committed a breach of the fiduciary duty of loyalty").

and a substantial likelihood of director liability *also* exist. As the emerging approach took hold, other decisions hewed to a more natural reading of *Aronson*'s second prong that did not require a substantial likelihood of liability in addition to a standard more onerous than the business judgment rule.[13]

During the years when Section 102(b)(7) was emerging as a consideration under the second prong of *Aronson*, there was uncertainty about the extent to which defendants could invoke Section 102(b)(7) at the pleading stage to obtain dismissal when entire fairness provided the standard of review. Delaware Supreme Court precedent at the time indicated that a court's ability to assess the availability of exculpation at the pleading stage depended on the standard of review, and that a court could not dismiss a defendant based on exculpation at the pleading stage if entire fairness applied.[14] Under this framework, exculpation operated as an affirmative defense, and director defendants could "avoid personal **[*885]** liability for paying monetary damages only if they ha[d] established that their failure to withstand an entire fairness analysis is exclusively attributable to a violation of the duty of care." Emerald Partners, 787 A.2d at 98; *accord* id. at 91, 93. For purposes of **[**38]** the second prong of *Aronson*, that meant that if the pleadings indicated that entire fairness provided the standard of review, then there was reason to doubt that the directors would be entitled to exculpation. Moreover, the Delaware Supreme Court had held that when entire fairness applied, the nature of a director's breach could not be determined until after trial, and hence, the directors would have their actions scrutinized and potentially called into question. Emerald Partners, 787 A.2d at 94. The prospect of public scrutiny, potential reputational harm, and possible liability combined to mean that when entire fairness applied, there was reason to doubt that a director could exercise disinterested and independent judgment regarding a demand.

In 2015, the Delaware Supreme Court clarified how Section 102(b)(7) operates at the pleading stage. Rejecting any distinction based on the standard of review, the high court explained that when a corporation's charter contains an exculpatory provision,

> [a] plaintiff seeking only monetary damages must

[13] *See, e.g.,* McPadden v. Sidhu, 964 A.2d 1262, 1272-73 (Del. Ch. 2008) (holding that demand was futile under second prong of *Aronson* because the directors were grossly negligent, even though the directors were entitled to exculpation and dismissed from the case on that basis); Khanna v. McMinn, 2006 Del. Ch. LEXIS 86, 2006 WL 1388744, at *25 n.201 (Del. Ch. May 9, 2006) (explaining the "tension" between a strict reading of *Aronson*'s second prong, which would render demand futile if the business judgment rule did not apply, and the effect of an exculpatory provision in limiting whether a director faced a substantial threat of liability; following then-current law, under which a court could not rely on an exculpatory provision at the pleading stage unless it was clear that the claim resulted exclusively from a breach of the duty of care); In re J.P. Morgan Chase & Co. S'holder Litig., 906 A.2d 808, 824 (Del. Ch. 2005) (stating that plaintiffs could establish demand excusal under the second prong of *Aronson* by pleading "particularized facts sufficient to raise (1) a reason to doubt that the action was taken honestly and in good faith or (2) a reason to doubt that the board was adequately informed in making the decision" (internal quotation marks omitted)); *see also* Emerald Partners v. Berlin, 1993 Del. Ch. LEXIS 273, 1993 WL 545409, at *7-8 (Del. Ch. Dec. 23, 1993) (rejecting argument that Section 102(b)(7) should overlay the *Aronson* test).

[14] *Compare* Emerald P'rs v. Berlin, 726 A.2d 1215, 1223 (Del. 1999) (holding that in a challenge to a transaction with majority stockholder to which entire fairness applied, the court could not apply Section 102(b)(7) on motion for summary judgment because transaction implicated loyalty issues, and factual conflicts required a trial to determine nature of the duty breached), *with* Malpiede v. Townson, 780 A.2d 1075, 1094-96 (Del. 2001) (holding that in a challenge to third-party, arm's-length merger that was approved by fully informed stockholder vote, court could apply Section 102(b)(7) at pleading stage unless plaintiff pled facts sufficient to show that a majority of the board was not disinterested or independent), *with* Emerald Partners v. Berlin, 787 A.2d 85, 93-94 (Del. 2001) (holding that in challenge to transaction with majority stockholder to which entire fairness applied, court could not apply Section 102(b)(7) without first analyzing transaction under entire fairness standard to determine nature of the fiduciary breach). *See generally* Drexler, *supra*, § 6.02[7], at 6-21. This approach recognized that by shifting the burden of proof, the entire fairness test operated as the functional equivalent of a rebuttable presumption of unfairness. *See* D.R.E. 301(a) ("In a civil case, unless a statute or these Rules provide otherwise, the party against whom a presumption is directed has the burden of proving that the nonexistence of the presumed fact is more probable than the existence of the presumed fact."). Put differently, by pleading facts sufficient to show at the pleading stage that the entire fairness test applied, the plaintiff established a rebuttable presumption of breach and threw the burden on to the defendant to establish either that there was no breach because the transaction was entirely fair or that any breach resulted exclusively from a breach of the duty of care. With inferences drawn in favor of the plaintiff, the defendants could not carry those burdens at the pleading stage.

> plead non-exculpated claims against a director who is protected by an exculpatory charter provision to survive a motion to dismiss, regardless of the underlying **[**39]** standard of review for the board's conduct—be it *Revlon, Unocal*, the entire fairness standard, or the business judgment rule.

In re Cornerstone Therapeutics Inc. S'holder Litig., 115 A.3d 1173, 1175-76 (Del. 2015) (footnotes omitted). "So applied, the existence of an exculpatory provision operates more in the nature of an immunity, comparable to the extent to which sovereign immunity typically protects government employees from suit, rather than as an affirmative defense." *In re EZCORP Inc. Consulting Agreement Deriv. Litig., 130 A.3d 934, 940 (Del. 2016)*.

The *Cornerstone* decision sapped any continuing vitality from *Aronson*'s use of the standard of review for the challenged decision as a proxy for whether directors face a substantial likelihood of liability sufficient to render demand futile. After *Cornerstone*, no matter what standard of review applies, a plaintiff can only state a claim against an individual director under the more lenient pleading standard used for *Rule 12(b)(6)* by "pleading facts supporting a rational inference that the director harbored self-interest adverse to the stockholders' interests, acted to advance the self-interest of an interested party from whom they could not be presumed to act independently, or acted in bad faith." *115 A.3d at 1179-80*. Reframed using the heightened pleading standard required for *Rule 23.1*, a plaintiff seeking to show that a director faces a **[**40]** substantial likelihood of liability for having approved a transaction, no matter what standard of review applies, must plead particularized facts providing a reason to believe that the individual director was self-interested, beholden to an interested party, or acted in bad faith.

Since *Cornerstone*, Delaware decisions have consistently interpreted the second prong of *Aronson* as requiring *both* that a standard more onerous than the business judgment applies *and* that a majority of the directors face a substantial likelihood of liability on a non-exculpated claim.[15] The **[*886]** application of a standard of review more onerous than the business judgment rule no longer implies the existence of a substantial likelihood of liability, as *Aronson* assumed. After *Cornerstone*, the first prong of *Aronson* remains viable, but only because the requirements for satisfying the first prong of *Aronson* also create a pleading-stage inference that exculpation will be unavailable to directors comprising a majority of the Board.[16] The second prong of *Aronson* remains viable only in the unlikely event that a corporation lacks a *Section 102(b)(7)* provision, or to the extent that the particularized factual allegations portray a transaction **[**41]** that is so extreme as to suggest bad faith. *See infoUSA, 953 A.2d at 972* (explaining that to render demand futile under the second prong of *Aronson*, a plaintiff "faces a task closely akin to proving that the underlying transaction *could not have been* a good faith exercise of business judgment"). That option

[15] *See Ellis v. Gonzalez, 2018 Del. Ch. LEXIS 227, 2018 WL 3360816, at *6 (Del. Ch. July 10, 2018)* (post-*Cornerstone* decision explaining that *Section 102(b)(7)* clause will affect analysis under "either *Aronson* or *Rales*" when determining whether the complaint adequately alleges that a director "faces a substantial likelihood of liability"); *Steinberg v. Bearden, 2018 Del. Ch. LEXIS 169, 2018 WL 2434558, at *7 n.54 (Del. Ch. May 30, 2018)* (post-*Cornerstone* decision holding that because corporation had an exculpatory charter provision, it was "inconsequential which test applies [i.e., *Rales* or *Aronson*], because under both *Rales* and *Aronson*, the relevant inquiry is whether Steinberg has pled sufficiently a non-exculpated claim for bad faith against a majority of the Board"); *Lenois, 2017 Del. Ch. LEXIS 784, 2017 WL 5289611, at *14* (post-*Cornerstone* decision holding that "where an exculpatory charter provision exists, demand is excused as futile under the second prong of *Aronson* with a showing that a majority of the board faces a substantial likelihood of liability for non-exculpated claims"); *see also Stritzinger v. Barba, 2018 Del. Ch. LEXIS 298, 2018 WL 4189535, at *5 (Del. Ch. Aug. 31, 2018)* (post-*Cornerstone* decision observing that "[t]here appears to be some confusion in our law whether the 'substantial likelihood of liability' theory used to challenge the impartiality of a director for demand futility purposes fits within the analysis contemplated by the first or second prong of *Aronson*," but applying test that required a showing of disloyalty or bad faith, i.e., a test that considered whether directors faced a substantial risk of liability and whether exculpation would be available).

[16] Isolated decisions have made this linkage more visible by considering whether directors faced a substantial risk of liability from a claim when evaluating whether they were disinterested and independent for purposes of the first prong of *Aronson. See Friedman v. Khosrowshahi, 2014 Del. Ch. LEXIS 121, 2014 WL 3519188, at *10-11 (Del. Ch. July 16, 2014)*, *aff'd*, *2015 Del. LEXIS 112, 2015 WL 1001009 (Del. Mar. 6, 2015)* (ORDER); *Higher Educ. Mgmt. Grp., Inc. v. Mathews, 2014 Del. Ch. LEXIS 224, 2014 WL 5573325, at *6 (Del. Ch. Nov. 3, 2014)*; *MCG Capital Corp. v. Maginn, 2010 Del. Ch. LEXIS 87, 2010 WL 1782271, at *18 (Del. Ch. May 5, 2010)*; *see also DiRienzo v. Lichtenstein, 2013 Del. Ch. LEXIS 242, 2013 WL 5503034, at *23 (Del. Ch. Sept. 30, 2013)*.

remains viable under *Section 102(b)(7)* because pleading bad faith is one means of pleading that exculpation is not available. For both prongs, exculpation dominates the analysis. The standard of review is secondary.

As this analysis shows, Delaware's evolving jurisprudence, and particularly the pleading-stage application of *Section 102(b)(7)* under *Cornerstone*, have dismantled the logic of *Aronson*. Viewed on its own terms, *Aronson* is no longer a functional test. Delaware decisions have managed to continue applying it only by emphasizing the overarching question of a substantial likelihood of liability, incorporating the implications of exculpation, and de-emphasizing the role of the standard of review. The foundational premise of the decision, which relied on the standard of review for the challenged **[**42]** decision as a proxy for whether directors face a substantial likelihood of liability, no longer endures. Fortunately, a viable alternative exists.

2. *Rales*

The narrow factual setting that produced the *Aronson* decision—in which the **[*887]** same directors who made the challenged decision also would consider the demand—and the close tailoring of the *Aronson* test to that factual setting meant that the two prongs of *Aronson* did not translate easily to other scenarios. In *Rales*, the Delaware Supreme Court confronted a board whose members had not participated in the challenged decision, and therefore "the test enunciated in *Aronson* . . . [was] not implicated." *634 A.2d at 930*. In response, the high court framed a second, more straightforward, and more comprehensive demand futility standard that asks "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." *Id. at 934*.

The significant advance made by *Rales* was to refocus the inquiry on the decision regarding the litigation demand, rather than **[**43]** the decision being challenged. In *Rales*, this step was necessary because the demand board had not made the decision being challenged. *See id. at 933*. The *Rales* decision thus asked directly "whether the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations." *Id. at 934*. Although necessity birthed this shift, the solution has the virtue of posing the pertinent question directly, rather than backing into an answer indirectly.

Under *Rales*, a director is disqualified from exercising judgment regarding a litigation demand if the director was interested in the alleged wrongdoing, such as when the director received a personal benefit from the wrongdoing that was not equally shared from the stockholders. *Id. at 936*. A director also is disqualified from exercising judgment regarding a litigation demand if another person was interested in the alleged wrongdoing, and the director lacks independence from that person. *Id.* Although these aspects of the *Rales* inquiry look to the relationship between the alleged wrongdoing and the directors considering the litigation demand, they do so for purposes of analyzing the directors' ability to evaluate the litigation **[**44]** demand, not to determine the standard of review that would apply to the alleged wrongdoing.

The *Rales* decision further explained that

> [d]irectorial interest also exists where a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders. In such circumstances, a director cannot be expected to exercise his or her independent business judgment without being influenced by the adverse personal consequences resulting from the decision.

Id. The *Rales* court held that a director is compromised for purposes of considering a demand if the director faces a risk from litigation that goes beyond a "mere threat" and reaches the level of a "substantial likelihood" of liability. *Id.* (internal quotation marks omitted). The *Rales* court rejected the argument that a plaintiff must demonstrate "a reasonable probability of success" on the claim, describing that requirement as "unduly onerous." *Id. at 934-35*. Although framed as a "substantial likelihood" of liability, the standard thus only requires that plaintiffs "make a threshold showing, through the allegation of particularized facts, that their claims have some merit." *Id. at 934*.

In a case in which one or more of **[**45]** the directors who are considering the litigation demand participated in the alleged wrongdoing that the derivative action **[*888]** would challenge, a court must conduct the same inquiry called for by contemporary interpretations of *Aronson* to determine whether those directors face a substantial likelihood of liability. As in *Aronson*, if the underlying claim is for breach of fiduciary duty, then the court must determine what standard of review would apply to that claim and take that standard into account when assessing whether a substantial likelihood of liability exists. The *Rales* approach also seamlessly accommodates derivative claims in which the plaintiff seeks to assert a corporate cause of action does not involve a claim for breach of fiduciary duty against the directors.[17] The *Aronson* framework has no tools to address any legal theory other a claim for breach of fiduciary duty against the same directors who would consider the demand.

Delaware decisions have consistently recognized that for purposes of analyzing whether a director faces a substantial likelihood of liability under *Rales*, a court must take into account the availability of exculpation **[**46]** under Section 102(b)(7).[18] Expressing sentiments equally applicable to the second prong of *Aronson*, this court has explained that after *Cornerstone*, the fact that entire fairness may govern the underlying claim does not give rise to substantial likelihood of liability for purposes of considering a demand *unless* the complaint pleads facts sufficient to raise a **[*889]** reasonable doubt that the director would not be entitled to exculpation.[19]

When announcing the *Rales* test, the Delaware Supreme Court envisioned that *Aronson* would remain the predominant approach and that the *Rales* test would be used

> in three principal scenarios: (1) where a business decision was made by the board of a company, but a majority of the directors making the decision have been replaced; (2) where the subject of the derivative suit is not a business decision of the board; and (3) where . . . the decision being challenged was made by the board of a different corporation.

Rales, 634 A.2d at 934. (footnotes omitted). In practice, however, the *Aronson* scenario is the exception. Changes in board composition are common, and the majority-of-directors principle **[**47]** that ostensibly creates a binary dividing line between *Aronson* and *Rales* leaves courts to wonder what standard should

---

[17] *See* 3 Stephen A. Radin, *The Business Judgment Rule* 3612 (6th ed. 2009) ("'Any claim belonging to the corporation may, in appropriate circumstances, be asserted in a derivative action,' including claims that do—and claims that do not—involve corporate mismanagement or breach of fiduciary duty.") (quoting Midland Food Servs., LLC v. Castle Hill Hldgs. V, LLC, 792 A.2d 920, 931 (Del. Ch. 1999)); *see, e.g.,* First Hartford Corp. Pension Plan & Trust v. United States, 194 F.3d 1279, 1293 (Fed. Cir. 1999) (permitting "contract actions brought derivatively by shareholders on behalf of the contracting corporation"); Slattery v. United States, 35 Fed. Cl. 180, 183 (1996) (same); Suess v. United States, 33 Fed. Cl. 89, 93 (Fed. Cl. 1995) (denying motion to dismiss a derivative claim for breach of contract against the United States); *see also* Ross v. Bernhard, 396 U.S. 531, 542-43, 90 S. Ct. 733, 24 L. Ed. 2d 729 (1970) (holding right to jury trial existed for breach of contract claim asserted by stockholder derivatively because "[t]he corporation, had it sued on its own behalf, would have been entitled to a jury's determination").

[18] *See, e.g.,* Oracle, 2018 Del. Ch. LEXIS 92, 2018 WL 1381331, at *14-15, *20; Baiera, 119 A.3d at 62-63; Zucker, 2012 Del. Ch. LEXIS 135, 2012 WL 2366448, at *10-11; Goldman Sachs, 2011 Del. Ch. LEXIS 151, 2011 WL 4826104, at *12, *18; Guttman, 823 A.2d at 501-02; In re Baxter Int'l, Inc. S'holders Litig., 654 A.2d 1268, 1270 (Del. Ch. 1995); *see also* Wood, 953 A.2d 136, 142 (Del. 2008) (evaluating demand futility under *Rales* in context of limited liability company; holding that if "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" (emphasis in original) (internal quotation marks omitted)); DiRienzo, 2013 Del. Ch. LEXIS 242, 2013 WL 5503034, at *28 (applying contractual exculpation provisions in partnership agreement when evaluating whether general partner faced a substantial likelihood of liability sufficient to render demand futile). Many of these decisions address *Caremark* claims. Ironically, in that setting, exculpatory provisions are superfluous because the Delaware Supreme Court has held that pleading a *Caremark* claim requires the complaint to support a reasonable inference bad faith. *See* Stone, 911 A.2d at 370 (holding that "a showing of bad faith conduct . . . is essential to establish director oversight liability" and therefore "the fiduciary duty violated by that conduct is the duty of loyalty"). Consequently, even in a corporation without an exculpatory provision, a complaint asserting a *Caremark* claim must plead bad faith to survive pleading-stage analysis. Likewise, a validly pled *Caremark* claim is unaffected by the presence of a Section 102(b)(7) because the a viable *Caremark* claim supports an inference of bad faith that defeats exculpation. Section 102(b)(7) therefore logically cannot affect the analysis of a *Caremark* claim.

[19] Sandys v. Pincus (Sandys I), 2016 Del. Ch. LEXIS 43, 2016 WL 769999, at *13-14 (Del. Ch. Feb. 29, 2016), *rev'd on other grounds*, 152 A.3d 124 (Del. 2016); *see* Oracle, 2018 Del. Ch. LEXIS 92, 2018 WL 1381331, at *10-15, *22 & n.287 (analyzing whether directors faced substantial risk of liability for purposes of Rule 23.1 based on whether complaint's allegations supported a non-exculpated claim; noting that entire fairness standard applied to purchase of company belonging to controlling stockholder).

apply to the new directors who have joined the board. Those directors could have relationships that would compromise their independence, which a strict application of *Aronson* would not take into account. As a practical matter, therefore, the broader *Rales* test must be used to evaluate any new directors who join the board, leading to a hybrid of *Aronson* and *Rales*.

For these and other reasons, leading commentators have argued that "the current state of this area of the law is conceptually inverted; i.e., that it would be both simpler and more direct to regard the original *Aronson* analysis as a subpart of the more generally applicable and consistently relevant test set forth in *Rales*." Donald J. Wolfe, Jr. & Michael A. Pittenger, *Corporate and Commercial Practice in the Delaware Court of Chancery* § 11.03[c][4][ii], at 11-113 (2019). Consistent with this view, decisions from the Court of Chancery have explained on multiple occasions that *Rales* encompasses *Aronson* and should be used as the general test.[20] As this decision has shown, *Aronson* is broken in its own right because subsequent **[*890]** jurisprudential **[**48]** developments have rendered non-viable the core premise on which *Aronson* depends—the notion that an elevated standard of review standing alone results in a substantial likelihood of liability sufficient to excuse demand. The Delaware Supreme Court already has overruled *Aronson* in part. *See* *Brehm, 746 A.2d at 253-54*. Perhaps the time has come to move on from *Aronson* entirely.

3. The Test In This Case

The composition of the Board in this case exemplifies the difficulties that the *Aronson* test struggles to overcome. The Board has nine members, six of whom served on the Board when it approved the Reclassification. Under a strict reading of *Rales*, because the Board does not have a new majority of directors, *Aronson* provides the governing test. But one of those six directors abstained from the vote on the Reclassification, meaning that the *Aronson* analysis only has traction for five of the nine. *Aronson* does not provide guidance about what to do with either the director who abstained or the two directors who joined the Board later. The director who abstained from voting on the Reclassification suffers from other **[**49]** conflicts that renders her incapable of considering a demand, yet a strict reading of *Aronson* only focuses on the challenged decision and therefore would not account for those conflicts. Similarly, the plaintiff alleges that one of the directors who subsequently joined the Board has conflicts that render him incapable of considering a demand, but a strict reading of *Aronson* would not account for that either. Precedent thus calls for applying *Aronson*, but its analytical framework is not up to the task. The *Rales* test, by contrast, can accommodate all of these considerations.

This decision therefore applies *Rales* as the general demand futility test. In doing so, this decision draws upon *Aronson*-like principles when evaluating whether particular directors face a substantial likelihood of liability as a result of having participated in the decision to approve the Reclassification. Rather than trifurcating the analysis into a first prong of *Aronson*, a second prong of *Aronson*, and *Rales*, this decision proceeds on a director-by-director basis, asking for each director (i) whether the director received a material personal benefit from the alleged misconduct that is the subject of the litigation **[**50]** demand, (ii) whether the director would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand, and (iii) whether the director lacks independence from

---

[20] *See* *Hughes v. Xiaoming Hu, 2020 Del. Ch. LEXIS 162, 2020 WL 1987029, at *12 (Del. Ch. Apr. 27, 2020)* ("Conceptually, . . . the *Rales* test supersedes and encompasses the *Aronson* test, making the *Aronson* test a special application of *Rales*."); *In re Wal-Mart Stores, Inc. Del. Derivative Litig., 2016 Del. Ch. LEXIS 75, 2016 WL 2908344, at *11 (Del. Ch. May 13, 2016)* ("[T]he *Rales* test encompasses all relevant aspects of the *Aronson* test."); *Baiera, 119 A.3d at 67 n.131* ("[O]ur jurisprudence would benefit . . . from the adoption of a singular test to address the question of demand futility."); *David B. Shaev Profit Sharing Account v. Armstrong, 2006 Del. Ch. LEXIS 33, 2006 WL 391931, at *4 (Del. Ch. Feb. 13, 2006)* ("[T]he *Rales* test, in reality, folds the two-pronged *Aronson* test into one broader examination"), *aff'd*, ***911 A.2d 802 (Del. 2006)*** (ORDER); *Huang, 823 A.2d at 501* ("At first blush, the *Rales* test looks somewhat different from *Aronson*, in that [it] involves a singular inquiry . . . . Upon closer examination, however, that singular inquiry makes germane all of the concerns relevant to both the first and second prongs of *Aronson*."); *see also* *Buckley Family Trust v. McCleary, 2020 Del. Ch. LEXIS 114, 2020 WL 1522549, at *9 (Del. Ch. Mar. 31, 2020)* ("This court has commented on many occasions that the *Aronson* and *Rales* tests look different but they essentially cover the same ground."); *Park Emples. & Ret. Bd. Emples. Annuity & Benefit Fund of Chi. v. Smith, 2017 Del. Ch. LEXIS 62, 2017 WL 1382597, at *5 (Del. Ch. Apr. 18, 2017)* ("The analyses in both *Rales* and *Aronson* drive at the same point; they seek to assess whether the individual directors of the board are capable of exercising their business judgment on behalf of the corporation.").

someone who received a material personal benefit from the alleged misconduct that is the subject of the litigation demand or who would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand.

In determining whether the director would face a substantial likelihood of, this decision considers *both* the operative standard of review, as called for by the original *Aronson* decision, *and* the potential availability of exculpation, as subsequent re-interpretations of *Aronson* recognize is necessary. Under *Cornerstone*, whether a director faces a substantial likelihood of liability turns primarily on whether the allegations of the complaint are sufficient to overcome the pleading-stage operation of Section 102(b)(7). As part of that analysis, this decision considers whether the complaint pleads particularized facts that support a reasonable inference that the director's decision could be attributed to bad faith. This inquiry both recognizes the only situation **[**51]** in which the second prong of *Aronson* has continuing vitality and identifies a scenario in which **[*891]** the pled facts render exculpation unavailable.[21]

B. The Transaction For Purposes Of Analyzing Demand Futility

Before turning to the director-by-director analysis, it is necessary to examine "the nature of the decision confronting" the Board. Rales, 634 A.2d at 935. Demand futility is assessed based on the particular corporate claim that a stockholder plaintiff wishes to assert. Baiera, 119 A.3d at 58 n.71. Framing the corporate claim properly is an important step in the demand futility analysis, because a director might be able to exercise disinterested and independent judgment for purposes one claim, but not for purposes of another.

In this case, the plaintiff seeks to recover damages that Facebook suffered as a result of the individual defendants having breached their fiduciary duties by approving the Reclassification. In the Reclassification Action, other stockholder plaintiffs challenged the Reclassification itself, and they sought permanent injunctive relief to block Facebook from completing it. Just before trial, Zuckerberg asked the Board to withdraw the Reclassification, and the Board complied. By doing so, the Board gave the plaintiffs **[**52]** in the Reclassification Action all of the relief they sought, rendering that action moot.

When a challenged transaction goes away, "the absence of *transactional* damages arising out of the abandoned deal does not necessarily render the underlying claims moot." OTK Assocs., LLC v. Friedman, 85 A.3d 696, 716 (Del. Ch. 2014) (emphasis in original). If a plaintiff proves that defendant directors breached their fiduciary duties by pursuing the abandoned transaction, then "[e]quity may require that the directors of a Delaware corporation reimburse the company for sums spent pursuing such faithless ends." *infoUSA*, 953 A.2d at 996. Equity also may require disgorgement of any benefit received by the defendant fiduciaries. *See* Oberly v. Kirby, 592 A.2d 445, 463 (Del. 1991) ("[T]he absence of specific damage to a beneficiary is not the sole test for determining disloyalty by one occupying a fiduciary position."). *See generally* Thorpe v. CERBCO, Inc., 676 A.2d 436, 437, 445 (Del. 1996) (holding that despite the absence of transactional damages from an abandoned transaction, the controlling stockholders were "liable for damages incidental to their breach of duty," which included "any expenses, including legal and due diligence costs, that the corporation incurred to accommodate the [controlling stockholders'] pursuit of their own interests prior to the deal being abandoned"). **[**53]**

The plaintiff relies on these principles in this case. The plaintiff contends that the individual defendants breached their fiduciary duties when approving the Reclassification, which led to Facebook incurring what might be thought of as reliance damages, i.e., expenses for professionals who worked on pursuing the Reclassification and defending the resulting litigation, as well as lost employee time that otherwise could have been spent on Facebook's business. They also maintain that Facebook suffered reputational harm and a loss of goodwill.

These types of damages arguably flow from the decision to approve the Reclassification. Viewed in this light, the proper inquiry for purposes of demand futility is whether the director could exercise disinterested and independent judgment with respect to a decision to embark on litigation over the Reclassification. If a director **[*892]** received a material personal benefit from the Reclassification, would face a substantial likelihood of liability in connection with a lawsuit challenging the Reclassification, or was not independent of someone who did or would, then that director cannot

[21] *See* Sandys I, 2016 Del. Ch. LEXIS 43, 2016 WL 769999, at *13-14; Goldman Sachs, 2011 Del. Ch. LEXIS 151, 2011 WL 4826104, at *12.

exercise disinterested and independent judgment regarding a demand.

The **[**54]** defendants disagree with this reasoning. They argue that this court must Balkanize its analysis by examining separately the decisions to retain each financial advisor and law firm. By slicing and dicing the decisions, the defendants can argue more persuasively that the members of the Board could exercise disinterested and independent judgment regarding a demand. For example, assuming that Zuckerberg was interested in the Reclassification, could he really be deemed interested in the Committee's decision to retain a financial advisor? Or the defendants' decision to retain litigation counsel?

The defendants also ask the court to analyze separately plaintiff's effort to recover the award of attorneys' fees and expenses that Facebook paid to the plaintiffs' counsel in the Reclassification Action. It is unclear under extant precedent whether the decision to withdraw the Reclassification would constitute a separate decision for purposes of demand futility, or whether it would be sufficiently connected to the Reclassification such that the Reclassification itself would remain the focus for demand-futility purposes. The defendants argue that the decision to withdraw the Reclassification was **[**55]** a separate decision, distinct from the initial decision to approve the Reclassification. And they maintain that the decision to pay a fee to plaintiffs' counsel in the Reclassification Action was another separate decision. They conclude that even if certain directors might not be able to exercise disinterested and independent judgment regarding a litigation demand challenging the Reclassification itself, there is no reason for any potential taint to extend to the decisions to withdraw the Reclassification and to pay a fee to plaintiffs' counsel.

Fortunately, this decision need not express a view on these questions. The plaintiff plainly believes that that its best case for establishing demand futility is to focus on the Reclassification. For the reasons described below, this decision adopts that framework and nevertheless finds that demand is not excused. It is therefore unnecessary to address whether the defendants could also prevail on a *Rule 23.1* motion by grinding the analysis more finely.

C. The Director-By-Director Analysis

When the complaint was filed, the members of the Board were:

• defendant Zuckerberg, the primary beneficiary of the Reclassification;

• defendants Andreessen, Desmond-Hellmann, **[**56]** Bowles, who were the members of the Committee that approved the Reclassification;

• defendant Peter Thiel, who has served as a director of Facebook since April 2005 and who voted to approve the Reclassification;

• defendant Reed Hastings, who has served as a director of Facebook since June 2011 and who voted to approve the Reclassification;

• nonparty Sandberg, who has served as the COO of Facebook since March 2008 and a director of Facebook since January 2012;

• nonparty Kenneth Chenault, who became a director after the Board approved the Reclassification; and

• nonparty Jeffrey Zients, who became a director after the Board approved the Reclassification.

[*893] This decision refers to these directors as the "Demand Board."

The fundamental question presented by the defendants' motion is whether the Demand Board validly could consider a litigation demand. The answer to that question depends on whether a majority of the members of the Demand Board would be disinterested and independent with respect to the litigation demand. Because the Demand Board has nine members, demand is excused if five directors could not exercise disinterested and independent judgment regarding a litigation demand. Conversely, **[**57]** demand is futile if the complaint's allegations establish a reason to doubt whether five directors could exercise disinterested and independent **[*894]** judgment regarding a demand.

For purposes of analyzing demand futility, this decision makes the following pro-plaintiff assumptions:

• The Reclassification would be subject to review under the entire fairness test for the reasons explained in *IRA Trust FBO Bobbie Ahmed v. Crane, 2017 Del. Ch. LEXIS 843, 2017 WL 7053964 (Del. Ch. Dec. 11, 2017)*. Unlike the transaction at issue in *Crane,* the Reclassification did not follow the template set out in *Kahn v. M & F Worldwide, Corp., 88 A.3d 635 (Del. 2014)*, so entire fairness would remain the operative standard of review.

• At a minimum, Andreesen's back-channel communications with Zuckerberg prevented the Committee from functioning effectively. As a result, the burden of proof would not shift to the plaintiff to prove unfairness, but rather would remain with the defendants to establish that the Reclassification was entirely fair.

• There is a substantial likelihood that the court would conclude after trial that the Reclassification was not entirely fair to Facebook's non-controlling stockholders.

• Zuckerberg could not exercise disinterested and independent judgment regarding a demand. As the controlling stockholder of Facebook, he received a material personal **[**58]** benefit from the Reclassification, and he would face a substantial risk of liability on a claim challenging it. Zuckerberg would not be entitled to exculpation because (i) he stood on both sides of the transaction and (ii) the plain language of Section 102(b)(7) does not extend to controlling stockholders.

• Andreesen could not exercise disinterested and independent judgment regarding a demand. Based on his back-channel communications during the Committee process and self-professed fealty to Zuckerberg, he is not independent of Zuckerberg and he would face a substantial risk of liability on a claim challenging the Reclassification. He would not be entitled to exculpation because he acted disloyally and in bad faith.

• Sandberg could not exercise disinterested and independent judgment regarding a demand. As Facebook's longstanding COO, she is not independent of Zuckerberg.

These assumptions leave six directors for consideration: Zients, Chenault, Hastings, Thiel, Bowles, and Desmond-Hellmann. If five of these six directors could exercise independent and disinterested judgment regarding a demand, then demand is not futile, and the complaint must be dismissed.

1. Zients

The complaint fails to plead facts supporting **[**59]** a reason to doubt that Zients could exercise disinterested and independent judgment regarding a demand. Zients joined the Board in May 2018, after the Board had approved the Reclassification. He is an outside director. There is no suggestion that he received any benefit from the Reclassification, and the plaintiff does not advance any argument about why he is not independent. Zients is deemed capable of exercising disinterested and independent judgment regarding a demand.

2. Chenault

The complaint fails to plead facts supporting a reason to doubt that Chenault could exercise disinterested and independent judgment regarding a demand. Chenault joined the Board in February 2018, after the Board had approved the Reclassification. There is no suggestion that he received any benefit from the Reclassification.

The complaint's only basis for questioning Chenault's ability to consider a demand is to assert that he is beholden to Zuckerberg, but the complaint does not plead any facts that undermine Chenault's independence. The complaint points to a Facebook post in which Zuckerberg announced that Chenault had joined the Board and said that he had been "trying to recruit [Chenault] for years." Compl. **[**60]** ¶ 107. Continuing, Zuckerberg stated,

> Adding someone to our board is one of the most important decisions our board makes. It's a long process that I take very seriously since this is the group that ultimately governs Facebook. [Chenault] and I have had dinners discussing our mission and strategy for years, and he has already helped me think through some of the bigger issues I'm hoping we take on this year.

Id.

The plaintiff asserts that this post suggests a close personal friendship that could compromise Chenault's independence, but that is a logical leap and not a reasonable inference. It is both expected and customary for a chair and CEO to comment favorably on a new director who is joining the board. Nothing about the post suggests a relationship of a bias-producing nature. *See* Beam, 845 A.2d at 1045, 1050-51 (rejecting as insufficient allegations that a director was "old friend" of the controller and was "recruited for the board" by the controller).

The complaint also alleges that in 2018, Chenault became the chair and a Managing Director of General Catalyst Partners, an early stage venture capital firm. The complaint alleges that Chenault "will rely on Zuckerberg for 'deal flow,'" making him beholden to Zuckerberg. **[**61]** Compl. ¶ 107. The complaint does not allege any specific facts to support this conclusory allegation, which seems based on nothing more than

Chenault's affiliation with a venture capital firm and Zuckerberg's status as a Silicon Valley superstar and mega-billionaire. "It is not enough, however, for a plaintiff simply to argue in the abstract that a particular director has a conflict of interest because she is affiliated with a particular type of institution." Chen v. Howard-Anderson, 87 A.3d 648, 671 (Del. Ch. 2014). There must be specific allegations that would support a reason to doubt that the director could exercise independent judgment on the issue presented. *See* Beam, 845 A.2d at 1048 (explaining that the court cannot infer that a director lacks independence "[w]ithout details about the nature of the contact").

The plaintiff has not called into question Chenault's independence. Whether viewed individually or together, the allegations against Chenault are insufficient to suggest that he could not exercise disinterested and independent judgment regarding a demand.

[*895] 3. Hastings

The complaint fails to plead facts supporting a reason to doubt that Hastings could exercise disinterested and independent judgment regarding a demand. The plaintiff argues that Hastings **[**62]** is not independent of Zuckerberg. The plaintiff also argues that Hastings faces a substantial likelihood of liability because he approved the Reclassification.

The complaint fails to allege facts supporting a reasonable inference that Hastings is beholden to Zuckerberg. Hastings is a cofounder of Netflix, serves as its CEO, and chairs its board of directors. The complaint alleges that "Netflix purchased advertisements from Facebook at relevant times." Compl. ¶ 99. Netflix also allegedly maintains "ongoing and potential future business relationships with" Facebook. *Id.* ¶ 100. The only specific facts that support this assertion allege that in March 2013, Netflix launched a "Friends and Community" initiative, which allows Facebook users to share data about their Netflix viewing habits with their Facebook friends. *Id.* The complaint also alleges that according to an article published by *The New York Times*, Facebook gave to Netflix and several other technology companies "more intrusive access to users' personal data than it ha[d] disclosed, effectively exempting those business partners from its usual privacy rules." *Id.* The exemption allowed Netflix and other favored companies to "read, write **[**63]** and delete users' private messages, and to see all participants on a thread." *Id.*

The complaint contends that "Hastings would not jeopardize this valuable relationship with Facebook and Zuckerberg by investigating or initiating the claims" because that "could prompt termination of the 'Friends and Community' data sharing or other current and future ventures." *Id.* The complaint's allegations support the existence of an ongoing, collaborative relationship between the two companies. They do not support an inference that the relationship is so important to Netflix as to compromise Hastings' independence. The complaint does not allege any specific facts about the extent to which Netflix relies on the Facebook relationship as part of its business model or how valuable this relationship is to Netflix. The complaint does not identify any facts about the "Friends and Community" feature, such as how many Facebook users take advantage of this feature, or whether Netflix has realized any concrete advantages through this feature. The complaint's allegations thus do not support an inference that the relationship is sufficiently material to Netflix that it would compromise Hastings' ability to consider **[**64]** a demand.

The complaint also contends that "Hastings (as a Netflix founder) is biased in favor of founders maintaining control of their companies." *Id.* ¶ 99. This allegation does not identify an interest of a bias-producing nature. A director could believe in good faith that it is generally optimal for companies to be controlled by their founders and that this governance structure is value-maximizing for the corporation and its stockholders over the long-term. Others might differ. As long as an otherwise independent and disinterested director has a rational basis for her belief, that director is entitled (indeed obligated) to make decisions in good faith based on what she subjectively believes will maximize the long-term value of the corporation for the ultimate benefit of its residual claimants. *See generally* Frederick Hsu Living Trust v. ODN Holding Corp., 2017 Del. Ch. LEXIS 67, 2017 WL 1437308, *16-22 (Del. Ch. Apr. 14, 2017). If a director believes that it will be better for the corporation to have the founder remain in control, then the director may make decisions to achieve that **[*896]** goal. As long as a director acts in good faith, exercises due care, and does not otherwise have any compromising interests, a director will not face liability for making a decision that she believes will maximize the long-term **[**65]** value of the corporation for the ultimate benefit of its residual claimants, even if a court later determines that the transaction was not entirely fair. Even if Hastings believed that maintaining Zuckerberg's control over Facebook was desirable, that belief would not produce a conflict of interest that would render him incapable of considering a demand.

The complaint also alleges that Hastings, like Zuckerberg, has a track record of supporting philanthropic causes and has publicly endorsed founders of large companies making substantial donations during their lifetimes. Compl. ¶ 99. Hastings and Zuckerberg each have made large contributions to the Silicon Valley Community Foundation, which solicits donations from company founders and manages donor funds for both Hastings and Zuckerberg. *Id.* There is no logical reason to think that a shared interest in philanthropy would undercut Hastings' independence. Nor is it apparent how donating to the same charitable fund would result in Hastings feeling obligated to serve Zuckerberg's interests.

The plaintiff additionally argues that Hastings faces a substantial likelihood of liability because he voted in favor of the Reclassification. This court **[**66]** has assumed that the Reclassification would be reviewed for entire fairness and that there is a substantial likelihood that the court would conclude after trial that it was not entirely fair to Facebook's non-controlling stockholders. But it does not follow from those assumptions that Hastings faces a substantial likelihood of liability.

Facebook's certificate of incorporation contains a provision that exculpates directors to the fullest extent permitted by Delaware law. Consequently, to establish that Hastings faces a substantial likelihood of liability in connection with the Reclassification, the complaint must plead facts supporting a reasonable inference that Hastings either harbored self-interest adverse to the stockholders' interest, acted to advance the self-interest of an interested party from whom they could not be presumed to act independently, or acted in bad faith. *Cornerstone, 115 A.3d at 1179-80*.

The complaint does not plead any facts that would support a pleading-stage inference that Hastings committed a non-exculpated breach of fiduciary duty and thus could face personal liability as a result of voting to approve the Reclassification. Referring to all six director defendants collectively, the complaint **[**67]** states, "They each face a substantial likelihood of liability for their individual misconduct." Compl. ¶ 73. It then states that each director defendant "owed [Facebook] fiduciary duties of good faith, due diligence, and reasonable inquiry" and "knew of their own unlawful acts, participated in the actions of their colleagues, and failed to prevent these breaches of loyalty and due care." *Id.* ¶ 74. Nowhere does the complaint describe any "individual conduct" on Hastings' part. The complaint does not contain any suggestion that Hastings was aware of the improper back-channel communications between Andreessen and Zuckerberg. The allegations against Hastings are conclusory and do not support a reasonable inference that he faces a substantial risk of liability.

In briefing and at argument, the plaintiff maintained that the Reclassification was so obviously unsound that the Board never should have considered it, much less approved it and defended it until the eve of trial. Doubtless there are proposals that are so extreme or bizarre that **[*897]** independent directors should reject them summarily. Generally speaking, however, directors have an obligation to respond to potential corporate actions on **[**68]** an informed basis and after due deliberation. *See, e.g., Technicolor, 634 A.2d at 367* ("[D]irectors 'have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must *then* act with requisite care in the discharge of their duties.'" (emphasis in original) (quoting *Aronson, 473 A.2d at 812*)). The Reclassification was not so outlandish as to warrant rejecting it out of hand. To the contrary, Google recently had implemented a similar transaction after a settlement that this court approved.

The plaintiff further argues that the process leading to the Board's approval of the Reclassification Plan was a sham marked by glaring problems and resulted in a transaction that did not extract any material concessions from Zuckerberg. The plaintiff disagrees with how the Committee proceeded, but those disagreements are not sufficient to support an inference of bad faith. "[T]here is a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties." *McElrath v. Kalanick, 2019 Del. Ch. LEXIS 107, 2019 WL 1430210, at *10 (Del. Ch. Apr. 1, 2019)* (internal quotation marks omitted).

Finally, the plaintiff tries to bolster its argument by pointing to the Board's decision to withdraw the **[**69]** Reclassification. It is not inherently suspect to decide to moot a case, whether due to changed business circumstances or to enable the company to avoid the burden of a public trial.

When evaluating Hastings' decision to approve the Reclassification, it is important to consider those allegations collectively and not in isolation. Even viewed collectively, it is not reasonable to infer that the

Reclassification was so extreme as to support an inference that Hastings approved it in bad faith. Nor is it reasonable to think that Hastings would be held liable after trial.

The complaint's allegations do not support a reasonable inference that Hastings is beholden to Zuckerberg. They do not support a reasonable inference that Hastings faces a substantial likelihood of liability on the claims that are the subject of the demand. Demand is not excused as to Hastings.

4. Thiel

The complaint fails to plead facts supporting a reason to doubt that Thiel could exercise disinterested and independent judgment regarding a demand. Like Hastings, Thiel voted in favor of the Reclassification. As with Hastings, the plaintiff maintains that Thiel faces a substantial threat of liability on the claims that would **[**70]** be the subject of a demand. As with Hastings, the plaintiff alleges that Thiel is not independent of Zuckerberg.

The complaint's allegations that Thiel faces a substantial likelihood of liability based on his decision to approve the Reclassification fall short for the same reasons as the allegations against Hastings. The complaint does not advance any incremental allegations against Thiel, so this decision will not repeat that analysis.

The complaint also fails to allege facts that provide reason to doubt whether Thiel is independent of Zuckerberg. The complaint alleges that Thiel was one of the early investors in Facebook and has served on the Board for longer than any of the other directors, with the exception of Zuckerberg. According to the complaint, Thiel has been "instrumental to Facebook's business strategy and direction over the years." Compl. ¶ 93. The complaint **[*898]** does not explain how Thiel's longstanding affiliation with Facebook or his instrumental contributions to Facebook translate into Thiel being beholden to Zuckerberg.

The complaint attempts to bolster its allegations with a variant of the argument about founder bias that the plaintiff leveled against Hastings. Thiel is **[**71]** a cofounder of PayPal, Inc., and he has been a partner at a venture capital firm called "Founders Fund" since 2005. The complaint alleges that the Founders Fund "strives to keep founders in long-term control of the companies they have created" and "touts Facebook as a primary example of that maxim, stating that 'we have often tried to ensure that founders can continue to run their businesses through voting control mechanisms, as Peter Thiel did with Mark Zuckerberg and Facebook.'" *Id.* As with Hastings, assuming that Thiel honestly believes that founder ownership benefits corporations and their stockholders over the long term, that belief is not a disqualifying interest. To support a contention that Thiel acted disloyally or in bad faith, the complaint would have to allege that Thiel believed that preserving founder ownership was harmful to Facebook, and that he nevertheless supported the Reclassification out of personal loyalty to Zuckerberg. As long as Thiel acted based on a sincerely and rationally held belief that his actions would benefit Facebook, his bias in favor of founders maintaining control is not disqualifying. The belief that founder control benefits corporations and their **[**72]** stockholders over the long run is debatable, but it is not irrational.

Harkening back to the allegations against Chenault, the complaint alleges that Thiel is beholden to Zuckerberg because the "Founders Fund gets 'good deal flow' from [its] high-profile association" with Facebook. *Id.* ¶ 94. As with Chenault, the complaint does not provide any specifics. It does not identify a single deal that has flowed to the Founders Fund as a result of Thiel's relationship with Facebook, still less that any such deal was material to Thiel or the Founders Fund.

The complaint similarly alleges that Thiel lacks independence because he has a "personal and financial interest in remaining on Facebook's Board." *Id.* ¶ 95. The complaint states that Facebook shares owned by the Founders Fund "will be released from escrow in connection with the Oculus VR acquisition" and that "Thiel stands to gain substantially from the vesting of stock in connection therewith." *Id.* The complaint fails to quantify those gains or explain why Thiel must retain his position on the Board to realize those gains.

Finally, the complaint attempts to suggest that Thiel must be indebted to Zuckerberg for allowing Thiel to continue serving **[**73]** on the Board despite a barrage of public criticism that Thiel has suffered. The complaint notes that Thiel played a major role in the Cambridge Analytica scandal and secretly financed lawsuits aimed at bankrupting a news website. *Id.* ¶¶ 96-97. The complaint also alleges that there were "widespread calls for Zuckerberg to remove Thiel from Facebook's Board . . . ." *Id.* ¶ 97. The complaint implies that Zuckerberg stood by Thiel, so it is reasonable to infer that Thiel feels a sense of obligation to Zuckerberg.

These allegations could support a reasonable inference that Thiel is beholden to Zuckerberg only if serving on the Board was material to Thiel. The complaint describes Thiel as a co-founder of PayPal and partner in a venture capital fund. These allegations support a reasonable inference that Thiel inhabits the rarified realms of the *uber*-rich and belongs to the Silicon Valley aristocracy. The complaint does not support an inference that Thiel's service on the Board is financially material **[*899]** to him. Nor does the complaint sufficiently allege that serving as a Facebook director confers such cachet that Thiel's independence is compromised.

When evaluating the Thiel's relationship with **[**74]** Zuckerberg, it is important to consider these allegations holistically. Even viewed in that light, it is not possible to infer that the Thiel is beholden to Zuckerberg.

5. Bowles

The complaint fails to plead facts supporting a reason to doubt that Bowles could exercise disinterested and independent judgment regarding a demand. The complaint does not adequately allege that Bowles received a material personal benefit from the Reclassification or lacked independence from someone who did. The complaint also does not provide a basis to infer that Bowles faces a substantial likelihood of liability based on his involvement in the decision to approve the Reclassification.

The complaint attempts to establish that Bowles received a material personal benefit from the Reclassification by linking him to the financial advisors who worked for Facebook and the Committee. The complaint alleges "Morgan Stanley—a company for which [Bowles] also served as a longstanding board member at the time (2005-2017)—directly benefitted by receiving over $2 million in fees for its work on behalf of [Facebook] in connection with the Reclassification . . . ." Compl. ¶ 92. The complaint similarly alleges that Bowles had **[**75]** a "direct personal interest in the [R]eclassification" because he "ensured that Evercore and his close friend Altman financially benefitted from the [Committee's] engagement without requisite vetting or consideration . . . ." *Id.* These allegations do not support a reasonable inference that Bowles received any material personal benefit, financial or otherwise, either from Facebook's retention of Morgan Stanley or the Committee's retention of Evercore.

The complaint next attempts to establish that Bowles was beholden to Zuckerberg. The complaint's allegations do not support that inference. The complaint alleges that Zuckerberg spoke with Bowles about taking the Giving Pledge and accelerating his charitable giving. It also alleges that after Zuckerberg made the announcement, Bowles told Zuckerberg that he was "proud to be a small part of [Zuckerberg's] life." *Id.* ¶ 40. These allegations suggest that Zuckerberg and Bowles had a collegial relationship, which is not sufficient to compromise Bowles' independence.

The complaint adds that "Bowles is beholden to the entire Board for granting a waiver of the mandatory retirement age for directors . . . so that [he] could stand for reelection despite **[**76]** having reached" that age. *Id.* ¶ 91. The complaint notes that under Facebook's Corporate Governance Guidelines, "the Board may only permit waivers in 'exceptional circumstances.'" *Id.* ¶ 92. So be it, but this conclusory assertion does not explain why or in what way Bowles would be beholden to the Board or what that would entail. The complaint does not suggest that the waiver was conditioned on Bowles supporting any particular initiative or person. Nor does it allege that Bowles' directorship is sufficiently important to him that continuing to serve on the Board could be viewed as a material inducement that would render Bowles beholden to his fellow directors.

The complaint also attempts to portray Bowles as facing a substantial likelihood of liability for having approved the Reclassification. The complaint relies on Bowles' service on the Committee in addition to the allegations advanced against Hastings and Thiel. This decision already has rejected the argument that the decision to approve **[*900]** the Reclassification was so extreme as to support a substantial likelihood of liability. The question is whether Bowles' service on the Committee changes that conclusion.

The complaint asserts the **[**77]** Committee "was not fully informed, did not negotiate at arm's-length, and never demanded anything meaningful from Zuckerberg." *Id.* ¶ 77. The complaint also asserts that the "Committee squandered the significant negotiating leverage Zuckerberg gave it" by publicly announcing his accelerated Giving Pledge before the Committee had recommended the Reclassification to the Board. *Id.* These allegations, at most, allege a breach of the duty of care. Bowles does not face any threat of liability for breaches of the duty of care because Facebook has an exculpatory provision in its charter, and these allegations do not support an inference of bad faith.

In an effort to build up to an inference of bad faith, the complaint criticizes the Committee's negotiations with Zuckerberg. The complaint does not plead particularized facts to suggest that the Committee extracted so little value from Zuckerberg that its members could be found to have acted in bad faith. The complaint notes that at one point, Andreessen told Zuckerberg that Bowles was worried about the provision in the Founder Agreement that authorized Zuckerberg to take a leave of absence for government service, but that allegation cuts in the **[**78]** opposite direction. The fact that Bowles voiced concerns suggests that he acted independently, not the opposite.

This decision has assumed that Andreesen's back-channel communications with Zuckerberg fatally undermined the Committee's deliberations, resulting in a transaction that was not negotiated at arm's-length. Those problems, however, cannot be attributed to Bowles, and there is no basis to conclude that Bowles knew about what Andreessen and Zuckerberg were doing. To the contrary, the complaint alleges that "Zuckerberg and Andreessen's shenanigans won over Bowles." *Id.* ¶ 49. Based on this allegation, the complaint seemingly agrees that Bowles was oblivious. Under *Cornerstone*, Bowles would be entitled to a pleading-stage dismissal because the plaintiff has not pled facts supporting an inference that Bowles acted with *scienter*. For the same reason, the complaint does not support a reasonable inference that Bowles would face a substantial threat of liability.

As with the allegations against Hastings and Thiel, it is essential to consider the allegations against Bowles in their totality. Even viewed in that light, it is not reasonable to infer that the Bowles could be held liable in **[**79]** connection with the Reclassification or that he is not independent.

6. Desmond-Hellmann

The last director is Desmond-Hellman. She did not receive a material personal benefit from the Reclassification. She also does not face a substantial likelihood of liability based on her service on the Committee because, as with Bowles, the complaint does not plead facts sufficient to overcome the protections of *Section 102(b)(7)*. That said, whether Desmond-Hellman is independent of Zuckerberg presents a comparatively close call. Because this decision already has found that five of the Board's nine directors can consider a demand, it does not evaluate Desmond-Hellman's independence.

III. CONCLUSION

A majority of the Demand Board is disinterested, independent, and capable of considering a demand. Demand thus is not **[*901]** excused, and the defendants' motion to dismiss under *Rule 23.1* is granted.

End of Document

Venoco, Inc. v. Eson

Court of Chancery of Delaware, New Castle

May 31, 2002, Submitted ; June 6, 2002, Decided

C.A. No. 19506-NC

Reporter

2002 Del. Ch. LEXIS 65 *

VENOCO, INC., Plaintiff, v. RODNEY L. ESON, WILLIAM L. WINELAND, JESSE NEYMAN, RICHARD LYDECKER, SUNDANCE ASSETS, L.P., JOINT ENERGY DEVELOPMENT INVESTMENTS II LIMITED PARTNERSHIP, ECTMI TRUTTA HOLDINGS LP, and ECT MERCHANT INVESTMENTS CORP., Defendants. SUNDANCE ASSETS, L.P., JOINT ENERGY DEVELOPMENT INVESTMENTS II LIMITED PARTNERSHIP, ECTMI TRUTTA HOLDINGS LP, and ECT MERCHANT INVESTMENTS CORP., Counterclaim-Plaintiffs, v. VENOCO, INC., Counterclaim-Defendant.

Disposition: Injunction issued enjoining Defendants Eson and Wineland from disclosing confidential information to third parties. Plaintiff not awarded damages.

Counsel: **[*1]** Jesse A. Finkelstein, Raymond J. DiCamillo, Becky A. Hartshorn, of RICHARDS, LAYTON & FINGER, Wilmington, Delaware; OF COUNSEL: Mark Holscher, Kevin B. Carter, of O'MELVENY & MYERS LLP, Los Angeles, California, Attorneys for Plaintiff.

Donald J. Wolfe, Jr., Matthew E. Fischer, of POTTER ANDERSON & CORROON LLP, Wilmington, Delaware; OF COUNSEL: Michael W. Case, Gisele Goetz, of FERGUSON, CASE, ORR, PATERSON & CUNNINGHAM LLP, Ventura, California, Attorneys for Defendants, Rodney L. Eson and William L. Wineland.

Andre Bouchard, Joel Friedlander, of BOUCHARD MARGULES & FRIEDLANDER, Wilmington, Delaware; OF COUNSEL: Irwin H. Warren, Seth Goodchild, Jeffrey M. Greilsheimer, WEIL, GOTSHAL & MANGES LLP, New York, New York, Attorneys for Defendants and Counterclaim Plaintiffs, Jesse Neyman, Richard Lydecker, Sundance Assets, L.P., Joint Energy Development Investments II Limited Partnership, ECTMI Trutta Holdings LP, and ECT Merchant Investments Corp.

Judges: CHANDLER, Chancellor.

Opinion by: CHANDLER

Opinion

MEMORANDUM OPINION

CHANDLER, Chancellor

This is my decision on plaintiff Venoco, Inc.'s claim that defendants Rodney L. Eson and William L. Wineland breached their fiduciary **[*2]** duties to Venoco and that defendants Jesse Neyman, Richard Lydecker, Sundance Assets, L.P. ("Sundance"), Joint Energy Development Investments II Limited Partnership ("JEDI"), ECTMI Trutta Holdings LP ("Trutta"), and ECT Merchant Investments Corp. ("ECT") (collectively, the "Enron Defendants") aided and abetted in that breach. All other issues raised in this action and its companion action under § 225, *Eson v. Venoco*, were resolved through this Court's ruling after a trial held May 29-31, 2002.

Venoco is a large and growing privately held oil and gas company with its principal place of business in Carpinteria, California. Venoco was founded in 1992 by Timothy M. Marquez and Eson. Marquez is the Chairman of Venoco's board of directors and has been Venoco's CEO since its inception. He owns Venoco common stock representing approximately 28% of Venoco's voting power. Eson is a director of Venoco and held various executive positions, including most recently President of Venoco's International Division, until he was fired in late March of this year. He owns Venoco common stock representing approximately 22% of Venoco's voting power. Wineland was Venoco's CFO from 1994 until he, too, **[*3]** was fired in late March. He owns Venoco common stock representing approximately 5% of Venoco's voting power. Eson and Wineland, through their holdings and the holdings of related shareholders, control approximately 52% of Venoco's common stock. This combined ownership does not give Eson and Wineland voting control over Venoco, however, because Venoco's preferred stock votes, on an as converted basis, as a single class with the company's other common stockholders on all matters. [1]

In 1998, two Enron affiliates, JEDI and Enron Capital Trade & Resources Corp. ("Enron Capital"), purchased 6000 shares of Venoco preferred stock for $ 60,000,000 pursuant to a Securities Purchase Agreement ("SPA"). JEDI purchased 4500 shares, which it has held continuously to this day. [2] Enron Capital purchased 1500 shares, which were later sold and assigned to Sundance, then transferred to ECT, then contributed **[*4]** and assigned to Trutta, which owns the shares today. [3] All of these entities are affiliates of Enron. Because Venoco's preferred shares vote on an as converted basis with its common shares, JEDI and Trutta control approximately 25% and 8%, respectively, of Venoco's voting power. The individual Enron Defendants, Neyman and Lydecker, are Enron executives and, as determined in the related § 225 action, are directors of Venoco.

In this action, Venoco alleges that Eson and Wineland breached their duty of loyalty to the company. Venoco contends that Eson and Wineland intentionally misused their positions and the information they received as directors to further their interests as stockholders in an attempt to take over control of Venoco. Specifically, Venoco alleges that Eson and Wineland **[*5]** gave the Enron Defendants confidential information and otherwise assisted the Enron Defendants so that the Enron Defendants could get a higher price from Venoco for their Venoco preferred stock. In exchange for this assistance, it is alleged that the Enron Defendants agreed to act by written consent to benefit Eson and Wineland. Venoco asserts that the Enron Defendants aided and abetted in these breaches of duty by colluding with Eson and Wineland in connection with the negotiation of Venoco's repurchase of the preferred stock.

I. FACTS

Venoco was founded as a California corporation in 1992. In 1998, Venoco reincorporated in Delaware. Its Delaware certificate of incorporation contemplates a staggered board, although no steps were taken to classify the board until late March of this year, after the control fight at issue here began. Venoco has not held a shareholder meeting since 1996.

In 1998, JEDI and Enron Capital entered into the Securities Purchase Agreement with Venoco. Under the terms of the SPA, JEDI and Enron Capital purchased $ 60 million of Venoco preferred stock. Section 6.04 of the SPA provided that the Enron affiliates would have the right to proportionate board **[*6]** representation as long as the original purchasers or their affiliates owned at least 80% of the original preferred shares. Initially, this right was not exercised.

In March of 2001, the Enron affiliates told Venoco they were interested in selling their preferred shares. The Enron affiliates pursued a variety of options, including a repurchase of the shares, a recapitalization of Venoco, and a sale to a third party. Over the next several months, the parties exchanged several offers and counteroffers but did not reach an agreement. Then, in August, Neyman and Lydecker requested a dinner meeting to discuss their newest proposal, which they had developed after extensive work with their bankers. At the dinner meeting, Marquez quickly dismissed the proposal, which he viewed as a "non-starter" because it would have required Venoco to incur substantial debt at a comparatively high interest rate. Both sides aggressively pushed their positions as tempers flared, and the meeting ended shortly thereafter.

Under the SPA, Enron was permitted to have an observer at Venoco board meetings or, at Enron's option, the right to designate a specific number of Venoco directors pursuant to a formula contained **[*7]** in the SPA. Neyman and Lydecker had previously been observers at Venoco's board meetings. On August 24, after the dinner meeting and after Venoco's board meeting the next day, at which Marquez proposed that Venoco shift its focus and begin expanding internationally, the preferred shareholders sent Venoco a letter requesting board representation as provided in the SPA. Venoco and the Enron affiliates exchanged

[1] The combined ownership of Eson, Wineland, and their affiliates, represents approximately 35% of the voting power of Venoco.

[2] JEDI now owns 6144.67 shares of Venoco preferred stock because it has received 1644.67 additional shares as dividends.

[3] Through the receipt of in-kind dividends, Trutta now owns 2048.22 shares of Venoco preferred stock.

letters about whom the Enron affiliates intended to nominate. Then, on September 28, Marquez wrote to Neyman on behalf of Venoco and agreed to interim appointments to Venoco's board for Neyman and Lydecker. [4]

[*8] In late 2001 and early 2002, Marquez, Eson, and Wineland were concerned about the effectiveness of Venoco's management. Accordingly, in January of 2002 they selected five mid-level managers to conduct an internal evaluation program. Those managers presented their report to Marquez, Eson, and Wineland on February 14, 2002. Among other things, the report was critical of Marquez's management style and excessive involvement in day-to-day operations of the company. Eson and Wineland suggested that Marquez focus instead on acquisitions and larger strategic issues, which were his strengths. The ensuing debate among Venoco's senior management continued during the following months, with Marquez ultimately seeking to be bought out of Venoco. It is clear from the evidence and testimony before me that each side genuinely believed its approach was better for the company.

During the period following Enron's request for board representation, Venoco's dispute with the Enron affiliates continued. Lydecker had attended Venoco's December 20 board meeting, although the minutes of that meeting identified him as an observer rather than a director. Neyman attended a board meeting on February 22 and attempted **[*9]** to vote as a director, but Marquez told him that his vote would not be recognized because he and Lydecker were merely observers and not directors. The Enron affiliates continued to seek board representation as provided in the SPA. In addition, the Enron affiliates also continued negotiating with Venoco over the repurchase of their preferred shares.

On February 28, Eson met with Neyman while in Houston on other business. Eson told Neyman that there was internal conflict at Venoco between he and Wineland on the one hand and Marquez on the other. They discussed the board representation issue, and Eson told Neyman that Venoco's board had never formally voted to exclude Neyman and Lydecker. As a result of this meeting, Neyman sent a letter to Marquez on March 8 requesting seats on the board for Neyman and Lydecker and demanding proof that the board had formally rejected them as directors.

On March 12, Venoco circulated a draft letter written by Terry Anderson, its General Counsel, in response to Neyman's letter. The draft letter said that Venoco's board did not want any members with employment ties to Enron. Eson and Wineland disagreed with the position taken in the draft letter because **[*10]** Venoco's board had not made any formal determination on the matter. Eson also discussed the draft letter with his personal attorney and with Neyman. At this time, Eson and Wineland began to consider acting by written consent to reconstitute Venoco's board in order to resolve the ongoing management dispute. To that end, Eson sent several e-mails to Neyman to try to gain the support of the Enron affiliates.

Those e-mails form the crux of Venoco's case. First, on March 13, Eson wrote Neyman to say that Marquez would be calling Neyman instead of sending the letter they discussed earlier. Eson noted that "it would not (at this time) be a good idea to mention we met" on February 28. The next day, Eson wrote to Neyman again, telling him that Marquez would be suggesting that Neyman meet with Eson to discuss a buyout of the Enron affiliates. Eson recommended "a non-committal stall" so that he and Neyman could "discuss/communicate about this" and "make this work to our mutual advantage." Finally, on March 15, Eson sent Neyman an e-mail updating Neyman on Eson's meeting with his personal attorneys and suggesting that Enron "take the position it is willing to negotiate a sale of the preferred, **[*11]** but only after a special Board meeting and electing you and Dick [Lydecker] as directors."

While Eson was sending these e-mails to Neyman, Venoco was renewing its efforts to repurchase the preferred stock from the Enron affiliates. On March 14, Eson, Wineland, Marquez, and Ed O'Donnell, president and director of Venoco, met with Glen Warren, Venoco's investment banker. They were considering selling Venoco, but they all agreed that Venoco would have to buy back its preferred stock before they could sell the company. This was because under the SPA a change in control of Venoco would trigger a put right under which

[4] There is some dispute about what duration was intended to accompany "interim" status. Venoco contends that it was not in the best interest of the company to appoint any Enron executives to its board in late 2001, for obvious reasons. Marquez sent a letter to Neyman on November 7 indicating that the interim period was to expire on January 31, 2002 and attaching letters of resignation that Venoco would require Neyman and Lydecker to execute before becoming directors. Neyman claims that he never received this letter. In any event, Marquez took the position that Neyman and Lydecker were no longer directors after January 31, 2002.

the Enron affiliates could force Venoco to repurchase the preferred shares at a price that was well above the stock's value at the time. After this meeting, Marquez decided to approach Enron again about the preferred stock. At Wineland's urging, Marquez agreed to send Eson to Houston on behalf of Venoco, not knowing that Eson and Neyman had met in February. Marquez then told Eson to meet with Neyman, and informed Neyman that Eson would be in Houston later that month.

In advance of the meeting between Eson and Neyman, Warren prepared a deal book describing three possible **[*12]** approaches for the transaction: a cash sale; a cash sale contingent on the sale of Venoco; and a conversion of the Enron affiliates' interest into common stock, also contingent on the sale of Venoco. Marquez instructed Eson to push the second approach, and authorized Eson to offer Neyman $ 45 million in cash contingent on the sale of Venoco. Eson reviewed these materials, and he also contacted Neyman to tell him that he wanted to discuss the proposed actions by written consent at the same time. On March 21, Eson and Wineland delivered a buyout proposal to Marquez, in accordance with their earlier discussions, and then Eson left for Houston.

On Friday, March 22, 2002, Eson met with Neyman and Gil Melman, a lawyer for Enron, in Houston. Eson, as instructed, offered to buy the Enron affiliates' shares for $ 45 million contingent on a sale of Venoco. Neyman was "not insulted" by the offer, which Eson took as encouraging. Later that day, Eson met with Neyman and Lydecker to discuss the transaction further. After that meeting concluded, the three of them also talked about the proposed actions by written consent. Neyman and Lydecker refused to tie the board representation and share repurchase **[*13]** issues together, as Eson had suggested in the March 15 e-mail.

Meanwhile, that same morning in California, Marquez reviewed the buyout proposal he had received the previous day from Eson and Wineland and determined that it was inadequate. Later that day, Marquez and Wineland talked about the internal evaluation report they had received in February. Marquez viewed some of Wineland's comments about the management of Venoco as an ultimatum, a characterization with which Wineland disagrees, and decided to fire Wineland. Marquez told O'Donnell at lunch that Eson and Wineland were trying to oust Marquez. Between then and Sunday, March 24, Marquez talked several times with other directors and executives, including O'Donnell, Anderson, and Venoco directors Joel Reed and Bill Richardson, about Wineland's comments. That Sunday, Marquez, Anderson, and O'Donnell met at Venoco to discuss Wineland's termination.

The next day, March 25, Marquez searched the computers of Eson and Wineland, finding the e-mails they sent to their personal attorneys and to the Enron affiliates contemplating actions by written consent. Marquez then fired Eson and Wineland from their positions as officers (though they **[*14]** remained directors) and retained Delaware counsel to initiate this suit. On March 26, Venoco sent Neyman and Lydecker a letter accusing them of conspiring with Eson to get proprietary information about their negotiations and recommending that Neyman and Lydecker consult with counsel. Marquez scheduled a board meeting for the next day to formalize the termination of Eson and Wineland.

The contest for control of Venoco began in earnest the next day, March 27. First, Venoco filed this action for breach of fiduciary duty of loyalty against Eson and Wineland early that morning. [5] Next, Eson and Wineland delivered the first of several shareholder actions by written consent. [6] The March 27 written consent made several amendments to Venoco's bylaws, appointed Faye Eson ("Faye"), Eson's wife, to the vacant seat on Venoco's board, and appointed Neyman and Lydecker to the board as representatives of the preferred shareholders. After those consents were delivered, the board meeting began. Initially, the board did not dispute Faye's appointment, but Marquez, Richardson, O'Donnell, and Reed (over the objections of Eson, Wineland, and Faye) refused to acknowledge the appointments of Neyman and **[*15]** Lydecker. The board meeting was then recessed for several hours.

During the recess, Marquez and Venoco's lawyers called Jeffrey McMahon, President of Enron Corp., and threatened to sue Enron if an agreement could not be reached. Venoco proposed that it would buy the preferred shares held by the Enron affiliates for $ 40 million if the Enron affiliates would revoke their earlier

[5] The original complaint did not contain any claims against the Enron Defendants, who were added to this action later in Venoco's amended complaint.

[6] All of the shareholder actions were approved by Eson and Wineland, their affiliates, and the Enron affiliates, who collectively represented approximately 68% of the voting power of Venoco. A fuller description of the actions taken by written consent can be found in this Court's ruling in the related § 225 action.

written consent. McMahon and Raymond Bowen, Enron's CFO, were not intimidated by the threat of litigation and refused to revoke the written consent. They also insisted on **[*16]** two other conditions in connection with the repurchase--a Venoco shareholder vote on any transaction and board representation for the Enron affiliates until the consummation of any transaction--that were not acceptable to Marquez. At the end of the day, the board meeting reconvened and then quickly was adjourned until 5:00 the following day.

The next day, March 28, before the board meeting resumed, Marquez e-mailed Bowen and McMahon, offering essentially the same deal that had been discussed the day before. Marquez offered to repurchase the Venoco preferred shares for $ 40 million, on the conditions that the Enron affiliates would act by written consent with Marquez to reverse the actions taken by Eson and Wineland, that Warren would be appointed to the board to fill a vacant seat, and that the Enron affiliates would take no further steps to change the board or management of Venoco. Marquez refused to enter into a repurchase agreement without these conditions because doing so would likely mean that he would be removed as CEO. Enron again rejected this offer. Later in the day, but still before the board meeting resumed, Eson, Wineland, and the Enron affiliates delivered another written **[*17]** consent that limited the power of board committees. Finally, Venoco's board meeting reconvened.

At the meeting, Marquez announced that the board was not going to recognize the appointments of Faye, Neyman, or Lydecker. The Enron affiliates, who were attending the meeting telephonically, disrupted the meeting by vehemently voicing their opposition, forcing Venoco to terminate their phone connection. Reed resigned from Venoco's board because of a conflict of interest stemming from his relationship to Enron. Marquez and his allies then purported to take several actions which were later determined by this Court to be invalid because they were not actions of the duly constituted board of Venoco. Specifically, Marquez, Richardson, and O'Donnell appointed Warren to Reed's former position on the board. The board, led by Marquez and his allies, then adopted a bylaw limiting the ability of shareholders to act by written consent, and formed an Executive Committee consisting of Marquez, O'Donnell, and Warren. The Executive Committee was vested with the full power of the board to act on all matters. The board meeting then concluded, and an Executive Committee meeting began. The Executive Committee **[*18]** staggered Venoco's board and classified its directors, putting Eson and Wineland in class I, with terms expiring at the next shareholder meeting, and Marquez and O'Donnell in class III, with terms expiring in 2005. The Executive Committee also affirmed the termination of Eson and Wineland from their positions as officers and ratified all past conduct of Marquez. Ultimately, all of these actions, and all later actions taken by the rogue board, were determined to be invalid in this Court's Opinion in the § 225 action.

The next day, March 29, the Executive Committee met again to schedule a shareholder meeting at which only the class I directors--that is, Eson and Wineland--would be up for election. Eson and Wineland, in response, sued Venoco in California to compel it to put all of its directors up for election at the meeting. The California court ordered that a meeting be held, and accordingly a shareholder meeting is scheduled for June 10. The California court expressly reserved judgment on all other issues, including that seats would be up for election and whether cumulative voting would be allowed. As this Court determined in the related § 225 action, all nine board positions will **[*19]** be up for election at the June 10 meeting.

In the following weeks, Marquez met with representatives of the Enron affiliates, Eson and Wineland filed the § 225 action and, Eson, Wineland, and the Enron affiliates submitted additional actions by written consent. Finally, after expedited briefing and discovery, this Court held a three-day trial in both this case and the related § 225 action from May 29 through May 31. At the conclusion of the trial, the issues raised in the § 225 action were decided, [7] leaving only Venoco's claims against Eson, Wineland, and the Enron Defendants to be decided in this opinion. There are no fiduciary claims against Marquez, and the counterclaims of the Enron Defendants seeking declaratory and injunctive relief were addressed by the ruling in the § 225 action. Accordingly, the only issues before me are whether Eson and Wineland breached their fiduciary duties and whether the Enron Defendants aided and

---

[7] In the decision on the § 225 action, this Court ruled that the written consents were all valid (except for one bylaw amendment purporting to vest the authority to set the size of Venoco's board in the shareholders); that the proper board of Venoco was Marquez, O'Donnell, Richardson, Eson, Wineland, Faye, Neyman, Lydecker, and a vacancy; that all actions taken by the rogue board of Venoco since the delivery of the March 27 written consent were without force and effect; and that all nine board positions would be up for election at the June 10 meeting.

abetted in any such breach.

[*20] II. DISCUSSION

Directors of Delaware corporations owe their corporations a duty of loyalty. It is well-settled that directors "are not permitted to use their position of trust and confidence to further their private interests" because the law "requires an undivided and unselfish loyalty to the corporation [and] demands that there shall be no conflict between duty and self-interest." [8] Venoco contends, essentially, that Eson and Wineland violated their duties as directors by trying to help the Enron affiliates in an attempt to further Eson and Wineland's personal interests as substantial shareholders of Venoco.

Eson and Wineland took several steps to endear themselves to the Enron affiliates after they decided that actions by written consent were necessary. First, Eson told Neyman that Venoco's board had not taken a formal position or voted on Neyman and Lydecker's directorships. Next, Eson discussed Venoco's draft **[*21]** letter of March 12 with Neyman. Then, Eson told Neyman that Marquez would be calling and recommended a "non-committal stall" to "make this work to [Eson and Neyman's] mutual advantage." Finally, Eson suggested to Neyman that the Enron affiliates connect the issues of repurchase and board seat, "taking the position [Enron] is willing to negotiate a sale of the preferred, but only after a special Board meeting and electing you and Dick as directors." Throughout this process, Wineland was working with Eson; he knew of Eson's activities and, indeed, the two of them were jointly represented by the same attorney. Eson and Wineland stepped over the line as directors to help themselves as substantial shareholders, surreptitiously using their positions as directors, without telling the other directors, to advance their position as shareholders.

At the same time, however, Venoco was arguably breaching the SPA by refusing board representation to the Enron affiliates. Directors must be given some latitude to take action in circumstances like these to ensure compliance with corporate obligations, even when those directors comprise a minority of a corporation's board. Nevertheless, in this **[*22]** case, Eson and Wineland did more than that. They did not simply seek to assist the Enron affiliates in their effort to enforce their contractual rights out of an overriding sense of duty and obligation on behalf of Venoco. This concern was, at most, an instrumental one for Eson and Wineland in their efforts to further their private interests as shareholders of Venoco. Eson and Wineland attempted to curry favor with the Enron affiliates on both the board representation issue and the share repurchase issue in order to obtain the Enron affiliates' agreement to act with Eson and Wineland by written consent. While they were arranging this, they took active steps to conceal their plans from other Venoco board members. Shareholders are indisputably free to meet to discuss corporate governance issues and, where allowed by the relevant corporate documents, to act by written consent, but shareholders who are also directors may not take actions, such as offering negotiating advice to an opposing party, that are adverse to the interests of their corporations. This is the essence of the duty of loyalty. The primary concern for directors, even if they are minority directors and significant shareholders, **[*23]** must be the best interests of the corporation rather than their own interests as shareholders.

Although Eson and Wineland were overly zealous in this case, their breach of the duty of loyalty ultimately had little effect on the Enron affiliates or on Venoco. Venoco contends that the Enron Defendants aided and abetted Eson and Wineland's breaches of fiduciary duty. To establish a claim for aiding and abetting, Venoco must prove the existence of a fiduciary relationship, a breach of fiduciary duty, knowing participation in the breach by a defendant who is not a fiduciary, and damages. [9] The first two elements have been established. I conclude, however, that Venoco has not proven the necessary participation of the Enron Defendants. The Enron affiliates treated the board representation and share repurchase issues as independent, refusing to change their position on either issue or to tie the two issues together even after Eson suggested that approach. The Enron affiliates consistently contended that they were entitled to board representation under the terms of the SPA, both before and after discussing the issue with Eson. Similarly, they tried to negotiate a repurchase of their shares **[*24]** of Venoco preferred stock both before and after talking with Eson. Nothing in their contacts with Eson and Wineland changed the Enron Defendants' negotiating strategy or gave the Enron

[8] *Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503, 510 (Del. 1939)*.

[9] *Malpiede v. Townson, 780 A.2d 1075, 1096 (Del. 2001)*.

Defendants additional leverage. They did nothing to take advantage of or to benefit from Eson and Wineland's breaches of fiduciary duty; nor were they knowing participants in those breaches. Consequently, I cannot agree with Venoco's contention that the Enron Defendants aided and abetted Eson and Wineland's breaches of fiduciary duty.

In its amended complaint, Venoco seeks declaratory and injunctive relief as well as damages "in an amount to be determined by the Court." For reasons discussed in connection with the aiding and abetting claim, I conclude that no calculable harm to Venoco was demonstrated at trial. No transaction has been consummated on terms that were less favorable than Venoco otherwise could have obtained. The composition of Venoco's board **[*25]** has changed through the shareholder actions by written consent, but this exercise of shareholder authority does not entitle the company to money damages. Accordingly, I decline to award Venoco money damages.

III. CONCLUSION

For the foregoing reasons, I conclude that Eson and Wineland breached their fiduciary duty of loyalty to Venoco and hereby enjoin them from disclosing any confidential Venoco information to third parties in the future.

IT IS SO ORDERED.

Zapata Corp. v. Maldonado

Supreme Court of Delaware

December 31, 1980, Submitted [*]; May 13, 1981, Decided

No. 113, 1980

[*] The appeal was argued on October 16, 1980 but certain procedural matters required by this Court were not accomplished until the date indicated.

Reporter

430 A.2d 779 *; 1981 Del. LEXIS 321 **; 22 A.L.R.4th 1190

ZAPATA CORPORATION, Defendant Below, Appellant, v. WILLIAM MALDONADO, Plaintiff Below, Appellee

Prior History: [1]** Upon appeal from the Court of Chancery.

Disposition: Reversed and Remanded.

Counsel: Robert K. Payson, (argued) of Potter, Anderson & Corroon, Wilmington, and Thomas F. Curnin, Thomas J. Kavaler, P. Kevin Castel and Edward P. Krugman of Cahill, Gordon & Reindel, New York, New York, of counsel, for defendant-appellant.

Charles F. Richards, Jr. of Richards, Layton & Finger, Wilmington, for individual defendants.

Irving Morris and Joseph A. Rosenthal of Morris & Rosenthal, Wilmington, Sidney L. Garwin (argued), and Bruce E. Gerstein of Garwin, Bronzaft & Gerstein, New York, New York, of counsel, for plaintiff-appellee.

Arthur G. Connolly, Jr. of Connolly, Bove & Lodge, Wilmington, for amici curiae.

Judges: Duffy, Quillen and Horsey, JJ.

Opinion by: QUILLEN

Opinion

[*780] This is an interlocutory appeal from an order entered on April 9, 1980, by the Court of Chancery denying appellant-defendant Zapata Corporation's (Zapata) alternative motions to dismiss the complaint or for summary judgment. The issue to be addressed has reached this Court by way of a rather convoluted path.

In June, 1975, William Maldonado, a stockholder of Zapata, instituted a derivative action in the Court of Chancery on behalf **[**2]** of Zapata against ten officers and/or directors of Zapata, alleging, essentially, breaches of fiduciary duty. Maldonado did not first demand that the board bring this action, stating instead such demand's futility because all directors were named as defendants and allegedly participated in the acts specified. [1] In June, 1977, Maldonado commenced an action in the United States District Court for the Southern District of New York against the same defendants, save one, alleging federal security law violations as well as the same common law claims made previously in the Court of Chancery.

[*781] By June, 1979, four of the defendant-directors were no longer on the board, and the remaining directors appointed two **[**3]** new outside directors to the board. The board then created an "Independent Investigation Committee" (Committee), composed solely of the two new directors, to investigate Maldonado's actions, as well as a similar derivative action then pending in Texas, and to determine whether the corporation should continue any or all of the litigation. The Committee's determination was stated to be "final, . . . not . . . subject to review by the Board of Directors and . . . in all respects . . . binding upon the Corporation."

Following an investigation, the Committee concluded, in September, 1979, that each action should "be dismissed forthwith as their continued maintenance is inimical to the Company's best interests . . . ." Consequently, Zapata moved for dismissal or summary judgment in the three derivative actions. On January 24, 1980, the District Court for the Southern District of New York granted Zapata's motion for summary judgment, *Maldonado v. Flynn, S.D.N.Y., 485 F. Supp. 274 (1980)*, holding, under its interpretation of Delaware law, that the Committee had the authority, under the "business judgment" rule, to require the termination of the derivative action. Maldonado appealed **[**4]** that decision to the Second Circuit Court of Appeals.

On March 18, 1980, the Court of Chancery, in a reported opinion, the basis for the order of April 9, 1980, denied Zapata's motions, holding that Delaware law does not sanction this means of dismissal. More specifically, it held that the "business judgment" rule is not a grant of authority to dismiss derivative actions and that a stockholder has an individual right to maintain derivative actions in certain instances. *Maldonado v. Flynn, Del.Ch., 413 A.2d 1251 (1980)* (herein *Maldonado*). Pursuant to the provisions of Supreme

[1] Court of Chancery Rule 23.1 states in part: "The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and the reasons for his failure to obtain the action or for not making the effort."

Court Rule 42, Zapata filed an interlocutory appeal with this Court shortly thereafter. The appeal was accepted by this Court on June 5, 1980. On May 29, 1980, however, the Court of Chancery dismissed Maldonado's cause of action, its decision based on principles of *res judicata*, expressly conditioned upon the Second Circuit affirming the earlier New York District Court's decision. [2] The Second Circuit appeal was ordered stayed, however, pending this Court's resolution of the appeal from the April 9th Court of Chancery order denying dismissal and summary judgment.

[5]** Thus, Zapata's observation that it sits "in a procedural gridlock" appears quite accurate, and we agree that this Court can and should attempt to resolve the particular question of Delaware law. [3] As the Vice Chancellor noted, *413 A.2d at 1257*, "it is the law of the State of incorporation which determines whether the directors have this power of dismissal, *Burks v. Lasker, 441 U.S. 471, 99 S. Ct. 1831, 60 L. Ed. 2d 404 (1979)*". We limit our review in this interlocutory appeal to whether the Committee has the power to cause the present action to be dismissed.

We begin with an examination of the carefully considered opinion of the Vice Chancellor which states, in part, that the "business judgment" rule does not confer power "to a corporate board of directors to terminate a derivative **[**6]** suit", *413 A.2d at 1257*. His conclusion is particularly pertinent because several federal courts, applying Delaware law, have held that the business judgment rule enables boards (or their committees) to terminate derivative suits, decisions now in conflict with the holding below. [4]

[*782] As the term is most commonly used, and given the disposition below, we can understand the Vice Chancellor's comment that "the business judgment rule is irrelevant to the question of whether the Committee has the authority to compel the dismissal **[**7]** of this suit". *413 A.2d at 1257*. Corporations, existing because of legislative grace, possess authority as granted by the legislature. Directors of Delaware corporations derive their managerial decision making power, which encompasses decisions whether to initiate, or refrain from entering, litigation, [5] **[**8]** from *8 Del.C. § 141 (a)*. [6] This statute is the fount of directorial powers. The "business judgment" rule is a judicial creation that presumes propriety, under certain circumstances, in a board's decision. [7] Viewed defensively, it does not create authority. In this sense the "business judgment" rule is not relevant in corporate decision making until after a decision is made. It is generally used as a defense to an attack on the decision's soundness. The board's managerial decision making power, however, comes from *§ 141(a)*. The judicial creation and legislative grant are related because the "business judgment" rule evolved to give recognition and deference to directors' business expertise when exercising their managerial power under *§ 141(a)*.

In the case before us, although the corporation's decision to move to dismiss or for summary judgment was, literally, a decision resulting from an exercise of the directors' (as delegated to the Committee) business judgment, the question of "business judgment", in a defensive sense, would not become relevant until and

---

[2] *Maldonado v. Flynn, Del.Ch., 417 A.2d 378 (1980)*. Proceedings in the Trial Court are not automatically stayed during the pendency of an interlocutory appeal. Supreme Court Rule 42(d).

[3] The District Court for the Southern District of Texas, in *Maher v. Zapata Corp., S.D.Tex., 490 F. Supp. 348 (1980)*, denied Zapata's motions to dismiss or for summary judgment in an opinion consistent with *Maldonado*.

[4] *Abbey v. Control Data Corp., 8th Cir., 603 F.2d 724 (1979)*, *cert. denied*, ***444 U.S. 1017, 100 S. Ct. 670, 62 L. Ed. 2d 647 (1980)***; *Lewis v. Adams*, N.D.Okl., No. 77-266C (November 15, 1979); *Siegal v. Merrick, S.D.N.Y., 84 F.R.D. 106 (1979)*; and, of course, *Maldonado v. Flynn, S.D.N.Y., 485 F. Supp. 274 (1980)*. See also *Abramowitz v. Posner, S.D.N.Y., 513 F. Supp. 120*, (1981) which specifically rejected the result reached by the Vice Chancellor in this case.

[5] *See* Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit*? 75 Nw.U.L.Rev. 96, 98 & n. 14 (1980); Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U.Chi.L.Rev. 168, 192 & nn. 153-54 (1976) (herein *Stockholder Derivative Actions*).

[6] *8 Del.C. § 141(a)* states:

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

[7] See Arsht, *The Business Judgment Rule Revisited*, 8 Hofstra L.Rev. 93, 97, 130-33 (1979).

unless the decision to seek termination of the derivative lawsuit was attacked as improper. *Maldonado, 413 A.2d at 1257*. **[**9]** Accord, *Abella v. Universal Leaf Tobacco Co., Inc., E.D.Va., 495 F. Supp. 713 (1980)* (applying Virginia law); *Maher v. Zapata Corp., S.D.Tex., 490 F. Supp. 348 (1980)* (applying Delaware law). See also, Dent, *supra* note 5, 75 Nw.U.L.Rev. at 101-02, 135. This question was not reached by the Vice Chancellor because he determined that the stockholder had an individual right to maintain this derivative action. *Maldonado, 413 A.2d at 1262*.

Thus, the focus in this case is on the power to speak for the corporation as to whether the lawsuit should be continued or terminated. As we see it, this issue in the current appellate posture of this case has three aspects: the conclusions of the Court below concerning the continuing right of a stockholder to maintain a derivative action; the corporate power under Delaware law of an authorized board committee to cause dismissal of litigation instituted for the benefit of the corporation; and the role of the Court of Chancery in resolving conflicts between the stockholder and the committee.

Accordingly, we turn first to the Court of Chancery's conclusions concerning the right of a plaintiff stockholder in a derivative action. We find **[**10]** that its determination that a stockholder, once demand is made and refused, possesses an independent, individual right to continue a derivative suit for breaches of fiduciary duty over objection by the corporation, *Maldonado, 413 A.2d at 1262-63*, as an absolute rule, is erroneous. The Court of Chancery relied principally upon *Sohland v. Baker, Del.Supr., 15 Del. Ch. 431, 141 A. 277* ***[*783]*** *(1927)*, for this statement of the Delaware rule. *Maldonado, 413 A.2d at 1260-61*. *Sohland* is sound law. But *Sohland* cannot be fairly read as supporting the broad proposition which evolved in the opinion below.

In *Sohland*, the complaining stockholder was allowed to file the derivative action in equity after making demand and after the board refused to bring the lawsuit. But the question before us relates to the power of the corporation by motion to terminate a lawsuit properly commenced by a stockholder without prior demand. No Delaware statute or case cited to us directly determines this new question and we do not think that *Sohland* addresses it by implication.

The language in *Sohland* relied on by the Vice Chancellor negates the contention that the case stands **[**11]** for the broad rule of stockholder right which evolved below. This Court therein stated that "a stockholder *may sue* in his own name for the purpose of enforcing corporate rights . . . in a proper case if the corporation on the demand of the stockholder refuses to bring suit." *141 A. at 281* (emphasis added). The Court also stated that "whether ("(t)he right of a stockholder *to file a bill* to litigate corporate rights") exists necessarily depends on the facts of each particular case." *141 A. at 282* (emphasis added). Thus, the precise language only supports the stockholder's right to initiate the lawsuit. It does not support an absolute right to continue to control it.

Additionally, the issue and context in *Sohland* are simply different from this case. Baker, a stockholder, suing on behalf of Bankers' Mortgage Co., sought cancellation of stock issued to Sohland, a director of Bankers', in a transaction participated in by a "great majority" of Bankers' board. Before instituting his suit, Baker requested the board to assert the cause of action. The board refused. Interestingly, though, on the same day the board refused, it authorized payment of Baker's attorneys fees **[**12]** so that he could pursue the claim; one director actually escorted Baker to the attorneys suggested by the board. At this chronological point, Sohland had resigned from the board, and it was he, not the board, who was protesting Baker's ability to bring suit. In sum, despite the board's refusal to bring suit, it is clear that the board supported Baker in his efforts. [8] It is not surprising then that he was allowed to proceed as the corporation's representative "for the prevention of injustice", because "the corporation itself refused to litigate an apparent corporate right." *141 A. at 282*.

[13]** Moreover, *McKee v. Rogers, Del.Ch., 18 Del. Ch. 81, 156 A. 191 (1931)*, stated "as a general rule" that "a stockholder cannot be permitted . . . to invade the discretionary field committed to the judgment of the directors and sue in the corporation's behalf when the managing body refuses. This rule is a well settled one." *156 A. at 193*. [9]

---

[8] Compare *Baker v. Bankers' Mortgage Co., Del.Ch., 14 Del. Ch. 427, 129 A. 775, 776-77 (1925)*, the lower *Sohland*. In *Baker*, Chancellor Wolcott posed a rhetorical question that is entirely consistent with the result we reach today: "Why should not a stockholder, if the managing body absolutely refuses to act, be permitted to assert on behalf of himself and other stockholders a complaint, not against matters lying in sound discretion and honest judgment, but against frauds perpetrated by an officer in clear breach of his trust?" *129 A. at 777*.

[9] To the extent that *Mayer v. Adams, Del.Supr., 37 Del. Ch.*

The *McKee* rule, of course, **[**14]** should not be read so broadly that the board's refusal will be determinative in every instance. Board members, owing a well-established fiduciary duty to the corporation, will not be allowed to cause a derivative suit to be dismissed when it would be a breach of their fiduciary duty. Generally **[*784]** disputes pertaining to control of the suit arise in two contexts.

Consistent with the purpose of requiring a demand, a board decision to cause a derivative suit to be dismissed as detrimental to the company, after demand has been made and refused, will be respected unless it was wrongful. [10] See, e. g., United Copper Securities Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64, 37 S. Ct. 509, 510, 61 L. Ed. 1119, 1124 (1917); *Stockholder Derivative Actions, supra* note 5, 44 U.Chi.L.Rev. at 169, 191-92; Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 Har.L.Rev. 746, 748, 759 (1960); 13 W. Fletcher, Cyclopedia of the Law of Private Corporations § 5969 (rev.perm.ed. 1980). A claim of a wrongful decision not to sue is thus the first exception and the first context of dispute. Absent a wrongful refusal, the stockholder in such **[**15]** a situation simply lacks legal managerial power. Compare Maldonado, 413 A.2d at 1259-60.

But it cannot be implied that, absent a wrongful board refusal, a stockholder can never have an individual right to initiate an action. For, as is stated in *McKee*, a "well settled" exception exists **[**16]** to the general rule.

> "(A) stockholder may sue in equity in his derivative right to assert a cause of action in behalf of the corporation, *without prior demand* upon the directors to sue, when it is apparent that a demand would be futile, that the officers are under an influence that sterilizes discretion and could not be proper persons to conduct the litigation."

156 A. at 193 (emphasis added). This exception, the second context for dispute, is consistent with the Court of Chancery's statement below, that "the stockholders' individual right to bring the action does not ripen, however, . . . unless he can show a demand to be futile." Maldonado, 413 A.2d at 1262. [11]

[17]** These comments in *McKee* and in the opinion below make obvious sense. A demand, when required and refused (if not wrongful), terminates a stockholder's legal ability to initiate a derivative action. [12] But where demand is properly excused, the stockholder does possess the ability to initiate the action on his corporation's behalf.

These conclusions, however, do not determine the question before us. Rather, they merely bring us to the question to be decided. It is here that we part company with the Court below. Derivative suits enforce corporate rights and any recovery obtained goes to the corporation. Taormina v. Taormina Corp., Del.Ch., 32 Del. Ch. 18, 78 A.2d 473, 476 (1951); Keenan v. Eshleman, Del.Supr., 23 Del. Ch. 234, 2 A.2d 904, 912-13 (1938). "The right of a stockholder to file a bill to litigate corporate rights is, therefore, solely for the purpose of preventing injustice **[**18]** where it is apparent that material corporate rights would not otherwise be protected." Sohland, 141 A. at 282. We see no inherent reason why the "two phases" of a derivative suit, the stockholder's suit to compel the corporation to sue and the corporation's suit (see 413 A.2d at 1261-62), should automatically result in the

---

298, 141 A.2d 458, 462 (1958) and Ainscow v. Sanitary Co. of America, Del.Ch., 21 Del. Ch. 35, 180 A. 614, 615 (1935), relied upon in Maldonado, 413 A.2d at 1262, contain language relating to the rule in *McKee*, we note that each decision is dissimilar from the one we examine today. *Mayer* held that demand on the stockholders was not required before maintaining a derivative suit if the wrong alleged could not be ratified by the stockholders. *Ainscow* found defective a complaint that neither alleged demand on the directors, nor reasons why demand was excusable.

[10] In other words, when stockholders, after making demand and having their suit rejected, attack the board's decision as improper, the board's decision falls under the "business judgment" rule and will be respected if the requirements of the rule are met. See Dent, *supra* note 5, 75 Nw.U.L.Rev. at 100-01 & nn. 24-25. That situation should be distinguished from the instant case, where demand was not made, and the *power* of the board to seek a dismissal, due to disqualification, presents a threshold issue. For examples of what has been held to be a wrongful decision not to sue, see *Stockholder Derivative Actions, supra* note 5, 44 U.Chi.L.Rev. at 193-98. We recognize that the two contexts can overlap in practice.

[11] These statements are consistent with Rule 23.1's "reasons for . . . failure" to make demand. See also the other cases cited by the Vice Chancellor, 413 A.2d at 1262: Ainscow v. Sanitary Co. of America, supra note 9, 180 A. at 615; Mayer v. Adams, supra note 9, 141 A.2d at 462; Dann v. Chrysler Corp., Del.Ch., 40 Del. Ch. 103, 174 A.2d 696, 699-700 (1961).

[12] Even in this situation, it may take litigation to determine the stockholder's lack of power, i. e., standing.

placement in the hands of the **[*785]** litigating stockholder sole control of the corporate right throughout the litigation. To the contrary, it seems to us that such an inflexible rule would recognize the interest of one person or group to the exclusion of all others within the corporate entity. Thus, we reject the view of the Vice Chancellor as to the first aspect of the issue on appeal.

The question to be decided becomes: When, if at all, should an authorized board committee be permitted to cause litigation, properly initiated by a derivative stockholder in his own right, to be dismissed? As noted above, a board has the power to choose not to pursue litigation when demand is made upon it, so long as the decision is not wrongful. If the board determines that a suit would be detrimental to the company, the board's determination prevails. Even when demand **[**19]** is excusable, circumstances may arise when continuation of the litigation would not be in the corporation's best interests. Our inquiry is whether, under such circumstances, there is a permissible procedure under *§ 141(a)* by which a corporation can rid itself of detrimental litigation. If there is not, a single stockholder in an extreme case might control the destiny of the entire corporation. This concern was bluntly expressed by the Ninth Circuit in *Lewis v. Anderson, 9th Cir., 615 F.2d 778, 783 (1979)*, *cert. denied*, *449 U.S. 869, 101 S. Ct. 206, 66 L. Ed. 2d 89 (1980)*: "To allow one shareholder to incapacitate an entire board of directors merely by leveling charges against them gives too much leverage to dissident shareholders." But, when examining the means, including the committee mechanism examined in this case, potentials for abuse must be recognized. This takes us to the second and third aspects of the issue on appeal.

Before we pass to equitable considerations as to the mechanism at issue here, it must be clear that an independent committee possesses the corporate power to seek the termination of a derivative suit. *Section 141(c)* allows a board to delegate all **[**20]** of its authority to a committee. [13] Accordingly, a committee with properly delegated authority would have the power to move for dismissal or summary judgment if the entire board did.

[21]** Even though demand was not made in this case and the initial decision of whether to litigate was not placed before the board, Zapata's board, it seems to us, retained all of its corporate power concerning litigation decisions. If Maldonado had made demand on the board in this case, it could have refused to bring suit. Maldonado could then have asserted that the decision not to sue was wrongful and, if correct, would have been allowed to maintain the suit. The board, however, never would have lost its statutory managerial authority. The demand requirement itself evidences that the managerial power is retained **[*786]** by the board. When a derivative plaintiff is allowed to bring suit after a wrongful refusal, the board's authority to choose whether to pursue the litigation is not challenged although its conclusion -- reached through the exercise of that authority -- is not respected since it is wrongful. Similarly, Rule 23.1, by excusing demand in certain instances, does not strip the board of its corporate power. It merely saves the plaintiff the expense and delay of making a futile demand resulting in a probable tainted exercise of that authority in a refusal by the board **[**22]** or in giving control of litigation to the opposing side. But the board entity remains empowered under *§ 141(a)* to make decisions regarding corporate litigation. The problem is one of member disqualification, not the absence of power in the board.

---

[13] *8 Del.C. § 141(c)* states:

"The board of directors may, by resolution passed by a majority of the whole board, designate 1 or more committees, each committee to consist of 1 or more of the directors of the corporation. The board may designate 1 or more directors as alternative members of any committee, who may replace any absent or disqualified member at any meeting of the committee. The bylaws may provide that in the absence or disqualification of a member of a committee, the member or members present at any meeting and not disqualified from voting, whether or not he or they constitute a quorum, may unanimously appoint another member of the board of directors to act at the meeting in the place of any such absent or disqualified member. Any such committee, to the extent provided in the resolution of the board of directors, or in the bylaws of the corporation, shall have and may exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation, and may authorize the seal of the corporation to be affixed to all papers which may require it; but no such committee shall have the power or authority in reference to amending the certificate of incorporation, adopting an agreement of merger or consolidation, recommending to the stockholders the sale, lease or exchange of all or substantially all of the corporation's property and assets, recommending to the stockholders a dissolution of the corporation or a revocation of a dissolution, or amending the bylaws of the corporation; and, unless the resolution, bylaws, or certificate of incorporation expressly so provide, no such committee shall have the power or authority to declare a dividend or to authorize the issuance of stock."

The corporate power inquiry then focuses on whether the board, tainted by the self-interest of a majority of its members, can legally delegate its authority to a committee of two disinterested directors. We find our statute clearly requires an affirmative answer to this question. As has been noted, under an express provision of the statute, *§ 141(c)*, a committee can exercise all of the authority of the board to the extent provided in the resolution of the board. Moreover, at lest by analogy to our statutory section on interested directors, *8 Del.C. § 141*, it seems clear that the Delaware statute is designed to permit disinterested directors to act for the board. [14] Compare *Puma v. Marriott, Del.Ch., 283 A.2d 693, 695-96 (1971)*.

[23]** We do not think that the interest taint of the board majority is per se a legal bar to the delegation of the board's power to an independent committee composed of disinterested board members. The committee can properly act for the corporation to move to dismiss derivative litigation that is believed to be detrimental to the corporation's best interest.

Our focus now switches to the Court of Chancery which is faced with a stockholder assertion that a derivative suit, properly instituted, should continue for the benefit of the corporation and a corporate assertion, properly made by a board committee acting with board authority, that the same derivative suit should be dismissed as inimical to the best interests of the corporation.

At the risk of stating the obvious, the problem is relatively simple. If, on the one hand, corporations can consistently wrest bona fide derivative actions away from well-meaning derivative plaintiffs through the use of the committee mechanism, the derivative suit will lose much, if not all, of its generally-recognized effectiveness as an intra-corporate means of policing boards of directors. See Dent, *supra* note 5, 75 Nw.U.L.Rev. at 96 & n. 3, 144 **[**24]** & n. 241. If, on the other hand, corporations are unable to rid themselves of meritless or harmful litigation **[*787]** and strike suits, the derivative action, created to benefit the corporation, will produce the opposite, unintended result. For a discussion of strike suits, see Dent, *supra*, 75 Nw.U.L.Rev. at 137. See also *Cramer v. General Telephone & Electronics Corp., 3d Cir., 582 F.2d 259, 275 (1978)*, *cert. denied*, *439 U.S. 1129, 99 S. Ct. 1048, 59 L. Ed. 2d 90 (1979)*. It thus appears desirable to us to find a balancing point where bona fide stockholder power to bring corporate causes of action cannot be unfairly trampled on by the board of directors, but the corporation can rid itself of detrimental litigation.

As we noted, the question has been treated by other courts as one of the "business judgment" of the board committee. If a "committee, composed of independent and disinterested directors, conducted a proper review of the matters before it, considered a variety of factors and reached, in good faith, a business judgment that (the) action was not in the best interest of (the corporation)", the action must be dismissed. See, e. g., *Maldonado v. Flynn, supra* ***[**25]*** *, 485 F. Supp. at 282, 286*. The issues become solely independence, good faith, and reasonable investigation. The ultimate conclusion of the committee, under that view, is not subject to judicial review.

We are not satisfied, however, that acceptance of the "business judgment" rationale at this stage of derivative litigation is a proper balancing point. While we admit an analogy with a normal case respecting board judgment,

---

[14] *8 Del.C. § 144* states:

"*§ 144*. Interested directors; quorum.

(a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if:

(1) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

(2) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or

(3) The contract or transaction is fair to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee, or the shareholders.

(b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction."

it seems to us that there is sufficient risk in the realities of a situation like the one presented in this case to justify caution beyond adherence to the theory of business judgment.

The context here is a suit against directors where demand on the board is excused. We think some tribute must be paid to the fact that the lawsuit was properly initiated. It is not a board refusal case. Moreover, this complaint was filed in June of 1975 and, while the parties undoubtedly would take differing views on the degree of litigation activity, we have to be concerned about the creation of an "Independent Investigation Committee" four years later, after the election of two new outside directors. Situations could develop where such motions could be filed after years of **[**26]** vigorous litigation for reasons unconnected with the merits of the lawsuit.

Moreover, notwithstanding our conviction that Delaware law entrusts the corporate power to a properly authorized committee, we must be mindful that directors are passing judgment on fellow directors in the same corporation and fellow directors, in this instance, who designated them to serve both as directors and committee members. The question naturally arises whether a "there but for the grace of God go I" empathy might not play a role. And the further question arises whether inquiry as to independence, good faith and reasonable investigation is sufficient safeguard against abuse, perhaps subconscious abuse.

There is another line of exploration besides the factual context of this litigation which we find helpful. The nature of this motion finds no ready pigeonhole, as perhaps illustrated by its being set forth in the alternative. It is perhaps best considered as a hybrid summary judgment motion for dismissal because the stockholder plaintiff's standing to maintain the suit has been lost. But it does not fit neatly into a category described in Rule 12(b) of the Court of Chancery Rules nor does it correspond **[**27]** directly with Rule 56 since the question of genuine issues of fact on the merits of the stockholder's claim are not reached.

It seems to us that there are two other procedural analogies that are helpful in addition to reference to Rules 12 and 56. There is some analogy to a settlement in that there is a request to terminate litigation without a judicial determination of the merits. See *Perrine v. Pennroad Corp., Del.Supr., 29 Del. Ch. 531, 47 A.2d 479, 487 (1946)*. "In determining whether or not to approve a proposed settlement of a derivative stockholders' action (when directors are on both sides of the transaction), the Court of Chancery is called upon to exercise its own business judgment." *Neponsit Investment Co. v. Abramson, Del.Supr., 405 A.2d 97, 100 (1979)* and cases therein cited. In this case, **[*788]** the litigating stockholder plaintiff facing dismissal of a lawsuit properly commenced ought, in our judgment, to have sufficient status for strict Court review.

Finally, if the committee is in effect given status to speak for the corporation as the plaintiff in interest, then it seems to us there is an analogy to Court of Chancery Rule 41(a)(2) where the plaintiff **[**28]** seeks a dismissal after an answer. Certainly, the position of record of the litigating stockholder is adverse to the position advocated by the corporation in the motion to dismiss. Accordingly, there is perhaps some wisdom to be gained by the direction in Rule 41(a)(2) that "an action shall not be dismissed at the plaintiff's instance save upon order of the Court and upon such terms and conditions as the Court deems proper."

Whether the Court of Chancery will be persuaded by the exercise of a committee power resulting in a summary motion for dismissal of a derivative action, where a demand has not been initially made, should rest, in our judgment, in the independent discretion of the Court of Chancery. We thus steer a middle course between those cases which yield to the independent business judgment of a board committee and this case as determined below which would yield to unbridled plaintiff stockholder control. In pursuit of the course, we recognize that "the final substantive judgment whether a particular lawsuit should be maintained requires a balance of many factors -- ethical, commercial, promotional, public relations, employee relations, fiscal as well as legal." *Maldonado **[**29]** v. Flynn, supra, 485 F. Supp. at 285*. But we are content that such factors are not "beyond the judicial reach" of the Court of Chancery which regularly and competently deals with fiduciary relationships, disposition of trust property, approval of settlements and scores of similar problems. We recognize the danger of judicial overreaching but the alternatives seem to us to be outweighed by the fresh view of a judicial outsider. Moreover, if we failed to balance all the interests involved, we would in the name of practicality and judicial economy foreclose a judicial decision on the merits. At this point, we are not convinced that is necessary or desirable.

After an objective and thorough investigation of a derivative suit, an independent committee may cause its corporation to file a pretrial motion to dismiss in the Court of Chancery. The basis of the motion is the best interests of the corporation, as determined by the committee. The motion should include a thorough written record of the investigation and its findings and recommendations. Under appropriate Court supervision, akin to proceedings on summary judgment, each side should have an opportunity to make a record on the **[**30]** motion. As to the limited issues presented by the motion noted below, the moving party should be prepared to meet the normal burden under Rule 56 that there is no genuine issue as to any material fact and that the moving party is entitled to dismiss as a matter of law. [15] The Court should apply a two-step test to the motion.

First, the Court should inquire into the independence and good faith of the committee and the bases supporting its conclusions. Limited discovery may be ordered to facilitate such inquiries. [16] The corporation should have the burden of proving independence, good faith and a reasonable investigation, rather than presuming independence, **[**31]** good faith and reasonableness. [17] **[*789]** If the Court determines either that the committee is not independent or has not shown reasonable bases for its conclusions, or, if the Court is not satisfied for other reasons relating to the process, including but not limited to the good faith of the committee, the Court shall deny the corporation's motion. If, however, the Court is satisfied under Rule 56 standards that the committee was independent and showed reasonable bases for good faith findings and recommendations, the Court may proceed, in its discretion, to the next step.

[32]** The second step provides, we believe, the essential key in striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation's best interests as expressed by an independent investigating committee. The Court should determine, applying its own independent business judgment, whether the motion should be granted. [18] This means, of course, that instances could arise where a committee can establish its independence and sound bases for its good faith decisions and still have the corporation's motion denied. The second step is intended to thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation's interest. The Court of Chancery of course must carefully consider and weigh how compelling the corporate interest in dismissal is when faced with a non-frivolous lawsuit. The Court of Chancery should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation's best interests.

[33]** If the Court's independent business judgment is satisfied, the Court may proceed to grant the motion, subject, of course, to any equitable terms or conditions the Court finds necessary or desirable.

The interlocutory order of the Court of Chancery is reversed and the cause is remanded for further proceedings consistent with this opinion.

End of Document

[15] We do not foreclose a discretionary trial of factual issues but that issue is not presented in this appeal. See *Lewis v. Anderson, supra, 615 F.2d at 780*. Nor do we foreclose the possibility that other motions may proceed or be joined with such a pretrial summary judgment motion to dismiss, e. g., a partial motion for summary judgment on the merits.

[16] See, e. g., *Galef v. Alexander, 2d Cir., 615 F.2d 51, 56 (1980)*; *Maldonado v. Flynn, supra, 485 F. Supp. at 285-86*; *Rosengarten v. International Telephone & Telegraph Corp., S.D.N.Y., 466 F. Supp. 817, 823 (1979)*; *Gall v. Exxon Corp., S.D.N.Y., 418 F. Supp. 508, 520 (1976)*. Compare Dent, *supra* note 5, 75 Nw.U.L.Rev. at 131-33.

[17] Compare *Auerbach v. Bennett, 47 N.Y.2d 619, 419 N.Y.S.2d 920, 928-29, 393 N.E.2d 994 (1979)*. Our approach here is analogous to and consistent with the Delaware approach to "interested director" transactions, where the directors, once the transaction is attacked, have the burden of establishing its "intrinsic fairness" to a court's careful scrutiny. See, e. g., *Sterling v. Mayflower Hotel Corp., Del.Supr., 33 Del. Ch. 293, 93 A.2d 107 (1952)*.

[18] This step shares some of the same spirit and philosophy of the statement by the Vice Chancellor: "Under our system of law, courts and not litigants should decide the merits of litigation." *413 A.2d at 1263*.