SHAREHOLDER DERIVATIVE ACTIONS: FROM CRADLE TO GRAVE

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1. What Is a Derivative Action?

a. A derivative action is actually two causes of action: it is an action to compel the corporation to sue and it is an action brought by a shareholder on behalf of the corporation to redress harm to the corporation. *See Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984) ("The nature of the action is two-fold. First, it is the equivalent of a suit by the shareholders to compel the corporation to sue. Second, it is a suit by the corporation, asserted by the shareholders on its behalf, against those liable to it."); *Brown v. Tenney*, 532 N.E.2d 230, 232 (Ill. 1988) (a derivative action is in effect two actions: "one against the directors for failing to sue; the second based upon the right belonging to the corporation.").

b. A derivative action allows shareholders to monitor and redress harm to the corporation caused by management where it is unlikely that management will redress the harm itself. *Meyer v. Fleming*, 327 U.S. 161, 167 (1946) ("[T]he purpose of the derivative action [is] to place in the hands of the individual shareholder a means to protect the interest of the corporation from the misfeasance and malfeasance of 'faithless directors and mangers'" (quoting *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 548 (1949)); *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 95 (1991) (same); *Jones v. H. F. Ahmanson & Co.*, 1 Cal. 3d 93 (1969) ("A shareholder's derivative suit seeks to recover for the benefit of the corporation and its whole body of shareholders when injury is caused to the corporation that may not otherwise be redressed because of failure of the corporation to act. Thus, 'the action is derivative, i.e., in the corporate right, if the gravamen of the complaint is injury to the corporation, or to the whole body of its stock or property without any severance or distribution among individual holders, or if it seeks to recover assets for the corporation or to prevent the dissipation of its assets.").

c. An action is derivative when brought by a shareholder on behalf of the corporation for harm suffered by all shareholders in common. *See Levine v. Smith*, 591 A.2d 194, 200 (Del. 1991) ("A shareholder derivative suit is a uniquely equitable remedy in which a shareholder asserts on behalf of a corporation a claim belonging not to the shareholder, but to the corporation."); *Lewis v. Knutson*, 699 F. 2d 230, 237-38 (5th Cir. 1983) ("When an officer, director, or controlling shareholder breaches [a] fiduciary duty to the corporation, the shareholder has no 'standing to bring [a] civil action at law against faithless directors and managers,' because the corporation and not the shareholder suffers the injury[; e]quity, however, allow[s] him to step into the corporation's shoes and to seek in its right the restitution he could not demand on his own."); *Avacus Partners, L.P. v. Brian*, CCH Fed. Sec. L. Rep. ¶ 96,232 (Del. Ch. 1990) (action is derivative because it is brought by one or more shareholders on behalf of the corporation rather than by the corporation itself); *see also*, *Katz v. Halperin,* 1996 WL 66006, at *4 (Del. Ch. Feb. 5, 1996) ("A proven claim of mismanagement resulting in corporate waste is a direct wrong to the corporation, and all stockholders experience an indirect wrong. Corporate waste claims are derivative, not individual.").

(1) "Although most derivative suits involve claims by a shareholder on behalf of a corporation, derivative suits also may be filed by members of an unincorporated association, such as a limited partnership." *Draper Fisher Jurvetson Mgmt. Co. V, LLC v. I-Enterprise Co. LLC*, 2004 WL 2944055, at *2 (N.D. Cal. Dec. 15, 2004) (plaintiff invested in venture capital funds, then alleged damages in the millions as a result of the defendants' fraudulent and negligent misrepresentation, breach of contract, breach of fiduciary duty, etc.; court held that most of the plaintiff's claims were derivative and had to be brought on behalf of the funds, of which plaintiff was a limited partner); *see also Caparos v. Morton*, 845 N.E.2d 773, 781 (Ill. App. 1 Dist. 2006) ("Limited partners seeking redress for the decreased value of their shares in the limited partnership must do so in a derivative action.").

(2) "The same factors that caused the courts to fashion the derivative action procedure for shareholders and limited partners thus apply to condominium unit owners. All are owners of fractional interests in a common entity run by managers who owe them a fiduciary duty that requires protection. Condominium unit owners are, therefore, entitled to the same consideration by the courts as the litigants in those situations in which the courts have historically allowed derivative actions to proceed, independent of any statutory authority." *Caprer v. Nussbaum*, 825 N.Y.S.2d 55, 67 (2d Dep't 2006).

d. In contrast, an action brought by a shareholder for harm done to an individual shareholder or a group of shareholders is a direct action. *See Kahn v. Kaskel*, 367 F. Supp. 784 (S.D.N.Y. 1973) (a class action by shareholders is based upon individual rights belonging to each member of the class); *Von Brimer v. Whirlpool Corp.*, 367 F.

Supp. 740 (N.D. Cal. 1973) (if the injury is to one of the shareholders and not the corporation, it is direct), *aff'd in part, rev'd on other grounds*, 536 F.2d 838 (9th Cir. 1976); *Behrens v. Aerial Comm., Inc.* Del. Ch., No. 17436 (May 18, 2001) ("The distinction between a direct and derivative claim . . . turns on the existence of direct or 'special' injury to the plaintiff stockholder.").

(1) A direct action can take many forms. *See, e.g., In re Worldcom, Inc.*, 323 B.R. 844, 850 (Bankr. S.D.N.Y. 2005) ("Common examples of direct actions include suits to compel the payment of a dividend, to protest the issuance of shares impermissibly diluting a shareholder's interest, to protect voting rights or to obtain inspection of corporate books and records."); *The Winer Family Trust v. Queen*, 2004 WL 2203709, at *25 (E.D. Pa. Sept. 27, 2004) ("If the injury is one to the plaintiff as an individual shareholder, as where the action is based on a contract to which the shareholder is a party, or on a right belonging severally to the shareholder, or on a fraud affecting the shareholder directly, or if there is a duty owed to the individual independent of the person's status as a shareholder, the shareholder may assert a direct action on his own behalf."); *Lefkowitz v. Wagner*, 395 F.3d 773, 777 (7th Cir. 2005) (held that partners in a general partnership have a right to bring individual suits against fellow partners; analogizing the position of a general partner's suit "to a suit by a minority shareholder against the majority shareholder, claiming that the latter has violated the fiduciary duty that such a shareholder, especially in a closely held corporation, owes to minority shareholders.").

2. How to Distinguish Between Direct and Derivative Actions?

a. It is not always easy to tell whether an action is derivative or direct. *See Abelow v. Symonds*, 156 A.2d 416, 420 (Del. Ch. 1959) ("[T]he line of distinction between derivative suits and those brought for the enforcement of personal rights asserted on behalf of a class of stockholders is often a narrow one, the latter type of actions being designed to enforce common rights running against plaintiffs' own corporation or those dominating it, while the former are clearly for the purpose of remedying wrongs to the corporation itself"). Often, the same set of facts gives rise to both direct and derivative claims. S*ee, e.g., Grimes v. Donald*, 673 A.2d 1207, 1212 (Del. 1996); *H. F. Ahmanson & Co.*, 1 Cal. 3d at 107 ("The individual wrong necessary to support a suit by a shareholder need not be unique to that plaintiff. The same injury may affect a substantial number of shareholders. If the injury is not incidental to an injury to the corporation, an individual cause of action exists.”); *Behrens*, Del. Ch., No. 17436 (“The distinction between a direct and derivative claim, which is difficult to apply in specific circumstances, turns on the existence of direct or ‘special’ injury to the plaintiff stockholder.”); *Tuscano v. Tuscano*, 403 F. Supp. 2d 214, 222 (E.D.N.Y. 2005) (“Obviously, any benefit derived by a corporation through derivative litigation will inure to an individual who owns half of that corporation. [But, that] standing alone, is not a reason to dismiss [a] plaintiff’’s lawsuit. Under New York law, a shareholder derivative action is an appropriate method for one fifty-percent shareholder to obtain relief in the name of the corporation against the other fifty-percent shareholder.”); *In re J.P. Morgan Chase & Co. S’’holders Litig.*, 2005 WL 1076069, at *6 (Del. Ch. Apr. 29, 2005) (“[When a] board of directors authorizes the issuance of stock for no or grossly inadequate consideration, the corporation is directly injured and shareholders are injured derivatively . . . [and] mere claims of dilution, without more, cannot convert a claim traditionally understood as derivative, into a direct one.”); *Gentile v. Rossette*, 2005 WL 2810683, at *4-5 (Del. Ch. Oct. 20, 2005) (plaintiffs’ claim for dilution for conversion of notes and stock was derivative; when board of directors authorizes the issuance of stock for no or grossly inadequate consideration the corporation itself is directly injured and the stockholders are injured derivatively); *Rawoof v. Texor Petroleum Co., Inc*., 521 F.3d 750, 757-58 (7th Cir. 2008) (plaintiff brought a direct action invoking the agency doctrine, claiming that he entered into an agreement with defendant corporation as an agent of his own company; court held that plaintiff was barred from bringing a direct claim because his status as a sole shareholder, officer and director of his own company did not “automatically make him an agent of the corporation for purposes of the transaction in question”).

(1) In *Gentile v. Rossette*, 906 A.2d 91, 99 (Del. 2006), the Delaware Supreme Court reversed the Chancery Court ruling in holding that a claim for dilution for conversion of notes and stock is not solely a derivative claim. The Court went on to explain that there is “a species of corporate overpayment . . . that Delaware case law recognizes as being both derivative and direct in character. A breach of fiduciary duty claim having this dual character arises where: (1) a stockholder having 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 stockholder, and a corresponding decrease in the share percentage owned by the public (minority)

shareholders. 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." *Id*. at 99-100. However, the "public (or minority) stockholders also have a separate, and direct, claim arising out of that same transaction . . . [b]ecause the shares representing the 'overpayment' embody both economic value and voting power, the end result of this type of transaction is an improper transfer—or expropriation—of economic value and voting power from the public shareholders to the majority or controlling stockholder. . . . A separate harm also results: an extraction from the public shareholders, and a redistribution to the controlling shareholder, of a portion of the economic value and voting power embodied in the minority interest. As a consequence, the public shareholders are harmed, uniquely and individually, to the same extent that the controlling shareholder is (correspondingly) benefited." *Id*. at 100.

(a) Following the holding in *Gentile*, the Delaware Supreme Court in *Gatz v. Ponsoldt*, held that public shareholders who became minority shareholders as a result of recapitalization could bring their claims arising out of the recapitalization as direct claims. 2007 WL 1120338, at *1, 9 (Del. Apr. 16, 2007). The public shareholders argued, and the Court agreed, that the complaint alleged a direct claim for breach of fiduciary duty . . . "because the Recapitalization constituted an expropriation of voting power and economic value from [the Company's] public stockholders, and a transfer of that voting power and economic value to [the defendants], to the corresponding detriment of [the Company's] public shareholders—all accomplished by [the Company's] de facto controlling stockholder . . . ." *Id*. at *9.

b. Courts "have wide discretion" to determine whether an action is derivative or direct. *See e.g., Hanson v. Kake Tribal Corp.,* 939 P.2d 1320 (Alaska 1997) (looking to the adequacy of the remedies under derivative and direct actions).

c. Deciding whether an action is direct or derivative has been greatly complicated by courts that use a "special injury" test to determine whether a claim is direct or derivative. These courts require shareholders to show that they have suffered a special or distinct injury from other shareholders in order to bring a direct claim. *See, e.g.*, *Geer v. Cox*, 242 F. Supp. 2d 1009, 1018 (D. Kan. 2003) ("Because plaintiff has failed to show that there was any duty owed to him that was not owed to all shareholders . . . or that he suffered any harm individually, his direct claim must be dismissed . . .") (interpreting Delaware law); *Pate v. Elloway*, 2003 WL 22682422, at *2 (Tex. App. Hous. Nov. 13, 2003) ("To have standing to assert a direct or individual claim, a stockholder must allege an injury that is separate and distinct from other stockholders . . .") (applying Delaware law). Other cases, however, have rejected this line of reasoning. *See, e.g., Strougo v. Bassini*, 282 F.3d 162, 172 (2d Cir. 2002) ("[W]here shareholders suffer a distinct injury, i.e., an injury that does not derive from corporate injury, they may bring direct suit, even if their injury is undifferentiated among them.") (interpreting Maryland law and rejecting "undifferentiated effect on shareholders" standard followed in other jurisdictions); *Kennedy v. Venrock Assoc.*, 348 F.3d 584, 591-92 (7th Cir. 2003) ("The charge that [the corporation's] directors issued a misleading proxy statement in violation of their fiduciary obligation is a legitimate direct claim . . . since the effect of the reincorporation was to reduce the shareholders' power over the corporation's affairs rather than to reduce the value of the corporation. It shows that a direct suit is not necessarily precluded by the common shareholders having suffered an 'undifferentiated harm.' They can suffer such a harm without the corporation's being injured."); *Dansie v. City of Herriman*, 134 P.3d 1139, 1144 (Utah 2006) ("A shareholder does not sustain an individual injury because a corporate act results in disparate treatment among shareholders. Rather, the shareholder must examine his injury in relation to the corporation and demonstrate that the injury was visited upon him and not the corporation."); *PricewaterhouseCoopers, LLP v. Massey*, 860 N.E.2d 1252, 1262 (Ind. Ct. App. 2007) (shareholder directors could not bring a direct action against company auditor because they did not suffer an injury separate and distinct from that suffered by all other shareholders; the value of their stock declined, but they had no additional out-of-pocket expenses due to their positions on the Board).

d. In 2004, the Delaware Supreme Court, acknowledging the prior "confusing jurisprudence on the direct/derivative dichotomy," stated that it "disapprove[d] [of] the use of the concept of 'special injury' as a tool" in analyzing whether a claim is direct or derivative. *See Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1035 (2004). The Court held: "We set forth in this Opinion the law to be applied henceforth in determining whether a stockholder's claim is derivative or direct. That issue must turn *solely* on the following questions: (1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?" *Id*. at 1033. The Court disapproved the concept that a claim is necessarily derivative if it affects all stockholders equally. *Id*. Rather, the focus, under the new test, is whether the stockholder has shown that he or she has suffered an injury that is not dependent on injury to the corporation. *Id*. at 1036.

(1) In *Tooley*, plaintiff stockholders brought a purported class action alleging that the members of the board of directors breached their fiduciary duties by agreeing to a 22-day delay in closing a proposed merger. Plaintiffs alleged that the delay cost them the lost time-value of the cash paid for their shares. *See id.* at 1033. The Court held that plaintiffs failed to state a derivative claim because they did not show an "injury to the corporate entity" or seek relief that "would go to the corporation. Accordingly, there is no basis to hold that the complaint states a derivative claim." *Id.* at 1039.

(2) *See also, Agostino v. Hicks*, 845 A.2d 1110, 1121 (Del. Ch. 2004) ("[W]hat must be discarded is the notion of using special injury, *i.e*., 'injury which is separate and distinct from that suffered by other shareholders' as a talismanic entreaty to the assertion of an individual claim. . . [T]he more grounded approach [is to ask] whether the plaintiff has suffered injury 'independent of any injury to the corporation.'").

(3) Many courts have subsequently applied the principles set forth in *Tooley*. *See, e.g., Marcoux v. Prim*, 2004 WL 830393, at *12 (N.C. Super. April 16, 2004) (relying on *Tooley*, held that plaintiffs stated a direct breach of fiduciary duty claim that directors failed to get a fair price for the corporation's stock in a merger because the injury was to the shareholders, not the corporation); *In re Syncor Int'l Corp. S'holders Litig.*, 857 A.2d 994, 996-97 (Del. Ch. 2004) (applying *Tooley*, the court found that shareholders did not have a direct claim against the company for the reduced price they received for their shares in a merger due to the misconduct of the company's founder and former chairman; rather, the claim was derivative because "the alleged misconduct was in connection with Syncor's core business activities and, if proven, would involve a breach of the duty of loyalty owed to Syncor. Moreover, although the immediate effect of the misconduct might have been to benefit Syncor through increased sales and profits, there is no mistaking that the alleged misconduct caused substantial

injury to Syncor, which became the focus of multiple criminal and civil proceedings."); *Dieterich v. Harrer*, 857 A.2d 1017 (Del. Ch. 2004) (mismanagement that precluded company from entering more lucrative merger transaction deemed derivative under *Tooley*); *Smith v. Waste Mgmt, Inc.*, 407 F.3d 381, 385 (5th Cir. 2005) (using the test articulated in *Tooley*, the court held that "when a corporation, through its officers, misstates its financial condition, thereby causing a decline in the company's share price when the truth is revealed, the corporation itself has been injured," and not just the shareholder); *Schuster v. Gardner*, 127 Cal. App. 4th 305, 313, 315-16 (2005) (action arising from alleged mismanagement improprieties of officers and directors of corporation and the attendant decline in company's stock value deemed derivative under either California or Delaware (applying *Tooley*) law); *McCarthy v. Middle Tennessee Elec. Membership Corp.*, 466 F.3d 399, 409-10 (6th Cir. 2006) (Sixth Circuit held that the Tennessee Supreme Court, if presented with the issue, "would likely adopt the rule articulated in *Tooley*").

e. An increasing number of courts have also abandoned the distinction between direct and derivative actions in the context of closely held corporations. *See Marcuccilli v. Ken Corp.*, 766 N.E. 2d 444, 450 (Ind. Ct. App. 2002) (quoting *Barth v. Barth*, 659 N.E. 2d 559 (Ind. 1995)) (quoting A.L.I., *Principles of Corporate Governance* § 7.01(d)) ("In the case of a closely held corporation, the court in its discretion may treat an action raising derivative claims as a direct action, exempt it from those restrictions and defenses applicable only to derivative actions, and order an individual recovery, if it finds that to do so will not (i) unfairly expose the corporation or the defendants to a multiplicity of actions, (ii) materially prejudice the interests of creditors of the corporation, or (iii) interfere with a fair distribution of the recovery among all interested persons."); *see also Sharkey v. Emery*, 272 B.R. 574, 582-83 (Bankr. D.N.J. Nov. 2001) (relying on *Brown v. Brown*, 323 N.J. Super. 30, 36 (App. Div. 1999) (the distinction between derivative and direct actions in a closely held corporation is immaterial where defendants will not be exposed to a multiplicity of actions, creditors, interests could be protected, and proceeds could be distributed fairly among interested persons); *Hubbard v. Tomlinson*, 747 N.E. 2d 69, 71-72 (Ind. Ct. App. 2001) (quoting the Indiana Supreme Court in *G & N Aircraft, Inc. v. Boehm*, 743 N.E. 2d 227, 236 (2001)) ("[A] shareholder in a close corporation need not always bring claims of corporate harm as derivative actions[;] rather, in such an arrangement, the shareholders are more realistically viewed as partners, and the formalities of corporate litigation may be bypassed."); *DeHoff v. Veterinary*

Hospital Operations of Central Ohio, Inc., 2003 WL 21470388, at *14 (Ohio App. 10 Dist. June 26, 2003) (allowing minority shareholder of closely held corporation to bring a direct action for breach of fiduciary duty against controlling shareholder because a derivative remedy would primarily benefit the alleged wrongdoers); *Fritzmeier v. Krause Gentle Corp.*, 669 N.W.2d 699, 707-08 (2003) (allowing shareholders of wholly owned corporations to pursue a direct action because there is no distinction between the shareholder and the corporation, and thus, no danger of duplicative recovery); *but see Mynatt v. Collis*, 57 P.3d 513, 529-30 (Kan. 2002) (although it recognized the "close corporation exception," the Court emphasized that "the decision whether to allow a party to proceed with a direct suit in lieu of a derivative action is entrusted to the court's discretion"; even if all three prongs are met (as discussed in *Marcuccilli* above) a court, "in its equitable power and discretion," can deny a shareholder from bringing a direct action); *Redeker v. Litt*, 2005 WL 1224697, at *5 (Iowa Ct. App. May 25, 2005) ("If a closely held corporation operates more like a partnership, some jurisdictions allow the shareholders to bring an individual action, even though the cause of action may technically be that of the corporation."); *Woolard v. Davenport*, 601 S.E.2d 319, 324-25 (N.C. Ct. App. 2004) (quoting *Norman v. Nash Johnson & Sons' Farms, Inc.*, 537 S.E.2d 248, 258 (N.C. Ct. App. 2000)) ("[I]t seems particularly appropriate to allow minority shareholders to file individual actions when a dispute arises within the context of a family owned corporation, or other corporation in which all shares of stock are held by a relatively small number of shareholders . . . . When the close relationships between the shareholders in a 'family' or closely held corporation tragically break down, the majority of shareholders are obviously in a position to exclude the minority shareholders from management decisions, leaving the minority shareholders with few remedies."); *Durham v. Durham*, 871 A.2d 41, 46 (N.H. 2005) ("A direct action may be appropriate in this case because all of the corporation's shareholders are before the court as either the plaintiff or defendants; thus, there is no risk that a direct suit would expose the corporation to a multiplicity of actions.").

f. Most states, including Delaware, however, have yet to adopt this so-called "closely held corporation exception." *See* Ferrara, Abikoff, Gansler, *Shareholder Derivative Litigation: Besieging the Board* §-1.02[2] (hereinafter "Ferrara, et al."); *see also Glod v. Baker*, 851 So. 2d 1255, 1264-67, 1276 (La. App. 3rd Cir. Aug. 6, 2003) (shareholders in closely held corporations, partnerships and limited liability companies could not pursue individual claims on their own behalf even though they were "severely personally damaged as a result of the wrongs done to their entities" because the right of action belonged solely to the entities); *Mannos v. Moss*, 155 P.3d

1166, 1172 (Idaho 2007) (shareholder in closely-held corporation could not bring a direct claim; "[a]ny claim . . . regarding the defendants depletion of corporate assets [could] only be pursued by [plaintiff] through a derivative action").

3. State Law Applies

a. State law controls the determination of whether an action is derivative or direct in diversity actions brought in federal court. *Sax v. World Wide Press, Inc.*, 809 F.2d 610, 613 (9th Cir. 1987) (characterization of an action as derivative or direct question of state law); *Seidel v. Allegis Corp*., 702 F. Supp. 1409 (N.D. Ill. 1989) (same); *Gadd v. Pearson*, 351 F. Supp. 895 (M.D. Fla. 1972) (same); *Sybold v. Groenink*, 2007 WL 737502, at *5-6 (S.D.N.Y. Mar. 12, 2007) (court applied New York's "internal affairs" doctrine to hold that plaintiff lacked standing to bring a derivative action under Dutch law).

B. Standing Requirements

1. Plaintiffs Must Be a Shareholder at Time of Suit

a. Most states and Federal Rule of Civil Procedure 23.1 require a plaintiff to be a shareholder of the corporation at the time a derivative action is filed and at the time of the challenged transaction. *See Ferrara*, et al., § 4.02[1] and [2] and cases and statutes cited therein; *see also* Wright, Miller & Kane, *Federal Practice and Procedure: Civil 2d* § 1826 and § 1828 and cases cited therein. The second requirement is often known as the "contemporaneous ownership" requirement. This requirement is designed to curtail strike suits by prohibiting potential plaintiffs from buying into a lawsuit or commencing a derivative action by simply purchasing shares after the alleged wrong has occurred. *See, e.g., Brambles USA, Inc. v. Blocker*, 731 F. Supp. 643 (D. Del. 1990); *In re Penn Cent. Transp. Co.*, 341 F. Supp. 845 (E.D. Pa. 1972).

(1) When all of a company's stock is owned through an Employee Stock Ownership Plan ("ESOP"), the ESOP shareholders "must be left with some type of recourse if the trustee is unable or unwilling to sue the officers of the corporation for a breach of their fiduciary duties." *Housman v. Albright*, 368 Ill. App. 3d 214, 220 (2006). Hence, ESOP participants are considered "equitable stockholders and have standing to maintain a shareholders' derivative suit." *Id*.

(2) In *Tzolis v. Wolff*, 10 N.Y.3d 100, 109 (2008), the court held that members of Limited Liability Companies ("LLC") may sue derivatively. Because the court found "no clear legislative mandate" barring the courts from entertaining derivative actions by LLC members, it concluded that derivative actions by LLC members should be recognized "even though no statute provides for them." *Id.*

(3) In *Schoon v. Smith*, 953 A.2d 196, 200 (Del. 2008), appellant, a director, but not a shareholder, of a privately held Delaware corporation filed a derivative action on behalf of the company alleging breaches of fiduciary duties by his fellow directors. The appellant argued that "as a matter of equity and public policy, a director should be entitled to assert a derivative claim on behalf of the corporation for the same reasons that stockholders are permitted to do so[,] []…urg[ing] that equipping directors with standing to sue derivatively is consistent with the fiduciary duties of directors and 'promotes the core Delaware public policy of protecting against misconduct by faithless fiduciaries.'" *Id.* The Delaware Supreme Court found no statutory authority for standing to sue as a director, and although it was empowered to extend the doctrine of equitable standing for a director to bring a derivative action, it declined to do so because it did not want to embrace "a policy that w[ould] divert the doctrine from its original purpose: to prevent a complete failure of justice." *Id.* 210. The appellant did not show that a "complete failure of justice" would occur unless he was granted standing to sue as a director, so the court affirmed the Chancery Court's dismissal for lack of standing. *Id.*

b. In diversity actions brought under Federal Rule 23.1, a threshold question is whether the court looks to state or federal law to determine a plaintiff's standing. The first requirement (i.e., that the plaintiff be a shareholder of the corporation at the time the action was filed) is governed by state law. *See* Wright & Miller § 1826 and cases cited therein. Courts have also generally held that the contemporaneous ownership requirement is procedural and have applied the contemporaneous ownership requirement found in Federal Rule 23.1 in the face of inconsistent state law. *See, e.g., Kona Enter., Inc. v. Estate of Bishop*, 179 F.3d 767, 769 (9th Cir. 1999); *Perrott v. U.S. Banking Corp.*, 53 F. Supp. 953 (D. Del. 1944); *Piccard v. Sperry Corp.*, 36 F. Supp. 1006 (S.D.N.Y.), *aff'd without opinion*, 120 F.2d 328 (2d Cir. 1941).

c. The size of plaintiff's financial stake in the corporation is immaterial. *Koster v. (American) Lumbermens Mut. Cas. Co.*, 330 U.S. 518 (1947); *Subin v. Goldsmith*, 224 F.2d 753, 761 (2d Cir. 1955). The only time a plaintiff's financial stake may be of consequence is where state law provides security-for-expenses. States that have adopted security-for-expenses statutes include Arizona, California, Colorado, Florida, Nebraska, New Jersey, New York, Pennsylvania, and Wisconsin. For a general discussion on securities-for-expenses statutes *see* Wright & Miller § 1835 and cases cited therein.

2. The Requirement that a Shareholder Own Stock When a Derivative Action Is Started

a. Maryland and New York have statutes that expressly require stock ownership at the time an action is commenced. *See* Md. Code Ann. § 4A-802 and N.Y. Bus. Corp. L. § 626. Other jurisdictions have judicially imposed this requirement. *See, e.g., Weffel v. Kramarsky*, 61 F.R.D. 674, 679 (S.D.N.Y 1974).

b. In some jurisdictions, beneficial owners are not permitted to bring derivative actions. *See Ferrara*, et al., § 4.02[1]. Other states expressly allow beneficial owners to bring such suits. *See id.* and statutes cited therein.

(1) The Court of Appeals of Kansas, in a case that involved record, but not beneficial, owners of stock held that a shareholder need not be a beneficial owner of stock in the corporation to have standing, finding that a "mere nominal owner of stock" has standing to bring a derivative suit because the nominal owner has an ongoing proprietary interest in the corporation. *Quality Dev., Inc. v. Thorman*, 31 P.3d 296, 301-02 (Kan. Ct. App. 2001).

(2) In *Daly v. Yessne*, 131 Cal. App. 4th 52, 60-61 (2005), the defendants asserted that plaintiff lacked standing to bring a shareholder derivative action because it was undisputed that all but one of the alleged acts took place before she acquired her shares. Plaintiff conceded this fact, but maintained she held a "vested beneficial interest" in the stock from the time she signed the Stock Repurchase Agreement. *Id*. The court disagreed, finding that "plaintiff had no current investment, direct or through a third party, in [the company] when most of the challenged events occurred," therefore, her interest before she acquired her shares was "only a contractual arrangement that permitted her to buy stock in the company; like a holder of a warrant or convertible debenture, she had

not assumed the risks and benefits of stock ownership." *Id*. The court concluded that the "plaintiff had no standing to bring a derivative claim for acts that took place before she converted her options into shares." *Id*.

c. In some community property states, a spouse has a beneficial interest arising from the other spouse's ownership of stock. *See, e.g.*, *American Guar. & Liab. Ins. Co. v. Keiter*, 360 F.3d 13, 18 (1st Cir. 2004) ("In Washington, a community property state, one spouse is deemed to have a beneficial interest in stock owned by the other spouse by virtue of the one-half community property interest" and is not contingent upon the other spouse's death because the non-ownership spouse is not merely a legatee, but rather, is an owner of the one-half community interest).

d. Those jurisdictions that do not have statutes addressing the issue, such as Delaware, look to see if the plaintiff has an equitable interest in the stock. *Quality Dev.*, 31 P.3d at 301-02. (citing *Anadarko Petroleum Corp. v. Panhandle E. Corp.*, 545 A.2d 1171, 1176 (Del. 1988); *Harrf v. Kerkorian*, 324 A.2d 215, 218 (Del. Ch. 1974), *aff'd in part*, *rev'd in part* 347 A.2d 133 (Del. 1975); *Rosenthall v. Burry Biscuit Corp.*, 60 A.2d 106, 113 (Del. Ch. 1948)).

e. The British Virgin Islands—an increasingly popular jurisdiction for incorporating—has a "leave to sue" provision requiring a shareholder in a B.V.I. corporation to obtain leave to initiate a derivative suit. On May 26, 2009, a California appellate court held that the "internal affairs doctrine" required the court to apply B.V.I. law and affirm a derivative action's dismissal because the plaintiff had not complied with the "leave to sue" provision. *Vaughn v. LJ Int'l, Inc.*, 174 Cal. App. 4th 217, 223-25 (2009).

3. The Contemporaneous Ownership Requirement

a. In most jurisdictions, a derivative plaintiff must have been a shareholder at the time of the challenged transaction and must remain a shareholder pending the outcome of the litigation. *See, e.g.*, *Lewis v. Anderson*, 477 A.2d 1040, 1049 (Del. 1984) ("[A] plaintiff who ceases to be a shareholder, whether by reason of a merger or for any other reason, loses standing" to sue derivatively); *see also Brambles USA, Inc.*, 731 F. Supp. at 648 ("[A] derivative plaintiff [must] be a shareholder of the corporation at the time of the transaction of which he complains . . . [and] must also maintain that status throughout the lawsuit"); *Schilling v. Belcher*, 582 F.2d 995, 996 (5th Cir. 1978) ("[A] shareholder who sells his stock pending appeal of a favorable judgment in a stockholder's derivative suit . . .

loses standing to further prosecute or defend the case"); *Strategic Asset Mgmt., Inc. v. Nicholson*, 2004 WL 2847875, at *3 (Del Ch. Nov. 30, 2004) (rejecting the argument that a shareholder need not maintain his or her status as a shareholder in situations where a settlement agreement has been reached; holding, instead, that a settlement agreement "without a final judgment by the Court" does not terminate the litigation). The purpose of this rule is "to prevent what has been considered an evil, namely, the purchasing of shares in order to maintain a derivative action designed to attack a transaction which occurred prior to the purchase of stock." *Burry Biscuit Corp*., 60 A.2d at 111.

(1) Courts have increasingly rejected general allegations of stock ownership "at all relevant times" and required shareholders to plead contemporaneous ownership with particularity. *See In re Computer Sciences Corp. Deriv. Litig*., 2007 WL 1321715, at *15 (C.D. Cal. Mar. 26, 2007) ("[G]eneral allegation[s] [are] insufficient to allege contemporaneous ownership during the period in which the questioned transactions occurred."); *see also Belova v. Sharp*, 2008 WL 700961, at *3 (D. Or. Mar. 13, 2008) ("A plaintiff's allegation of ownership must be sufficiently particularized."); *Travis v. Mittelstaedt*, 2008 WL 755842, at *2 (E.D. Cal. Mar. 19, 2008) (finding general allegations of stock ownership insufficient). *But see Plymouth County Retirement Ass'n v. Schroeder*, 576 F. Supp. 2d 360, 374 (E.D.N.Y. 2008) ("[T]he law of [the Second] Circuit does not require that the plaintiff indicate the specific dates or time-periods on which it obtained MSC stock.").

(2) If a plaintiff sells its shares during a derivative action's pendency, another qualified shareholder can intervene to maintain the lawsuit because their rights are no longer represented. *In re Extreme Networks, Inc. S'holders Deriv. Litig.*, 573 F. Supp. 2d 1228, 1237 (N.D. Cal. 2008) (after dismissing derivative complaint without prejudice because lead plaintiff sold all his shares in the company, the court requested other plaintiffs and intervening shareholders to file new motions to appoint lead plaintiff).

b. Exceptions to the Contemporaneous Ownership Rule

(1) Statutory Exceptions

(a) Several state statutes provide exceptions to the contemporaneous ownership rule. *See, e.g.*, Alaska Stat. § 10.06.435; Cal. Corp. Code § 800; Ill. Ann.

Stat., Ch. 32, § 7.80; 15 Pa. Stat. § 1782; Va. Code Ann. § 13.1-672.1.

(i) In *Lynn v. Martin County Marine Corp*., 980 So. 2d 536 (Fla. App. 4 Dist. Apr. 2, 2008), shareholders brought a derivative action and then sold their shares and assigned their rights in the action to a third-party buyer. The third-party buyer wanted to maintain the derivative action and was allowed to do so under Section 607.07401(1) of the Florida Statutes. *Id*. Section 607.07401(1) states that "A person may not commence a proceeding in the right of a domestic or foreign corporation…unless the person became a shareholder through transfer by operation of law from one who was a shareholder at that time." *Id*.

(b) Factors used to determine whether the exception should apply include: (1) whether there is a strong *prima facie* case in favor of the claim; (2) whether a similar action has or is likely to be commenced; (3) whether the shareholder acquired shares in the corporation before public disclosure of the alleged misconduct; (4) whether the defendant(s) will be permitted to retain ill-gotten gains if the suit does not go forward; and (5) whether the suit, if successful, will result in unjust enrichment to the shareholder. *Ferrara*, et al., § 4.02[3] collecting factors from Alaska's and California's statutes.

(2) The Continuing Wrong Doctrine

(a) Under the continuing wrong doctrine, the contemporaneous ownership requirement will not apply where the alleged wrong is occurring at the time the shareholder bought stock even if it began before the shareholder purchased the stock. *See, e.g., Brambles USA, Inc.*, 731 F. Supp. at 643; *Noland v. Barton*, 741 F.2d 315 (10th Cir. 1984); *see also* cases cited in Wright & Miller § 1828.

(b) Recently, the Second Circuit, declining to adopt an expansive interpretation of the continuing wrong doctrine, held that plaintiff "must have acquired his or her stock in the corporation before the core of the allegedly wrongful conduct transpired." *In re Bank of New York Deriv. Litig.*, 320 F.3d 291, 298 (S.D.N.Y. 2003). *See also Lerner v. Allaire*, 2003 WL 22326504, at *3 (D. Conn. Sept. 30, 2003) ("[A] proper plaintiff must have acquired his or her stock in the corporation before the core of the allegedly wrongful conduct transpired").

(c) The cost of defending against related class-action lawsuits and the negative impact of a company's standing in the financial markets does not constitute continuing harm. *In re Omnivision Tech., Inc.*, 2004 WL 2397586, at *3 (N.D. Cal. Oct. 26, 2004) (concluding that "such open-ended injuries" as a company's "legal woes" and "reduced standing" in the capital markets "are well outside the bounds of the continuing wrong doctrine" because they could "continue for years").

(d) Not all courts allow a plaintiff to allege a continuing wrong to overcome the contemporaneous ownership rule. *See, e.g., Pullman-Peabody Co. v. Joy Mfg.*, 662 F. Supp. 32 (D. N.J. 1986) (rejecting continuing wrong exception to the contemporaneous ownership rule); *Herald Co. v. Seawell*, 472 F.2d 1081 (10th Cir. 1972) (same); *Lowell Wiper Supply Co. v. Helen Shop, Inc.*, 235 F. Supp. 640, 647 (S.D.N.Y. 1964) (shareholder could not maintain action on the theory that payment of dividends subsequent to plaintiff's ownership constituted continuing wrong); *Cadle v. Hicks*, 2008 WL 895992, at *2-3 (10th Cir. Apr. 2, 2008) (shareholder filed derivative action challenging indemnification of corporation's CEO for legal fees incurred in connection with litigation, even though he purchased his shares after the company's indemnification decision; court held that periodic indemnification payments did not amount to a continuing wrong); *Conrad v. Blank*, 940 A.2d 28, 41-42 (Del. Ch. 2007) (rejecting continuing wrong theory in stock-option backdating context).

(3) The Contemporaneous Ownership Rule and Mergers

(a) Normally, a merger destroys a derivative claim. Thus, under the general rule, a plaintiff loses standing to maintain a derivative action where a merger has occurred. *See, e.g., Schreiber v. Carney*, 447 A.2d 17, 21 (Del. Ch. 1982) ("[U]pon the merger the derivative rights pass to the surviving corporation which then has the sole right or standing to prosecute the action"); *Lewis v. Anderson*, 477 A.2d 1040, 1047 (Del. 1982) ("A merger which eliminates ownership of stock eliminates standing to pursue a derivative claim."); *see also*, *Lewis v. Ward*, 852 A.2d 896, 904 (Del. 2004) (affirming *Lewis v. Anderson*) (concluding that "the established principle of Delaware corporate law recogniz[es] the separate corporate existence and identity of corporate entities, as well as the statutory mandate that the management of every corporation is vested in its board of directors, not its stockholders."); *In re Countrywide Fin. Corp. Deriv. Litig.*, 581 F. Supp. 2d 650, 653 (D. Del. 2008) (adhering to long line of Delaware state law precedent when granting motion to dismiss for lack of standing following Countrywide's merger with Bank of America).

(i) The issue of whether a plaintiff maintains standing to continue to prosecute a derivative action following a merger under California law was recently resolved by the California Supreme Court in *Grosset v. Wenaas*, 42 Cal. 4th 1100 (2008). The Court held "California law, like Delaware law, generally requires a plaintiff in a shareholder's derivative suit to maintain continuous stock ownership throughout the pendancy of the litigation. *Id*. at 1119. "Under this rule, a derivative plaintiff who ceases to be a stockholder by reason of a merger ordinarily loses standing to continue the litigation. Although equitable considerations may warrant an exception to the continuous ownership requirement if the merger itself is used to wrongfully deprive the plaintiff of standing, or if the merger is merely a reorganization that does not affect the plaintiff's ownership interest…." *Id*.

(ii) When a federal court sits in diversity jurisdiction, it will apply the law of the state of incorporation, rather than "federal common law" when analyzing standing in the post-merger context. *In re Merrill Lynch & Co.,* *Inc. Sec., Deriv. & ERISA Litig.*, 597 F. Supp. 2d 427, 430-31 (S.D.N.Y. 2009) (applying Delaware law when ruling that Merrill Lynch merger with Bank of America eliminated the plaintiff's standing to continue the derivative action).

(b) There are, however, exceptions to this rule. For example, Delaware allows a shareholder to maintain a derivative action if the merger is the subject of a fraud claim and was perpetrated merely to deprive shareholders of standing. *See Kramer v. Western Pac. Indus.*, 546 A.2d 348, 354 (Del. 1988); *see also Arnett v. Gerber Scientific, Inc.*, 566 F. Supp. 1270, 1273 (S.D.N.Y. 1983) (shareholders had standing to sue after merger because "(1) plaintiffs' disposition of the stock was involuntary; (2) the disposition was related to the allegedly illegal acts of defendants; and (3) the remedy sought [rescission of the merger] would result in plaintiffs regaining shareholder status"). This exception is difficult to plead. *See,e.g., Lewis v. Ward*, 2003 WL 22461894, at *5 (Del. Ch. Oct. 29, 2003) (the exception to the contemporaneous ownership rule in the merger context "requires a showing that the sole basis for [the corporation's] decision to enter the merger was to divest the plaintiff of derivative standing"; the absence of well-pled facts suggesting that defendants' derivative liability was so substantial as to have been the motivating factor for a pre-textual merger with another company is fatal); *Kolancian v. Snowden*, 532 F. Supp. 2d 260, 263 (D. Mass. 2008) ("plaintiff must plead fraud not only on the part of the acquired corporation, *but also on the part of the surviving entity*…"). Shareholders relying on this exception must plead with particularity facts showing the fraud. *Id*. at *4-5.

(c) A shareholder also has standing to bring a derivative suit if the merger is simply a reorganization that does not affect plaintiff's ownership in the business enterprise. *See Kramer*, 546 A.2d at 354; *see also Schreiber*, 447 A.2d at 17 (because the "structure of the old and new companies [was] virtually identical" and thus "had no meaningful effect on the plaintiff's ownership of the business enterprise," the plaintiff did not lose standing to maintain derivative action).

(d) The American Law Institute proposed a rule that would allow a derivative plaintiff to maintain suit following the loss of stockholder status if that loss was the result of a corporate action in which the holder did not acquiesce, and either: (1) the derivative action was commenced prior to the corporate action terminating the holder's status, or (2) the court finds that the holder is better able to represent the interests of the shareholders than any other holder who has brought suit. Principles of Corp. Governance § 7.02(a)(2) (2003).

(e) *Compare FirstCom, Inc. v. Qwest Corp.*, 2004 WL 2315289, at *2-3 (D. Minn. Oct. 13, 2004) (under Minnesota's Business Corporations Act, shareholders of defunct company still had standing to bring derivative suit).

4. Standing for Derivative Action Involving Insolvent Company Subject to Bankruptcy Court Jurisdiction

a. Upon the commencement of a bankruptcy proceeding, derivative claims become the property of the bankruptcy estate and are subject to the control of the Bankruptcy Court. *See, e.g., Thornton v. Bernard Tech., Inc.*, 2009 WL 426179, at *3 (Bankr. D. Del. Feb. 20, 2009); *In re The 1031 Tax Group, LLC*, 397 B.R. 670, 680-81 (Bankr. S.D.N.Y. 2008) (holding that breach of fiduciary duty and negligence claims are derivative and belong to the trustee). The right to bring a derivative action asserting claims for injury to the debtor corporation by its officers and directors vests exclusively to the trustee. *Thornton*, 2009 WL 426179, at *3 n.9.

b. If a derivative action is pending at the time the bankruptcy petition is filed, it must be dismissed unless the plaintiff is able to show: (1) the bankruptcy trustee has affirmatively assigned or abandoned the derivative claims to the plaintiff; and (2) the Bankruptcy Court approves of the plaintiff's continued prosecution of the derivative claims. *Thornton*, 2009 WL 426179, at *3-4 (dismissing derivative suit because the plaintiff failed to show that the trustee had abandoned or assigned the derivative claims).

C. The Demand Requirement

1. As discussed above, a derivative action redresses harm to the corporation. *See, e.g., H. F. Ahmanson & Co.*, 1 Cal. 3d at 93 ("A stockholder's derivative suit is brought to enforce a cause of action which the corporation itself possesses against some third party, a suit to recompense the

corporation for injuries which it has suffered as a result of the acts of third parties."). Thus, there is a presumption that the corporation, through its directors and officers, controls the decision to pursue a claim on behalf of the company. Accordingly, a shareholder that wishes to maintain a derivative action must attempt to secure corporate action through a demand to the board that it initiate the litigation. *See Grimes*, 673 A.2d at 1207 (citing *Kamen*, 500 U.S. at 90); *see also Delaware & Hudson Co. v. Albany & Susquehanna R.R. Co.*, 213 U.S. 435, 447 (1909) (demand requirement "recognizes the right of the corporate directory to corporate control; in other words, to make the corporation paramount, even when its rights are to be protected or sought through litigation"). The demand requirement is not limited to corporations, but also applies to business trusts and investment funds. *See ING Principal Protection Funds Deriv. Litig.*, 369 F. Supp. 2d 163, 171 (D. Mass. 2005) (applying universal demand requirement to derivative action brought on behalf of business trust). One way around this requirement, as discussed below, is to allege demand futility.

2. To satisfy the demand requirement, a complaint must "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires . . . and the reasons for the plaintiff's failure to obtain the action or for not making the effort." Del. Ch. Ct. R. 23.1; *see also* Cal. Corp. Code § 800(b)(2) ("[P]laintiff [must] allege in the complaint with particularity plaintiff's efforts to secure from the board such action as plaintiff desires, or the reasons for not making such effort"); N.Y. Bus. Corp. Law § 626(c) ("The complaint shall set forth with particularity the efforts of the plaintiff to secure the initiation of such action by the board or the reasons for not making such effort"). Because of the particularity requirement, notice pleading is insufficient. *Grobow v. Perot*, 539 A.2d 180, 187 (Del. 1989) ("[C]onclusionary allegations of fact or law not supported by allegations of specific fact [are] not [to] be taken as true"); *Allison ex rel. General Motors Corp. v. General Motors Corp.*, 604 F. Supp. 1106, 1112 (D. Del. 1985) (Rule 23.1 "is a marked departure from the 'notice' pleading philosophy of the Federal Rules of Civil Procedure").

   a. *In re Merck & Co., Inc. Sec., Deriv. & ERISA Litig.*, 493 F.3d 393 (3d Cir. 2007), shareholders filed a derivative action against the directors and officers of Merck. The District Court granted Merck's motion to dismiss and denied shareholders leave to amend their complaint. The shareholders appealed. The Third Circuit, "agree[d] with the District Court and Merck that, as a general rule, a plaintiff in a shareholder derivative suit may not use discovery to amend demand futility allegations. Whether the discovered materials existed before or after the filing of the operative complaint does not alter [the] analysis. However, this case presents a rare exception to this rule because both parties voluntarily entered into a stipulated discovery agreement that did not preclude the plaintiffs from using this after-acquired information in an amended complaint. Thus, the standard argument——that allowing discovery in demand futility scenarios undermines the authority of the corporation to decide whether to bring suit against itself and gives incentive to shareholder to engage in fishing expeditions——has no applicability when the plaintiffs and the corporation voluntarily agree to permit limited discovery." *Id*. at 401.

3. To make a demand a shareholder generally must send a letter or draft complaint or other comparable communication to the board of directors although some state statutes and Federal Rule 23.1 do allow a demand to be made on someone other than the board if that party is of "comparable authority." For a list of state statutes allowing demand on "comparable authority" *see Ferrara*, et al., § 3.03[1] n.11.

   a. The following cases have considered the issue of who besides the board of directors may be served with a demand: *Kaster v Modification Sys., Inc.*, 731 F.2d 1014, 1017-19 (2d Cir. 1984) (demand on individual who was president and chairman of the board and who owned 71% of voting stock was not sufficient); *Greenspun v. Deb E. Webb Corp.*, 634 F.2d 1204, 1209 (9th Cir. 1980) (demand to individual who was president, director, and general counsel of company insufficient); *In re Penn Cent. Sec. Litig.*, 335 F. Supp. at 1026 (demand on receiver or trustee for a bankrupt company sufficient); *Kemper v. Am. Broad. Cos.*, 365 F. Supp. 1272, 1274 (S.D. Ohio 1973) (same); *Womble v. Dixon*, 585 F. Supp. 728, 731 (E.D. Va. 1983), *aff'd in part, vacated in part* 752 F.2d 80 (4th Cir. 1984) ("demand to bring suit on the savings and loan association's behalf must be made on the receiver or agency possessing the right to assert the associations claim").

   b. The demand does not need to "assume a particular form . . . [or] be made in any special language." *Stoner v. Walsh*, 772 F. Supp. 790, 796 (S.D.N.Y. 1991); *see also Khanna v. McMinn*, 2006 WL 1388744, at *13 (Del. Ch. May 9, 2006) (there are no "magic words" that establish "that a communication is a demand for purposes of Court of Chancery Rule 23.1."). It must simply "fairly and adequately apprise the directors of the potential cause of action so that they, in the first instance, can discharge their duty of authorizing actions that 'in their considered opinion . . .[are] in the best interest of the corporation.'" *Id.* Accordingly, the demand typically must (1) identify the alleged wrongdoers; (2) describe the factual basis for the allegations; (3) describe the harm caused to the corporation; and (4) describe the request for relief. *See, e.g.*, *Levner v. Saud*, 903 F. Supp. 452, 456 (S.D. N.Y. 1994), *aff'd* 61 F.3d 8 (2d Cir. 1995); *Seidel v. Allegis Corp.*, 702 F. Supp. 1409, 1412 (N.D. Ill. 1989); *Lewis ex rel. Nat'l Semiconductor Corp. v. Sporck*, 646 F. Supp. 574, 578 (N.D. Cal. 1986).

4. A new demand is not typically required where there has been a change in the board's make-up. *See Nelson v. Pac. Sw. Airlines Indus., Inc., S'holder Litig.*, 399 F. Supp. 1025 (S.D. Cal. 1975); *In re Fuqua Indus.*, 1997 WL 257460 (Del. Ch. May 13, 1997) (new demand not required even where the entire membership of the board has changed). But where an amended complaint raises issues not previously included in the earlier demand, these issues need to be presented to the board, absent futility, before they can be litigated. *In re Fuqua Indus.*, 1997 WL 257460, at *15.

   a. "When an amended derivative complaint is filed, the existence of a new independent board of directors is relevant to a Rule 23.1 demand inquiry only as to derivative claims in the amended complaint that are not already validly in litigation." *Braddock v. Zimmerman*, 906 A.2d 776, 786 (Del. 2006). "Three circumstances must exist to excuse a plaintiff from making demand under Rule 23.1 when a complaint is amended after a new board of directors is in place: first, the original complaint was well pleaded as a derivative action; second, the original complaint satisfied the legal test for demand excusal; and third, the act or transaction complained of in the amendment is essentially the same as the act or transaction challenged in the original complaint." *Id*.

5. In assessing the reasonableness of the time between a demand and the filing of a derivative action, courts balance the needs of a corporation to make a conscientious decision against the potential desire of the corporation to delay the suit by engaging in "idle ceremony." *See Mills v. Esmark, Inc.*, 91 F.R.D. 70, 73 (N.D. Ill. 1981) (failure to respond to demand within three months tantamount to admitting demand futility); *but compare Recchion ex rel. Westinghouse Elec. Corp. v. Kirby*, 637 F. Supp. 1309, 1319 (W.D. Pa. 1986) (two months deemed insufficient to complete adequate investigation); *see also Mozes ex rel. General Elec. Co. v. Welch*, 638 F. Supp. 215, 221 (D. Conn. 1986) (eight months deemed insufficient where investigation impeded by parallel criminal proceedings); *Gen. Motors Corp.*, 604 F. Supp. at 1117-18 ("amount of time needed for a response will vary in direct proportion to the complexity of the technological, quantitative, and legal issues raised by the demand"); *MacCoumber v. Austin*, 2004 WL 1745751, at *4 (N.D. Ill. Aug. 2, 2004) ("[C]ourts have not formulated a specific rule as to what constitutes a reasonable response time," instead, they "determine reasonable response time by examining the complexity of the issues presented by the demand and the surrounding circumstances"); *Piven v. Ryan*, 2006 WL 756043, at *3-4 (N.D. Ill. Mar. 23, 2006) ("A board's decision to delay responding to a demand in order to focus on related litigation is reasonable"; until the related litigation is complete "it would be unreasonable to require the board to expend [the company's] resources unnecessarily.").

6. Choice of Law Considerations

a. The U.S. Supreme Court in *Kamen* settled the issue of what law governs the determination of whether a plaintiff has made an adequate demand or has been excused from making such a demand. In *Kamen* the Supreme Court held that the demand requirement of Federal Rule 23.1 "speaks only to the adequacy of the shareholder representative's pleadings," and does not itself create a demand requirement. *Id.* at 97 ("[T]he function of the demand doctrine in delimiting the respective powers of the individual shareholder and of the directors to control corporate litigation clearly is a matter of 'substance,' not 'procedure.'") Accordingly, state law (i.e., the law of the state of incorporation), rather than federal law determines whether a demand is required and, if so, whether the demand was adequate. *Id.; see also, Hicks v. Lewis*, 2003 WL 22309482 (Tenn. Ct. App. Oct. 7, 2003) ("After a thorough review of the applicable case law, this Court has found no case decided after *Kamen* applying the substantive law of any state other than the state of incorporation to issues relating to the demand requirement").

(1) Puerto Rican law does not specifically elaborate upon the requirements of demand or when it is excused, therefore, when a company is incorporated in Puerto Rico courts must "turn to Delaware corporate law for the test of demand futility." *In re First Bancorp Derivative Litig.*, 465 F. Supp. 2d 112, 118 (D.P.R. 2006).

D. Demand Futility

1. There are certain circumstances where a demand will be excused and a majority of courts still recognize a futility exception to the demand requirement. *See, e.g., Aronson*, 473 A.2d at 814; *In re Abbott Labs. Derivative S'holder Litig.*, 325 F.3d 795, 803 (7th Cir. 2003); *In re Prudential Ins. Co. Deriv. Litig.*, 659 A.2d 961, 970 (N.J. Super. Ct. Ch. Div. 1995); *In re Patterson Cos., Inc. Sec., Derivative & ERISA Litig.*, 479 F. Supp. 2d 1014, 1038 (D. Minn. 2007) ("Minnesota courts have yet to expressly adopt Delaware law as it relates to demand futility," thus, the "determination of demand futility under Minnesota law remains a mixed question of law and fact based on the particular circumstances of the case and in light of the principles enunciated" in Minnesota's own case law); *In re F5 Networks, Inc. Deriv. Litig.*, 207 P.3d 433, 437-39 (Wash. 2009) (in answering a question certified by the Western District of Washington, the the court determined that Washington is a demand-futility state that follows Delaware's demand futility analysis).

2. The growing trend, however, has been for states to adopt a rule of universal demand. *See Ritter v. Dollens*, 2004 WL 1771597, at *1 (S.D. Ind. July 13,

2004) (noting that "nineteen states, including eight since 1997, have adopted the universal demand standard," this includes, Arizona, Connecticut, Florida, Georgia, Hawaii, Michigan, North Carolina, Texas and Virginia). *See also, Warden v. McLelland*, 288 F.3d 105, 111 (3d Cir. 2002) ("Pennsylvania law no longer recognizes a futility exception"); *McCann v. McCann*, 61 P.3d 585, 593 (Idaho 2002) ("There is no futility exception in Idaho's Business Corporations Act"); *Equitec-Cole Roesler LLC v. McClanahan*, 2003 U.S. Dist. LEXIS 4340, at *11 (S.D. Tex. 2003) ("Under Texas law plaintiff must make a demand regardless of whether such a demand would be futile"); *ING Principal Protection Funds Derivative Litig.*, 369 F. Supp. 2d at 170 (Under Massachusetts' new "universal demand" statute, "demand must be made prior to the commencement of every derivative case, whether or not the directors are independent with respect to the matter subject to the demand."); *Speetjens v. Malaco Inc.*, 929 So. 2d 303, 309 (Miss. 2006) ("The fact is, Mississippi's written demand statute does not contain an exception for futility, and unless and until the Legislature decides to include one, it does not exist.").

3. Acknowledging the growing trend toward universal demand, some courts that still recognize the demand futility analysis have nonetheless come to apply it quite narrowly. *See, e.g., Scalisi v. Fund Asset Mgmt, L.P.*, 380 F.3d 133, 140-41 (2d Cir. 2004) (applying Maryland law as stated in *Werbowsky v. Collomb*, 766 A.2d 123 (2001)) (allegations made by shareholders of mutual fund that directors of the fund's investment adviser would not authorize a suit against the fund for fear they would lose their highly paid positions were inadequate to excuse the demand requirement under Maryland law, citing *Werbowsky's* firm adherence to the importance of the demand requirement even when a director "would be hostile to the action"; the court further noted the value of allowing "directors—even interested, non-independent directors—an opportunity to consider, or reconsider, the issue in dispute" (quoting *Werbowsky*)).

4. Rule 23.1 of the Delaware Chancery Court, as well as most of its counterparts, and Federal Rule 23.1 require a shareholder who fails to make a pre-suit demand to plead with particularity reasons why a demand was not made. *See e.g.,* Delaware Court of Chancery Rule 23.1, Fed. R. Civ. P. 23.1, N.Y. Bus. Corp. L. § 626, Cal. Corp. Code § 800(b)(2).

5. The plaintiff bears the burden of showing that a demand would be futile. *See, e.g., In re Oxford Health Plans, Inc. Sec. Litig.*, 192 F.R.D. 111 (S.D.N.Y. 2000); *Siegman v. Tri-star Pictures, Inc.*, 1989 WL 48746 (Del. Ch. May 5, 1989). Conclusory allegations that a demand would be futile are insufficient. As the California Court of Appeal held in *Shields v. Singleton*: "[B]road, conclusory allegations against all directors of a corporation are insufficient to establish demand futility." 15 Cal. App. 4th 1611, 1621 (1993) (citing *Findley v. Garrett,* 109 Cal. App. 2d 166, 174

(1952)); *see also Simon v. Becherer*, 775 N.Y.S.2d 313, 318 (1st Dept. 2004) (plaintiffs failed to meet Delaware's pleading requirement that demand futility be supported by particularized facts where allegations failed to specify board members who allegedly participated in fraudulent transactions and lacked specific facts regarding the nature of the purported "systematic failure" to provide appropriate oversight and the "myriad" of "red flags" that were allegedly ignored; without such facts, plaintiffs failed to show that directors faced the substantial likelihood of liability, and therefore, lacked disinterest); *In re SONUS Networks, Inc. Deriv. Litig.*, 2004 WL 2341395, at *2 (Mass. Super. Sept. 27, 2004) ("If a plaintiff does not actually make demand prior to filing suit, he or she 'must set forth . . . particularized factual statements that are essential to the claim.' The pleading requirements of Rule 23.1 are 'an exception to the general notice pleading standard' and 'more onerous than that required to withstand a Rule 12(b)(6) motion to dismiss.'") (citations omitted); *see also Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); *Scattered Corp. v. Chicago Stock Exch. Inc.*, 701 A.2d 70 (Del. 1997); *Grimes*, 673 A.2d at 1207; *Lewis v. Graves*, 701 F.2d 245 (2d Cir. 1983); *In re E.F. Hutton Banking Practices Litig*, 634 F. Supp. 265 (S.D.N.Y 1986).

a. Determining whether a shareholder has met the burden is "predominately a factual issue." *Kaster*, 731 F.2d at 1014.

b. In *In re Sonus Networks, Inc. S'holder Deriv. Litig.*, 422 F. Supp. 2d 281, 284 (D. Mass. 2006), the issue was whether a decision in a state court shareholder derivative action precluded different shareholder plaintiffs in a parallel federal derivative suit from relitigating the question of demand futility. The plaintiffs argued that they should be able to relitigate the issue because they were not in privity with the state court plaintiffs since they had "different lawyers and filed a different lawsuit in a different court armed with a different set of facts." *Id*. at 292. While the court acknowledged that the federal plaintiffs were not the same individuals as the state plaintiffs, it found privity because the company is the "true party in interest" in a derivative action. *Id*. The court noted that the state and federal complaints were filed during the same time period with similar allegations against the same defendants. Thus, the "demand futility question [was] virtually identical in each case." *Id*. at 293. Based on this analysis, the court granted the defendants' motion to dismiss because the plaintiffs already had an opportunity to litigate the identical demand futility issue in state court. *Id*. at 294 (the "overlap between the state and federal suits [was] so substantial that preclusion [was] plainly appropriate").

6. While most jurisdictions recognize this exception, the contours of the exception vary. The following are the demand futility tests for Delaware, New York, and California:

a. The Delaware Test

(1) Demand futility is to be determined solely from the well-pled allegations of the Complaint. *Aronson*, 473 A.2d at 814-17. A court's decision on whether a demand is futile is reviewed *de novo*. *Brehm*, 746 A.2d at 244 ("[R]eview of decisions of the Court of Chancery applying Rule 23.1 is *de novo* and plenary").[1]

(2) Delaware, which has the most developed body of law concerning demand futility, applies a two-prong test to determine whether demand futility has been adequately pled. For demand to be excused, a shareholder must allege facts that if taken as true raise a reasonable doubt that (1) a majority of the directors are disinterested and independent or (2) the challenged transaction was otherwise "the product of a valid business judgment." *Aronson*, 473 A.2d at 805. If either prong is met, demand is excused. *Id.* at 814.

(a) This test was first articulated in *Aronson* and, as discussed below, has been refined in later cases. In *Aronson*, a shareholder brought a derivative action against Meyers Corporation and its directors to challenge the compensation package of, and certain loans to a director who owned 47% of the stock. The shareholder alleged that a demand would be futile because (1) all of the current directors were named as defendants; (2) they all approved or acquiesced to the challenged transaction; and (3) the other board members and officers were "controlled" and "dominated" by the director owning 47% of the shares. The court rejected these arguments, holding that the shareholder had failed to meet the two-prong test articulated by the court. 473 A.2d at 814 ("even proof of majority ownership of the company does not strip the directors" of the protection of the business judgment rule, nor do allegations that a majority of the members of the board approved of or acquiesced to the challenged transaction).

[1] Until the decision in *Brehm*, the Delaware courts had operated, based on dicta beginning in *Aronson*, 473 A.2d at 805, that a court's decision would be reviewed for an abuse of discretion, the standard used by the federal courts. *See, e.g., Kaster*, 731 F.2d at 1020 (the determination of "whether the complaint pleads sufficient facts to establish that . . . a demand on the directors would be futile is within the sound discretion of the district court"). To the extent that *Aronson* and its progeny imply otherwise, those decisions have been overruled on that basis but otherwise remain good law.

(3) *Pogostin v. Rice* amplified the *Aronson* test. The court stated: "As to the first *Aronson* inquiry, the court reviews the factual allegations to determine whether they create a reasonable doubt as to the disinterestedness and independence of the directors . . . Directorial interest exists wherever divided loyalties are present, or a director either has received, or is entitled to receive, a personal financial benefit from the challenged transaction which is not equally shared by the stockholders. The question of independence flows from an analysis of the factual allegations pertaining to the influences upon the directors' performance of their duties generally, and more specifically in request to the challenged transaction. . . . Thus, the *Aronson* test examines the alleged wrong to the corporation in relation to issues of independence, interest, and the exercise of business judgment by the directors." *Id.* at 624-25.

(a) *Pogostin v. Rice* arose as a result of a tender offer for shares of City Investing Company by Tamco Enterprises, Inc. The plaintiff shareholders claimed that the board rejected Tamco's tender offer in an effort to retain control of the company. The shareholders did not make a pre-suit demand, alleging that such a demand would have been futile because "each of the directors participated in the wrongs alleged" and because "the directors could not and would not sue themselves." *Pogostin*, 480 A.2d at 623. The court rejected the shareholders' claim that a pre-suit demand was excused. *Id.* at 626-27 ("An informed decision to reject a takeover proposal, hostile or friendly, will not excuse demand absent particularized allegations of a breach of fiduciary duty, such as self-dealing, fraud, overreaching, or lack of good faith.").

(4) The *Aronson* test was further amplified in *Grobow*. Rejecting the trial court's reading of *Aronson*, the *Grobow* court stated: "The test for demand futility should be whether the well-pleaded facts of the particular complaint support a reasonable doubt of business judgment protection, not whether the facts support a judicial finding that the directors' actions are not protected by the business judgment rule." 539 A.2d at 186. The court declined to create a hard rule for determining when a plaintiff has established reasonable doubt under *Aronson*: "It would be neither practicable nor wise to attempt to formulate a criterion of general application for determining reasonable doubt. The facts

necessary to support a finding of reasonable doubt either of director disinterest or independence, or whether proper business judgment was exercised in the transaction will vary with each case. Reasonable doubt must be decided by the trial court on a case-by-case basis employing an objective analysis." *Id.*

(a) In *Grobow*, General Motors' decision to repurchase shares of its own stock from Ross Perot was challenged. Plaintiffs alleged that the repurchase agreement was motivated by the board's desire to maintain control of GM and that a demand to the board would have been futile. The court disagreed, finding that the plaintiffs failed to raise a reasonable doubt that the directors were not disinterested in the transaction or that the directors were not independent. *Id.* at 189.

(b) The *Grobow* plaintiffs filed a second-amended complaint several months later based on newly acquired evidence. The case was consolidated with another derivative action. *See Levine*, 591 A.2d at 194. After dismissal based on Rule 23.1 of the consolidated action, plaintiffs appealed. On appeal, the Supreme Court further clarified the *Aronson* test: "[A] plaintiff in a demand futility case must plead particularized facts creating a reasonable doubt as to the 'soundness' of the challenged business transaction sufficient to rebut the presumption that the business judgment rule attaches to the transaction. The point is that in a claim of demand futility, there are two alternative hurdles, either of which a derivative shareholder complaint must overcome to successfully withstand a Rule 23.1 motion." *Id.* at 205-06.

(5) The Court in *In re The Walt Disney Co. Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2003), further refined the business judgment hurdle imposed under *Aronson*. The Court stated that for demand to be excused under the second prong of *Aronson*, "plaintiffs must allege 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." *Id*. at 286. Although it stated that "[i]t is rare when a court imposes liability on directors of a corporation for breach of the duty of care, and this Court is hesitant to second-guess

the business judgment of a disinterested and independent board of directors" the Court, nevertheless, did just that, stating that the *Disney* directors "failed to exercise *any* business judgment and failed to make *any* good faith attempt to fulfill their fiduciary duties" in approving an executive compensation contract for then president, Michael Ovitz, as well as implicitly approving a non-fault termination provision that resulted in a substantial monetary award to Ovitz after barely one year of employment. *Id*. at 278. The Court found that "all of the alleged facts, if true, imply that the defendant directors *knew* that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss. Viewed in this light, plaintiffs' new complaint sufficiently alleges a breach of the directors' obligation to act honestly and in good faith in the corporation's best interests for a Court to conclude, . . . , that the defendant directors' conduct fell outside the protection of the business judgment rule." *Id*. at 289.

(6) The Court also held that "[w]here a director consciously ignores his or her duties to the corporation, thereby causing economic injury to its stockholders, the director's actions are either 'not in good faith' or 'involve intentional misconduct' [and] . . . fall *outside* the liability waiver provided under Disney's certificate of incorporation [which is based on 8 Del. C. § 102(b)(7)]." *Id*. at 290 (emphasis in original). The Court additionally found that Ovitz had also breached his fiduciary duties to the company. The Court explained that because Ovitz was a "fiduciary during both the negotiation of his employment contract and the non-fault termination, he had an obligation to ensure the process of his contract negotiation and termination was both impartial and fair [to the corporation]." *Id*. at 290-91. Citing *Telxon Corp. v. Meyerson*, 802 A.2d 257, 265 (Del. 2002), the *Disney* Court noted that "directoral self-compensation decisions lie outside the business judgment rule's presumptive protection, so that, where properly challenged, the receipt of self-determined benefits is subject to an affirmative showing that the compensation arrangements are fair to the corporation." *Id*. The Court held that Ovitz had breached this duty to negotiate honestly and in good faith by working together with his close friend, Michael Eisner, to develop a "secret strategy" to attain the maximum benefit from his contract, all without board approval. *Id*. at 291.

(a) In *Disney*, plaintiffs brought a derivative action alleging that defendant directors breached their fiduciary duties when they blindly approved an employment contract with defendant Michael Ovitz and then, again without adequate deliberation or information, ignored defendant Michael Eisner's negotiations with Ovitz regarding his non-fault termination deal. The Court found that the board had breached its fiduciary duty of care because: (1) the board failed to review the actual draft employment agreement, including details of Ovitz's salary and severance provisions, basing its decision instead, on a summary of an incomplete agreement with no additional information or investigation; (2) no expert was available to advise the board as to the details of the agreement, outlining the pros and cons of either the salary or non-fault termination provisions or analyzing comparable industry standards for such agreements; and (3) the board, after approving Ovitz's hire under these circumstances, appointed CEO, Michael Eisner, a close friend of Ovitz for over 25 years, to negotiate the unresolved terms of the employment contract, never reviewing the final terms, which varied significantly from the draft agreement presented to the board in that the terms for the stock options and the non-fault termination were much more favorable to Ovitz. *Disney*, 825 A.2d at 287-89.

(b) The *Disney* Court noted similar failings regarding Ovitz's subsequent termination deal, again negotiated by his close friend Eisner. The deal included a payout of more that $38 million in cash and three million in "A" stock options, "all for leaving a job that Ovitz had allegedly proven incapable of performing." *Disney*, 825 A.2d 290-91. The Court noted that the board was neither informed of nor consulted on this deal, even though a formal board approval appeared necessary for such an action. Moreover, when the board learned of the agreement, it failed to ask any questions, did not seek to negotiate with Ovitz regarding his departure, and did not consider whether to seek a termination based on fault. *Id*. The Court indicated that if the "board had taken the time or effort to review these or other options, perhaps with the assistance of expert legal advisors, the business judgment rule might well protect its decision." *Id*. Having failed to pursue any of these options, the Court held that the board's conduct fell outside the protection of the business judgment rule. *Id*.

(7) The Delaware Supreme Court in *In re The Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 35 (Del. 2006), affirmed the Chancery Court ruling holding that "the [Disney] director[s] did not breach their fiduciary duties or commit waste"; *see also id*. at 62 ("the business judgment rule presumptions protected the decisions of the compensation committee and the remaining Disney directors, not only because they had acted with due care but also because they had not acted in bad faith,").

(a) In reaching its decision, the Delaware Supreme Court noted that the lower court was correct to point out that there are different definitions for bad faith in the context of corporate fiduciary conduct. *Id*. at 61. The Court concluded that there are "at least three different categories of fiduciary behavior [that] are candidates for the 'bad faith' [] label." *Id*. at 64.

(i) "The first category involves so-called 'subjective bad faith,' that is, fiduciary conduct motivated by an actual intent to do harm." *Id*. "That such conduct constitutes classic, quintessential bad faith is a proposition so well accepted in the liturgy of fiduciary law that it borders on axiomatic." *Id*.

(ii) "The second category of conduct, which is at the opposite end of the spectrum, involves lack of due care——that is, fiduciary action taken solely by reason of gross negligence and without any malevolent intent." *Id*. The Court found that gross negligence (including a failure to inform one's self of available material facts), without more, cannot constitute bad faith. *Id*.

(iii) "[The] third category is what the Chancellor's definition of bad faith—intentional dereliction of duty, a conscious disregard for one's responsibilities—is intended to capture." *Id*. at 66. Such misconduct is "properly treated as a non-exculpable, nonindemnifiable violation of the fiduciary duty to act in good faith." *Id*. "The universe of fiduciary misconduct is not limited to either disloyalty in the classic sense (i.e., preferring the adverse self-interest of the fiduciary or of a related person to the interest of the corporation) or gross negligence"; "the legislature has also recognized this intermediate category of fiduciary misconduct, which ranks between conduct involving subjective bad faith and gross negligence." *Id*. at 67. Section 102(b)(7)(ii) "expressly denies money damage exculpation for 'acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law.' *Id*. "By its very terms that provision distinguishes between 'intentional misconduct' and a 'knowing violation of law' . . . on the one hand, and 'acts ... not in good faith,' on the other." *Id*. For these reasons, the Court upheld the Chancery Court's "definition as a legally appropriate, although not the exclusive, definition of fiduciary bad faith." *Id*.

(8) Delaware courts apply a slightly different test where the board takes no action. In such cases, "no business judgment has been made and thus the second prong of the *Aronson* test . . . is inapplicable." *Rales v. Blasband*, 634 A.2d 927, 933-34 (Del. 1993). "Where there is no conscious decision by directors to act or refrain from acting, the business judgment rule has no application." *Id.* The second prong of the *Aronson* test is also inapplicable where a majority of the board that undertook the challenged transaction has been replaced or where the challenged transaction was made by a board of a different corporation, such as might occur where there has been merger or sale. *Id.* at 933-34. In these circumstances, the a court must determine whether the allegations in the 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." *Zimmerman v. Braddock*, 2002 WL 31926608, at *6 (Del. Ch. Dec. 20, 2002) (citing *Rales*, 634 A.2d at 934); *see also*, *Guttman v. Huang*, 823 A.2d 492, 503 (Del. Ch. 2003) (director's impartiality compromised when facing a

substantial likelihood of personal liability for actions not covered under company's exculpatory charter provisions); *Rattner v. Bidzos*, 2003 WL 22284323 (Del. Ch. Oct. 7, 2003) ("Directors are considered disinterested . . . when they 'appear on both sides of a transaction [or] expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally.' Directorial interest may also be said to exist when 'a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders.") (citations omitted).

(9) When director liability is predicated upon a failure to monitor or oversee the management of the corporation or other liability-creating activities, "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." *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996). *See, e.g.*, *In re Countrywide Fin. Corp. Deriv. Litig.*, 554 F. Supp. 2d 1044, 1081-83 (C.D. Cal. 2008) ("For the same reasons that it found a strong inference of scienter," plaintiffs established "a strong inference of deliberate recklessness for several of the Individual Defendants," the Court found that "the Complaint pleads evidence of a 'sustained or systematic failure of the board to exercise oversight,' so as to create a substantial likelihood of liability for at least the members of th[e] [Audit and Finance] Committees," thus demand was excused as to oversight claim; demand was futile as to claim for waste only as it pertained to the company's stock repurchase program); *Salsitz v. Nasser*, 208 F.R.D. 589, 592 (E.D. Mich. 2002) (quoting *McCall v. Scott*, 239 F.3d 808, *amended in part by* 250 F.3d 997, 999 (6th Cir. 2001)). *See also, Simon v. Becherer*, 775 N.Y.S. 2d 313, 318 (1st Dept. 2004) (directors who are sued for failure to oversee subordinates have a disabling interest when the potential for liability is not a "mere threat" but instead a "substantial likelihood"); *but see In re Biopure Corp. Deriv. Litig.*, 424 F. Supp. 2d 305, 308 (D. Mass. 2006) ("on the threshold question of demand futility, [the] Court . . . determine[ed] that the *Aronson* test applies to cases where . . . the plaintiffs allege a sustained and systemic failure of the board to exercise oversight.") (citations and quotations omitted).

(a) In *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006), the Delaware Supreme Court held that "*Caremark* articulates the necessary conditions predicated for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. . . . In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations." *Id*. "Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith." *Id*.

(i) The *Stone* court noted that the "phraseology used in *Caremark* . . . —describing the lack of good faith as a 'necessary condition to liability'—is deliberate." *Id*. at 369. The court went on to explain that "[t]he purpose of that formulation is to communicate that a failure to act in good faith is not conduct that results, *ipso facto*, in the direct imposition of fiduciary liability. The failure to act in good faith may result in liability because the requirement to act in good faith 'is a subsidiary element[,]' i.e., a condition, 'of the fundamental duty of loyalty.' It follows that because a showing of bad faith conduct, in the sense described in *Disney* and *Caremark*, is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty." *Id*. at 369-70.

(ii) "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, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly

> result in liability, whereas a failure to act in good faith may do so, but indirectly. The second doctrinal consequence is that the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith. As the Court of Chancery aptly put it in *Guttman*, '[a] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest.'" *Id*. at 370.

(10) The Delaware Chancery Court dismissed the novel argument that the duties of care and loyalty include the duty to monitor the personal and financial affairs of the corporation's directors, or at least those directors who are "closely identified" with the success and welfare of the corporation. *See*, *e.g.*, *Beam v. Stewart*, 833 A.2d 961, 971 (Del. Ch. 2003) ("[I]t is unreasonable to impose a duty upon the Board to monitor [a director's] personal affairs because such a requirement is neither legitimate nor feasible.").

b. The New York Test

(1) The standard for demand futility under New York law is set forth in *Marx* and is similar to the *Aronson* test. To establish demand futility under *Marx*, a plaintiff must allege with particularity that (1) a majority of the directors is interested in the challenged transaction; (2) the board of directors did not fully inform themselves to the extent reasonably appropriate under the circumstances; or (3) the challenged transaction was so egregious on its face that it could not have been the product of a sound business judgment. 666 N.E.2d at 1039; *see also Bansbach v. Zinn*, 769 N.Y.S.2d 175, 183 (N.Y. 2003) (demand excused and directors held to be dominated and controlled by the corporation's president where directors voted to indemnify all legal costs and expenses incurred by the president even after the president admitted in open court, under penalty of perjury, that he misused corporate funds to violate federal campaign finance laws).

(2) The principal difference between the New York and Delaware tests are the degree of certainty with which a plaintiff must allege demand futility. New York has

expressly rejected a "reasonable doubt" standard. *Id.* at 1039. Instead, a plaintiff must show a greater degree of certainty that the board lacked independence or care or failed to exercise sound business judgment.

c. The California Test

(1) Under California law, demand futility is established when "the court [is] apprised of facts specific to each director from which it can conclude that the particular director could or could not be expected to fairly evaluate the claims of the shareholder plaintiff." *Shields*, 15 Cal. App. 4th at 1622 (1993).

(a) Plaintiff in *Shields* brought a derivative action against the directors and officers of Teledyne, Inc. and a number of employees and consultants of one of its subsidiaries to recover damages that the company allegedly suffered as a result of defendants intentional and negligent breach of their fiduciary duties by failing to prevent criminal acts of the subsidiary's employees. The court of appeals, rejecting plaintiff's claim that a demand was futile, stated that "the general allegations which plaintiff here indiscriminately level against all the directors of the Company are insufficient to establish that demand on the board would have been futile." 15 Cal. App. 4th at 1622.

(2) Although there is relatively little case law discussing demand futility under California law, a litigant should be able to use Delaware law as persuasive authority. "There is obviously no problem where the laws of the two states [Delaware and California] are identical . . . Defendants do not argue that a different result would obtain if Delaware, rather than California, law is applied, or even that the laws of the two jurisdictions are in conflict." *Shields*, 15 Cal. App. 4th at 1621.

7. Many demand futility cases rely on acts of entrenchment by the board, allegations of domination and control by a majority shareholder, and director compensation levels to prove the requisite director interest or lack of independence. *See Zimmerman v. Braddock*, 2005 WL 2266566, at *9 (Del. Ch. Sept. 8, 2005) ("Evaluation of a board's independence . . . requires a contextual inquiry. Not only must the Court consider the power and influence of the allegedly dominating person, but it also must assess the susceptibility of the directors to the exercise of that leverage. A large

shareholder may be able to control the affairs of a corporation as a matter of voting power even without being able to exercise controlling influence over the company's directors that would raise reasonable doubts about the directors' ability to discharge their fiduciary duties loyally. Under these circumstances, a careful analysis of why the directors, on an individual basis, might need to curry favor with (or otherwise consider their obligations to) the majority shareholder is necessary. For example, the Court must consider what material benefits (or detriments) the majority shareholder can bestow (or impose) upon each of the directors, other than, as a general matter, the majority shareholder's capacity to deny them their continuing status as directors. On the other hand, there are circumstances in which a shareholder with less than a majority of a company's equity can effectively control and dominate a board. Something more than merely owning a sizable (but less than majority) block of the Company's stock is necessary. This inquiry may involve, for example, the exercise of power by a dominant chief executive."); *California Pub. Employees' Ret. Sys. v. Coulter*, 2002 WL 31888343, at *8 (Del. Ch. Dec. 18, 2002) ("Directors are presumptively 'interested' in . . . actions taken for entrenchment purposes" and "golden parachute" agreements for incumbent directors, especially after receiving serious complaints from shareholders, raised a reasonable doubt as to directors' disinterest); *Orman v. Cullman*, 794 A.2d 5, 25 (Del. Ch. 2002) (where court defined "controlled" director as one who is dominated by another, whether through close personal or familial relationship or through force of will; director may also be "controlled" by another if he or she is beholden to the allegedly controlling entity, such as when the entity has the unilateral power to decide whether the director continues to receive a benefit upon which the director is so dependent or of such subjective importance that the threatened loss of the benefit might create a reason to question whether the director can objectively consider the corporate merits of the challenged transaction); *see also In re The Limited, Inc. S'holders Litig.*, 2002 WL 537692, at *5-6 (Del. Ch. Mar. 27, 2002) ("as a general matter, compensation from one's principal employment is 'typically of great consequence' to the employee" and it was reasonable to infer that director lacked independence from majority shareholder of corporation where position in corporation provided director his principal employment and an average salary of $1.8 million); *In re The Student Loan Corp. Deriv. Litig.*, 2002 WL 75479, at *3 (Del. Ch. Jan. 8, 2002) (where a majority of the directors owe their livelihood to the corporation, it is "difficult to conceive . . . how any of them could impartially consider a demand in this case."); *In re Nat'l Auto Credit, Inc. S'holders Litig.*, 2003 WL 139768, at *10 (Del. Ch. Jan. 10, 2003) (although directors' fees usually do not suggest a conflict of interest, fees that constitute a "massive increase" over existing fees, such as $1000 per meeting increased to $55,000 annually, could reasonably be inferred to compromise a director's ability to properly consider a demand); *In re Ebay, Inc. S'holders Litig*. 2004 WL 253521, at *3 (Del. Ch. Feb. 11, 2004) (outside, non-managing director deemed to lack independence because value of his stock options "potentially run into the millions of dollars" and "one cannot conclude realistically that [the director] would be able to objectively and impartially consider a demand to bring litigation against those to whom he is beholden for his current position and future position on [the corporation's] board"); *but compare In re Merrill Lynch Focus Twenty Fund Inv. Co. Act Litig.*, 218 F.R.D. 377, 380-81 (E.D.N.Y. 2003) (directors' service on multiple boards associated with the corporation, with significant remuneration ($160-260,000), was not enough to demonstrate demand futility) (applying Maryland law) *aff'd by Scalisi*, 380 F.3d 133 (2d Cir. 2004); *In re Sagent Tech., Inc., Deriv. Litig.*, 278 F. Supp. 2d 1079, 1089 (N.D. Cal. 2003) ("demand futility cannot be pled merely on the basis of allegations that directors acted or would act to preserve their position" in the Company, even in situations concerning the directors' principal occupation); *Jacobs v. Yang*, 2004 WL 1728521, at *4 (Del. Ch. Aug. 2, 2004) (receipt of director's fees or remuneration not enough for purposes of pleading demand futility where director defendants do not control the nomination, election and continued tenure of directors on the company's board); *Kanter v. Barella*, 489 F.3d 170, 178 (3d Cir. 2007) (plaintiff argued that defendant controlled the board because it owned 71% of the Company's stock, a fact she claimed "strengthen[ed] the inference that the directors nominated by [the defendant could] exert considerable influence over other directors; the court found that ownership of a majority stake in a company alone does not necessarily demonstrate a lack of ability to act with the company's best interests in mind, conversely, it "may suggest that [the defendant's] interest [are] aligned with those of other stockholders or that it would benefit from the company's success.").

8. Plaintiffs in a number of recent cases have relied on allegations of insider stock sales to prove that directors lack disinterest. Recently, the Delaware Chancery Court noted the differences between archetypical claims of self-dealing and insider trading claims, concluding that "it is unwise to formulate a common law rule that makes a director 'interested' 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." *Rattner*, 2003 WL 22284323, at *11. The Court held that a more balanced approach is to focus the impartiality analysis on whether the plaintiffs "have pled particularized facts regarding the directors that create a sufficient likelihood of personal liability because they have engaged in material trading activity at a time when . . . they knew material, non-public information about the company's financial condition." *Id*. (citing *Guttman*, 823 A.2d at 502). *See also*, *Sagent*, 278 F. Supp. 2d at 1089 (held director not disinterested because plaintiffs "fail[ed] to plead particularized facts raising a reasonable doubt that [the director] face[d] a substantial likelihood of liability for the alleged insider trading."); *Mitzner v. Hastings*, 2005 WL 88966, at *5 (N.D. Cal. Jan. 14, 2005) (plaintiff failed to plead particularized facts that directors lacked disinterest because of alleged

insider stock sales where the "complaint does not contain particular facts showing that the outside directors knew about the alleged inside information or connecting particular trades to information acquired at particular times . . . Nor does the plaintiff place the allegedly insider trades in the context of the defendant's trading histories."); *McCabe v. Foley*, 424 F. Supp. 2d 1315, 1322 (M.D. Fla. 2006) ("the timing of stock sales is much more important than the amount of stock sales in determining insider trading [. . .] [a] complaint should show inconsistency in trading patterns, and connect the non-public information to those sales."); *In re Goodyear Tire & Rubber Co. Deriv. Litig*., 2007 WL 43557, at *8 (N.D. Ohio Jan. 5, 2007) ("Ohio law does not recognize a derivative claim for insider trading.").

a. In *Friese v. Superior Court of San Diego County*, 134 Cal App. 4th 693, 697 (2005), a Trustee, as successor in interest to Delaware corporation with headquarters and principal place of business in California, brought an action alleging insider trading, under California Corporations Code § 25502.5, against former officers and directors of a corporation. Defendants demurred on the ground that the action was barred by the internal affairs doctrine and the Superior Court sustained the demurrer. *Id*. The California Court of Appeals disagreed, holding that claims for insider trading were not barred by internal affairs doctrine. *Id*. at 709. The court reasoned that given the public and regulatory interests Section 25502.5 serves, it is not subject to the internal affairs doctrine as codified in Section 2116. *Id*. at 710.

9. The futility analysis has also focused on the extent to which personal or business relationships affect a director's independence. For example, the Delaware Supreme Court held that "[a]llegations of a mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about the director's independence"; such allegations "largely boil down to a 'structural bias' argument, which presupposes that the professional and social relationships that naturally develop among members of a board impede independent decision making." *Beam*, 845 A.2d at 1050-51. *See also Yang*, 2004 WL 1728521, at *6 (directors with outside business ties to Yahoo! were not prevented from considering a demand independently and free from "extraneous influences" where the complaint failed to allege "sufficient facts to support the inference that the [Insider Directors] had the authority or ability to cause Yahoo! to terminate its relationships" with these outside companies; complaint also failed to show that the outside business relationships were "material").

a. In *Beam*, a shareholder of Martha Stewart Living Omnimedia, Inc. ("MSO") brought a derivative action against Martha Stewart for allegedly breaching her fiduciary duties of loyalty and care by illegally engaging in insider trading and mishandling the media attention that followed, thereby jeopardizing the financial future of MSO. *Id*. at 1044. Defendants moved to dismiss, citing plaintiff's failure to make a demand. The Court granted defendants' motion and held that demand was not futile because the majority of the board, consisting of three outside, non-managing directors, were deemed to be independent, even though the outside directors were "longstanding personal friends" of Martha Stewart. *Id*.

b. The Court held that "[a]llegations that Stewart and the other directors moved in the same social circles, attended the same weddings, developed business relationships before joining the board, and described each other as 'friends,' even when coupled with Stewart's 94% voting power, are insufficient, without more, to rebut the presumption of independence. . . Whether they arise before board membership or later as a result of collegial relationships among the board of directors, such affinities—standing alone—will not render presuit demand futile." *Id*. at 1051. The Court went on to note that the outside directors all held significant positions in other businesses and companies so that a "reputation for acting as a careful fiduciary" was essential to their careers and was an issue in which they would have a material interest. *Id*. at 1047.

10. The presumption of independence and/or disinterest is particularly strong for outside, non-managing directors. 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." *Beam*, 845 A.2d at 1052; *see also, Marcoux v. Prim*, 2004 WL 830393, at *16-17 (N.C. Super. April 16, 2004) (allegations that outside directors served on the same boards, belonged to the same social clubs, vacationed together, and had prior business relationships with interested directors not sufficient to show that outside directors were beholden and lacked independence); *see also, Mitzner*, 2005 WL 88966, at *6 (outside directors found not interested because they were unlikely to face substantial likelihood of liability for false and misleading statements in prospectuses, registration statements, annual reports, press releases, or other "group-published information" since the complaint failed to set forth particularized facts to show that the outside directors either participated in day-to-day corporate activities or had a special relationship with the corporation); *Halpert Enter. v. Harrison*, 362 F. Supp. 2d 426, 433 (S.D.N.Y. 2005) (Allegations that "several . . . Board members sit together, in various configurations, on other boards do[es] not call into question the ability of the board members to exercise proper business judgment."); *Kanter v. Barella*, 2007 U.S. App. LEXIS 12220, at *19 ("no automatic

inference of bias or control on the part of a director who had himself given legal assistance to the company as outside counsel").

a. A Board's retention of a law firm to investigate accounting and auditing issues is not an "'implicit concession' of the Board's lack of independence and inability to consider a shareholder demand." *In re Bristol-Myers Squibb Deriv. Litig.*, 2007 WL 959081, at *5, (S.D.N.Y. Mar. 30, 2007). To the contrary, hiring a law firm or accounting firm to assist in an independent investigation of alleged wrongdoings may demonstrate a board's independence. *Kanter v. Barella*, 2007 U.S. App. LEXIS 12220, at *18, 23 (court noted that hiring a law firm to conduct an independent investigation "suggest[ed] that the board reacted appropriately" to allegations of wrongdoing and is "precisely the type[] of action[] an independent board exercising valid business judgment should take when made aware of a serious problem"). Similarly, the court in *In re Bristol-Myers Squibb*, found that "[n]o responsible board would assess the legal ramifications of potential corporate misconduct (including the corporation's liabilities and remedies) without consulting counsel." 2007 WL 959081, at *5.

11. A Delaware court has recently held that it is not enough to destroy the presumption of board independence for demand futility purposes simply to allege that the company publicly announced that it believed the derivative litigation lacked merit. *Highland Legacy Ltd. v. Singer*, 2006 WL 741939, at *6 (Del. Ch. Mar. 17, 2006) ("Public statements about the merits (or lack thereof) of derivative litigation are routinely made in SEC filings. It would be unreasonable for [a] court to conclude that a board made up of a majority of independent directors could not be asked to pursue [] litigation simply because the company expressed a belief in a public filing that the claims in a series of related litigations were unfounded.").

12. Recent cases that have focused on the business judgment prong in determining demand futility have found that plaintiffs were successful in raising a reasonable doubt that the board's decision was a valid exercise of business judgment. *See e.g.*, *Geer v. Cox*, 292 F. Supp. 2d 1282, 1294, (D. Kan. 2003) (reasonable doubt sufficiently alleged where directors accepted a liquidation for 50 percent of market value and failed to seek required shareholder approval for the action or have any valid business reason to choose such a transaction, particularly when an alternative transaction (sale of the assets by consignment) would have yielded 90 percent of fair market value); *California Pub. Employees' Ret. Sys.*, 2002 WL 31888343, at *12 (demand excused where directors relied on investment bank valuation report alleged to have contained some opinions that were fabricated and unfounded; moreover, special litigation committee designated to approve the challenged transaction was found to have abdicated its role to CEO and other directors); *In re Abbott Labs.*, 325 F.3d at 808-09 (directors' failure to

respond to repeated warnings for six years about quality control abuses, which resulted in $100 million fine by FDA, was sufficient to overcome presumption of business judgment rule) (decided under Illinois law, which follows Delaware); *compare White v. Panic*, 783 A.2d 543, 552-555 (2001) (plaintiff failed to overcome the presumption that the board's decisions were a valid exercise of business judgment even though board settled several sexual harassment lawsuits because of CEO's alleged behavior for $3.5 million, failed to take any action against the CEO for this behavior, and made a loan to the CEO to settle a paternity suit brought against him); *cf. In re SONUS Networks, Inc. Deriv. Litig.*, 2004 WL 2341395, at *4 (generalized complaints alleging poor supervision over financial statements, particularly as to controls over how the statements were prepared, and a lack of particularized allegations as to any specific act by any particular board member individually or by the board as a whole, cannot overcome the presumption of a valid business judgment).

13. Certain actions, such as self-compensation decisions and knowing violations of the law, have been held to be outside the protections of the business judgment rule. S*ee, e.g.*, *Telxon Corp. v. Meyerson*, 802 A.2d 257, 265 (Del. 2002) ("Like any other interested transaction, directoral self-compensation decisions lie outside the business judgment rule's presumptive protection."); *Padgett v. McGee*, 2004 WL 1098986, at *7 (Cal. Ct. App. May 18, 2004) ("[G]ood faith reliance on the advice of counsel, without any further inquiry, is ordinarily presumed to be an appropriate and protected exercise of business judgment"; if, however, "directors have knowledge that would make them suspect [that this] reliance is unwarranted, then the failure to conduct further inquiry is . . . unprotected by the business judgment rule"); *Landy v. D'Alessandro*, 2004 WL 1045783, at *17 (D. Mass. March 30, 2004) (A "knowing violation of the law renders a decision outside the business judgment rule . . .").

14. On March 18, 2006, *The Wall Street Journal* reported that corporate executives at several companies may have backdated their stock option grant dates to price their options on unusually favorable dates. Since then dozens of derivative actions have been filed alleging stock option backdating schemes. Courts subsequently set forth pleading requirements for these breach of fiduciary duty claims arising out of allegations of backdating in the demand excused context.

    a. In *In re Linear Tech. Corp. Derivative Litig.*, 2006 WL 3533024, at *3 (N.D. Cal. Dec. 7, 2006), the court granted defendants' motion to dismiss, holding that plaintiffs failed to plead with particularity that a "reasonable doubt exist[ed] as to whether any of the [defendants was] disinterested or independent." The court found that "[w]ith respect to the allegation of 'backdating,' the only factual allegation offered by plaintiffs [was] that on seven occasions over a period of seven years, stock options were dated 'just after a sharp drop' in [the Company's] stock and 'just before a substantial rise.'" *Id*. These allegations were found to be insufficient to meet the necessary pleading requirements "[b]ecause plaintiffs provide[d] no facts as to how often and at what times the . . . Defendants . . . granted stock options in the past . . . ." *Id*. Plaintiffs also failed to allege facts as to how the asserted backdating affected the price the officers paid for the stock, and as a consequence failed to demonstrate how the directors' approval of the options harmed the Company. *Id.*

b. In *In re Tyson Foods, Inc. Consol. S'holder Litig*, 2007 WL 416132, at *5 (Del. Ch. Feb. 6 2007), shareholders alleged that the directors breached their fiduciary duties by allegedly "spring-loading" stock option grants. "Spring-loading" is the granting of stock options "before the release of material information reasonably expected to drive the shares of such options higher." *Id*. at *5 n.16. Chancellor Chandler held that demand was futile primarily because many of the directors were dependant or interested members of the Tyson family or were participants in related-party transactions that also involved the Tyson family. *Id*. at *11-12. The court also found that plaintiffs sufficiently demonstrated that the granting of the relevant stock options was not within the Compensation Committee's business judgment. *Id*. at *18. The court stated that "[a] director who intentionally uses inside knowledge not available to shareholders in order to enrich employees while avoiding shareholder-imposed requirements cannot . . . be said to be acting loyally and in good faith as a fiduciary. . . . This conclusion . . . rests upon at least two premises, each of which should be . . . alleged by a plaintiff in order to show that a spring-loaded option issued by a disinterested and independent board is nevertheless beyond the bounds of business judgment. First, a plaintiff must allege that options were issued according to a shareholder-approved employee compensation plan. Second, a plaintiff must allege that the directors that approved spring-loaded . . . options (a) possessed material non-public information soon to be released that would impact the company's share price, and (b) issued those options with the intent to circumvent otherwise valid shareholder-approved restrictions upon the exercise price of the options." *Id*. at 18-19.

c. The Delaware Chancery Court held that conclusions alleging knowledge of backdating practices on behalf of the Board of Directors are sufficient for demand futility purposes. *Ryan v. Gifford*, 918 A.2d 341, 355 n.35 (Del. Ch. 2007). The directors argued that plaintiff failed to properly plead demand futility; however, Chancellor Chandler held that the complaint was pled with "sufficient particularity" because it was "difficult to understand how a plaintiff can allege that directors backdated options without simultaneously alleging that such directors knew that the options were being backdated." *Id*. The Chancellor also agreed with the plaintiff that the "board had no discretion to contravene the terms of the stock option plans [and] . . . [a]ltering the actual date of the grant so as to affect the exercise price contravenes the plan. Thus, knowing and intentional violations of the stock option plans . . . cannot be an exercise of business judgment." *Id*. at 354. The court also noted that "[w]here at least one half or more of the board in place at the time the complaint was filed approved the underlying challenged transactions, which approval may be imputed to the entire board for purposes of proving demand futility, the *Aronson* test applies." *Id*. at 353.

d. In *In re Computer Sciences Corp. Derivative Litig*., 2007 WL 1321715, at *5 (C.D. Cal. Mar. 26, 2007), the court found that *Rales* applied because plaintiffs did not sufficiently allege that the actions related to the backdated options constituted transactions or decisions by the whole board. In its holding, the court noted that the "option grants were executed by a subcommittee comprising at most two of the seven directors" on the board. *Id*. at *13. "Even adding the one director who received the allegedly backdated options to the 'interested' group, there remain[ed] a clear four-director board majority whose disinterestedness and independence [were] not placed in reasonable doubt by Plaintiffs' allegations." *Id*. The court found that plaintiffs did not adequately plead their status as shareholders at all times relevant to the transactions at issue and during the lawsuit, as required by Rule 23.1. *Id*. at *15.

(1) In *In re Computer Sciences Corp. Derivative Litig*., 244 F.R.D. 580, 583 (C.D. Cal. 2007), the shareholder plaintiffs filed an amended complaint alleging improper stock-option backdating, and adding allegations of spring-loading and re-pricing of stock options. Once again, the court found that plaintiffs did not allege that they owned stock during "all of the relevant periods when the questioned transactions occurred," as well as during the pendency of the action, as required by Rule 23.1 and Nevada law. *Id*. The court applied the *Rales* analysis a second time, despite the addition of an allegation that a statement in the company's 8-K constituted an admission that "improper option grants were approved by the entire [] board," because even with the 8-K the plaintiffs' only made particularized allegations with respect to the involvement and interestedness of two of the seven board members for the challenged option grant transactions. *Id*. at 588-90. Ultimately, the court found that plaintiffs' amended complaint still did not establish demand futility because it lacked "particularized allegations raising a

reasonable doubt as to whether a majority of [the] board could have properly exercised its independent and disinterested business judgment in responding to a demand." *Id*. at 590.

(a) Although the court ruled against the plaintiffs, the court noted the following:

> The Court is not blind to the fact that errors have been made in the granting of, and accounting for, stock options at CSC between 1996 and 2006. Some parties, whether directors, executives or both, are undoubtedly responsible, if not liable, for these errors. … The Court is further cognizant of the fact that CSC directors and executives, perhaps even potentially liable ones, currently control the answers to these questions. Nonetheless, in a derivative case like this one, a board of directors is entitled to a presumption that they can and should be allowed to manage the business affairs of a corporation, including the decision of whether and how to investigate errors like these and whether ultimately to bring claims on the corporation's behalf. Whatever its merits or faults, the balance of power between derivative plaintiffs and the corporation (or its directors) in a derivative action is purposefully asymmetric, and the pleading standards more exacting, because of this presumption and the fact that a derivative plaintiff seeks to vindicate the corporation's interests, not just its own. Absent particularized allegations showing the board is unworthy of this deference, a derivative plaintiff must first make a demand on the board to investigate its claims. At this stage, this is what Plaintiffs in this case must do. *Id*. at 590-91 (citation omitted).

e. In *In re CNET Networks, Inc. S'holder Deriv. Litig*., 483 F. Supp. 2d 947, 958 (N.D. Cal. 2007), the court did not accept the notion in *Ryan v. Gifford*, that the directors must have known that grants were being backdated simply based on their membership on the Compensation Committee. Instead, because plaintiffs did not plead particular facts, including how often and at what time past stock options were granted, there was not an apparent pattern of backdating. As a result, the court analyzed each allegedly backdated stock option grant in detail, and determined that five of the eight grants were part of a previously established option granting plan, and therefore, plaintiffs did not plead sufficient facts to show that those grants were intentionally backdated. *Id*. at *11-15. Although the court found the allegations concerning the three remaining grants to raise a possibility of backdating, only one of the recipients of those grants was on the board when the complaint was filed. *Id*. at *15. Therefore, for plaintiffs to show that demand was excused they needed to allege facts sufficient to demonstrate that at least two of the other six directors had a substantial likelihood of liability. Although, two of the other directors served on the Compensation Committee at the time of the allegedly backdated options, because the Company's stock option plan allowed the Compensation Committee to delegate options-granting authority to its executives the Court found that membership on the Compensation Committee was not by itself enough to establish a substantial likelihood of liability. *Id*. at *18-19.

f. In *Desimone v. Barrows*, 924 A.2d 908 (Del. Ch. 2007), the Delaware Chancery Court dismissed a stock options derivative action for failure to plead demand futility and failure to state a claim against the officers and directors. The court also found that the plaintiff lacked standing to challenge any grants made prior to the date that he purchased stock. *Id*. at 927. The court rejected plaintiff's argument that a claim may be stated against a director because he or she was a member of a board that approved misdated stock option grants, absent particularized allegations demonstrating that the director engaged in deliberate misconduct or acted with fraudulent intent, reasoning that even where there have been clear acts of backdating, a plaintiff still must include specific factual allegations demonstrating "the state of mind of those accused of involvement." *Id*. at 931, 933.

(1) The court described a hypothetical scenario where a compensation committee, with the advice of the corporation's general counsel and CFO, approved backdated option grants and signed written consents "without realizing that the grants violate the terms of the stock option plan and without realizing that the corporation is accounting for them improperly." *Id*. at 932-33. The court stated that under these facts, there was a "serious argument" that the directors did not face the risk of liability:

> [T]o find them liable for breach of fiduciary duty absent the exculpation clause, one would have to consider whether their failure to realize the impropriety of the options grants rose to a level of gross negligence…. But because they are protected by the exculpation clause, the directors can only be held liable if they act with a state of mind that is disloyal to their obligations to the corporation. In this context, that

would likely require a finding that the compensation committee knew that the options violated the stock option plan and that the options were being accounted for in a manner that was improper, or that their failure to obtain that information resulted from their knowing abdication of their directorial duties. *Id*. at 933.

g. In *In re Finisar Corp. Deriv. Litig*., 542 F. Supp. 2d 980, 987 (N.D. Cal. 2008), the shareholder plaintiffs alleged that demand would be futile because "(1) six of the seven members of the board at the time the complaint was filed received backdated stock options, (2) four of the directors…served on Finisar's Compensation Committee during the relevant period, (3) three of the directors…served on Finisar's Audit Committee during the relevant period, and (4) all of the directors signed Finisar's Form 10-K which contain the alleged fraudulent statements regarding the exercise price of stock option grants." The court used *Rales* to determine demand futility because at the time the complaint was served less than half of the board served on the Compensation Committee during the periods backdating allegedly occurred. *Id*. at 988, 990. Under *Rales*, the court concluded that plaintiffs' allegations did not support a finding of backdating to directors and officers, thus, demand could not be excused "on the basis that the directors who served on the board at the time plaintiffs' complaint was filed received backdated options." *Id*. at 994.

E. Demand Made and Board Response

1. The effect of making a demand "is to place control of the derivative litigation in the hands of the board of directors." *Spiegel v. Buntrock*, 571 A.2d 767, 773 (Del. 1990) ("The purpose of the pre-suit demand is to assure that the stockholder affords the corporation the opportunity to address the alleged wrong without litigation, to decide whether to invest the resources of the corporation in litigation and to control any litigation which does occur."); *Stotland v. GAF Corp.*, 469 A.2d 421, 422 (Del. 1983) ("[O]nce a demand has been made, absent a wrongful refusal, the stockholders' ability to initiate a derivative suit is terminated") .

2. After a demand has been made, the board can decide whether to pursue the litigation, resolve the grievance short of litigation, or reject the demand. *Weiss v. Temporary Inv. Fund, Inc.*, 692 F.2d 928, 941 (3d Cir. 1982) (in response to a demand the board "can exercise their discretion to accept the demand and prosecute the action, to resolve the grievance internally without resort to litigation, or to refuse the demand"), *vacated and remanded on other grounds*, 465 U.S. 1001 (1984); *see also, Zapata Corp. v. Maldonado*, 430 A.2d 779, 783 (Del. 1981).

3. Directors served with a demand cannot stand neutral. *Spiegel*, 571 A.2d at 767 (board of directors confronted with a derivative action cannot stand neutral); *Grimes*, 673 A.2d at 1207 (board may not assume position of neutrality with respect to demand). Some courts have viewed neutrality as tacit approval for the continuation of the derivative litigation. *See Kaplan v. Peat, Marwick, Mitchell & Co.*, 540 A.2d 726, 729 (Del. 1988) (neutral position by the board will "be viewed as tacit approval for the continuation of the litigation[,]" thus excusing demand); *Halprin v. Babbitt*, 303 F.2d 138 (1st Cir. 1962). *But see*, *Benak v. Alliance Capital Mgmt L.P.*, 2005 WL 1285652, at *2-3 (D.N.J. May 23, 2005) rejecting holding by Delaware Supreme Court that a corporate board's position of neutrality excuses demand) (applying Maryland law).

4. The board assumes control of the litigation if it accepts the demand. *See Daily Income Fund, Inc v. Fox*, 464 U.S. 523, 533 (1984) ("If, in the view of the directors, litigation is appropriate, acceptance of the demand places the resources of the corporation, including its information, personnel, funds and counsel behind the suit.").

5. Frequently, the board of directors will reject a shareholder's demand as not being in the best interest of the corporation. This is the most likely scenario. *See Ferrara*, et al., § 7.02, citing A.L.I., *Principles of Corporate Governance: Analysis and Recommendations* § 7.08, Reporter's Note 9 (Proposed Final Draft, March 31, 1992). If after board rejection of a demand a shareholder decides to move forward with the suit, the shareholder must prove that the board's decision to reject the demand was wrongful. *See Levine v. Smith*, 1989 WL 150784, at *4 (Del. Ch. Nov. 27, 1989) (a shareholder "will be permitted to proceed with his derivative suit if the Court is satisfied that the board's rejection of the demand was wrongful."), *aff'd*, 591 A.2d 194 (Del. 1991); *see also Grimes*, 763 A.2d at 1207; *Stepak v. Addison*, 20 F.3d 398 (11th Cir. 1994); *Miller v. Thomas*, 656 N.E.2d 89 (Ill. App. 1995).

6. To show that a board's decision to reject the demand was wrongful, a shareholder must overcome the presumption that the board acted in good faith, with due care and in the honest belief that the action taken was in the best interest of the corporation. *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 64 (Del. 1989); *Aronson*, 473 A.2d at 812. This calls into play the business judgment rule.

7. Demand Rejected and Business Judgment Rule

    a. The business judgment rule determines when a shareholder may bring a derivative action after a demand has been rejected. *Mt. Moriah Cemetery v. Moritz,* CCH Fed. Sec. L. Rep. ¶ 95,900 (Del. Ch. April 4, 1991) ("Where demand is made and refused by a board, a plaintiff may proceed with a derivative action only if the Court is satisfied that the board's rejection of the demand was wrongful. The business judgment rule is used in reviewing a board's refusal to act pursuant to a stockholder demand"); *Zapata Corp.*, 430 A.2d at 784 n.10 ("[W]hen 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"); *Stoner*, 772 F. Supp. at 800-01 ("The business judgment inquiry is proper whenever a board or a committee of the board is charged with wrongfully preventing shareholder litigation of a corporate cause of action"); *United Copper Sec. Co. v. Amalgamated Copper Co.*, 244 U.S. 261 (1917) (Whether or not a corporation shall seek "to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management and is left to the discretion of the directors").

(1) Absent such a showing, a shareholder lacks standing to maintain a suit on behalf of the corporation. *See Zapata Corp.*, 430 A.2d at 784 ("Absent wrongful refusal, the stockholder [where a demand has been made and refused] lacks managerial power.").

b. The business judgment rule provides that absent evidence of bad faith, fraud or lack of due care, courts will defer to the business judgment of corporate directors. *See Zapata Corp.*, 430 A.2d at 782 ("The 'business judgment' rule is a judicial creation that presumes propriety, under certain circumstances, in a board's decision").

(1) In some jurisdiction, such as California, the business judgment rule is codified. *See* Cal. Corp. Code § 309. In other jurisdictions, such as Delaware the rule is judicially imposed. *See,* e.g., *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); *Behradrezaee v. Dashtara*, 910 A.2d 349, 361 (D.C. 2006) (the District of Columbia finally adopted the business judgment rule as defined by Delaware law).

c. The business judgment rule "creates 'a presumption that in making a business decision, the directors of a corporation'" met their fiduciary duties to the corporation, that is that that they "acted on an informed basis (i.e., with due care), in good faith, and in the honest belief that the action taken was in the best interest of the company." *Citron*, 569 A.2d at 64 (quoting *Aronson*, 473 A.2d at 812); *see also Schreiber v. Pennzoil Co.*, 419 A.2d 952, 956 (Del. Ch. 1980) ("The business judgment rule is a presumption that a rational business decision of the officers or directors of a corporation is proper unless there exists facts which remove the decision from the protection of the rule.").

(1) In most circumstances, the business judgment rule places the burden on the party challenging the board decision to introduce evidence that the board either lacked good faith, acted in self-interest, or acted without due care. *Citron*, 569 A.2d at 64. *But see, e.g., Sadler v. Jorad, Inc*., 2004 WL 1175773, at *5-6 (Neb. May 28, 2004) (burden is shifted in close corporation where defendants control the books and the business).

(2) A 2002 case from the New Jersey Supreme Court, however, explicitly holds otherwise. In *In re PSE & G S'holder Litig.*, 173 N.J. 258, 286 (2002), the Court stated that a "modified" version of the business judgment rule is the proper standard of review to apply when evaluating whether a corporation's board of directors has responded properly in rejecting a shareholder's demand or terminating existing litigation in a demand-excused context. In this "modified" version, the initial burden is actually on the directors to demonstrate that they "(1) were independent and disinterested, (2) acted in good faith and with due care in their investigation of the shareholder's allegations, and that (3) the board's decision was reasonable." *Id*. Moreover, "shareholders in these circumstances must be permitted access to corporate documents and other discovery 'limited to the narrow issue of what steps the directors took to inform themselves of the shareholder demand and the reasonableness of its decision.'" *Id*. The court also noted that an appellate court's review of a trial court's decision in this context is *de novo* on the record. *Id*. at 287. The court pointed to renewed questions about the objectivity and responsibility of corporate directors in the marketplace as a basis for their decision in this matter. *Id*. at 297.

8. Absent a showing that the directors failed to meet their fiduciary obligations, the business judgment rule shields directors from personal liability. *Citron*, 569 A.2d at 64 (If the party challenging a board decision "fails to meet [the] burden of establishing facts rebutting the presumption, the business judgment rule, as a substantive rule of law, will attach to protect the directors and the decisions they make.").

9. As with other business decisions a board's decision "not to pursue legal recourse pursuant to a shareholder's complaint" is given "great deference under the business judgment rule." *Lewis v. Hilton*, 648 F. Supp. 725, 727 (N.D. Ill. 1986); *Halpert Enter., Inc. v. Harrison*, 2007 WL 486561, at *5 (S.D.N.Y. Feb. 14, 2007) (audit committee's actions reasonable and in good faith because its investigation into whether the company should sue its directors, which the board ultimately decided not to do, was led by an

independent law firm that conducted a five-month investigation, interviewed dozens of people, reviewed numerous documents and produced a voluminous report). Accordingly, courts seldom interfere with a board decision not to pursue litigation unless "the directors are guilty of misconduct equivalent to a breach of trust, or where they stand in a dual relation which prevents an unprejudiced exercise of judgment." *United Copper Sec. Co.*, 244 U.S. at 261; *see also Aronson*, 473 A.2d at 812.

a. To demonstrate that the decision of the board in rejecting a demand violated the business judgment rule, a shareholder must allege particular facts that "create a reasonable doubt that the directors' action was entitled to the protections of the business judgment rule." *Aronson*, 473 A.2d at 808.

(1) Delaware courts held that shareholders concede the disinterestedness and independence of a board as to the underlying claims by making a pre-suit demand. *See, e.g., Spiegel*, 571 A.2d at 773-77 (act of making a demand on a board of directors is a concession that demand is not futile); *Levine*, 591 A.2d at 212 (plaintiff's "complaint based on wrongful refusal of demand not only tacitly concedes lack of self-interest and independence of a majority of the Board, but expressly concedes both issues"); *see also Thorpe v. CERBCO, Inc.*, 611 A.2d 5, 10 (Del. Ch. 1991); *Abbey v. Computer & Comm. Tech. Corp.*, 457 A.2d 368 (Del. Ch. 1983).

(2) But in other jurisdictions a plaintiff can, even after a demand has been made, show that the board improperly rejected the demand because the board lacked independence and was under the influence of an improper party. *See Findley v. Garrett*, 109 Cal. App. 2d 166, 174 (1952); *Behradrezaee*, 910 A.2d at 360-61 ("shareholder did not lose his right to allege directors bias and lack of independence in its action on his demand simply by filing a presuit demand. He retains the right to show . . . that the board's bias, lack of independence or failure to conduct a reasonable investigation creates a reasonable doubt that the demand was properly refused.").

10. Successful wrongful refusal claims tend to involve allegations that the business judgment rule does not apply to a board's decision to reject a demand because either the board lacked due care or did not demonstrate good faith in reviewing and responding to a derivative demand. *See, e.g., Stepak*, 20 F.3d at 398 (finding that the board lacked due care in rejecting a demand because of the board's reliance on counsel who had previously represented the company's officers and directors in criminal investigations

relating to the subject matter of the demand; "[b]oard members were merely passive recipients of the product of an 'investigation' orchestrated by counsel"); *Syracuse Television, Inc. v. Channel 9, Syracuse, Inc.*, 273 N.Y.S.2d 16 (N.Y. Sup. 1966) ("[B]oard took none of the many actions which might be anticipated in view of the gravity of the charges. It did not direct an investigation, it did not direct an audit, it did not refer the matter to committee, it did not amend the motion, the motion was tabled."); *see also Mt. Moriah Cemetery*, CCH Fed. Sec. L. Rep. at ¶ 95,900 ("In responding to plaintiff's demand letter, as in every other business decision, the directors of D&B had a duty to inform themselves of 'all material information reasonably available to them. In deciding whether directors have made an informed decision, the standard is gross negligence. Thus, the alleged deficiencies in the Special Committee's investigation must rise to the level of gross negligence if the directors' decision is to be condemned as uninformed.").

11. Even if the derivative action proceeds, the business judgment rule can come into play to determine whether liability exists for the underlying transaction if it involved a decision by the board. *Aronson*, 473 A.2d at 812 ("The function of the business judgment rule is of paramount significance in the context of a derivative action. It comes into play in several ways—in addressing a demand, in the determination of demand futility, in efforts by independent disinterested directors to dismiss the action as inimical to the corporation's best interests, and generally, as a defense to the merits of the [underlying] suit.").

12. Special Litigation Committees

    a. Use of a Litigation Committee to Review a Demand

        (1) A board may act as a whole in reviewing a shareholder's demand or it may choose to appoint a committee to investigate the facts underlying a demand and make a report and recommendation regarding the suit. *See, e.g.*, *Spiegel*, 571 A.2d at 767; *Seminaris v. Landa,* 662 A.2d 1350 (Del. Ch. 1995); *Abbey,* 457 A.2d at 368.

            (a) The Chancery Court in *Abbey* called into question whether the appointment of a committee to review a shareholder's demand concedes the board's lack of independence to the demand. 457 A.2d at 368 ("[B]y divesting itself of any power to make a decision on the pending suit, and by adding a new and independent director and by designating him as a Special Litigation Committee of one with the final and absolute authority to make the decision on behalf of the corporation, the incumbent board of directors, in effect, conceded the circumstances alleged in the complaint justified the initiation of the suit by the plaintiff. This is so because the incumbent board opted for the possible use of the new *Zapata* procedure and, as I read *Zapata*, that procedure necessarily presumes a suit properly initiated by a shareholder.").

(b) Later cases, however, have clarified that the statement in *Abbey*, conceding the board's lack of independence is not a per se rule. *See Spiegel v. Buntrock*, 571 A.2d 767 (Del. 1990) ("[W]e find that the Court of Chancery properly rejected Spiegel's argument that *Abbey* stands for the proposition that a board of directors, *ipso facto*, waives its right to challenge a shareholder plaintiff's allegation that demand is excused by the act of appointing a special litigation committee and delegating to that committee the authority to act on the demand."); *Peller v. Southern Co.*, 911 F.2d 1532 (11th Cir. 1990) (applying Delaware law) ("In determining whether a shareholder is excused from making a demand, Delaware courts examine the response of a challenged board when first confronted with a derivative suit. If a board responds to a derivative suit by appointing a special litigation committee with the sole authority to evaluate whether to pursue the litigation before making a motion to dismiss for failure to make a demand, then a court may conclude that the board has conceded its disqualification and therefore demand may be excused. By contrast, if a board responds before appointing a special litigation committee to evaluate the suit, a court may not find that such a board has conceded that demand is excused.").

(c) A subsequent Delaware decision on the issue rejected the view that *Abbey* or *Spiegel* establishes a bright-line rule about when a board concedes independence by forming a committee to review a shareholder complaint. *See Seminaris*, 662 A.2d at 1350. The *Seminaris* court held that where a plaintiff claims that the formation of a committee before a motion to dismiss constitutes concession of the independence issue, "a derivative plaintiff must allege particularized facts that support a factual finding that the board made the concession." *Id.* at 1353. This decision strongly undercuts the view that the formation of the committee constitutes a per se concession of lack of independence. That said, a board confronted with a demand should take care not to be perceived as having conceded its lack of independence.

(2) Cases that have rejected the decisions of special litigation committees have largely focused on the independence or good faith of the committee members and the reasonableness of the investigations. *See e.g.*, *Janssen v. Best & Flanagan*, 662 N.W.2d 876, 888-89 (2003) (committee's decision rejected because committee "acted more like a legal advisor than a neutral decision maker" and conducted inadequate factual investigation, especially given that plaintiff and plaintiff's attorneys were not interviewed; board of directors have only "one opportunity to exercise its business judgment" before plaintiff is allowed to proceed with the action); *Kloha v. Duda*, 226 F. Supp. 2d 1342, 1344 (M.D. Fla. 2002) (it was "impossible" for committee members to maintain their independence given that members received salary and retirement benefits from corporation and faced potential "crippling" personal liability from derivative suit that was not covered by corporation's indemnification policy.); *Klein v. FPL Group, Inc.*, 2003 WL 22768424, at *20-24 (S.D. Fla. Sept. 26, 2003) (Florida court, seeking guidance from Delaware law, rejected the decision of the special litigation committee and held that its members were not independent given that they were involved and/or approved the challenged transactions, faced substantial financial liabilities because of these transactions, were hand-selected by the defendant CEO and approved by the board without any inquiry into their independence or objectivity, did not have the authority to make a final determination on the issue, and were assisted by outside counsel that had a past and ongoing relationship with the corporation and its senior officers; the court also found it "troublesome" that the company's management had issued public statements "opining on the legality of the issue in question prior to a final decision from the committee"); *cf. Powell v. First Republic Bank*, 274 F. Supp. 2d 660, 669-71 (E.D. Penn. 2003) (directors justified in not pursuing derivative action based on recommendation of one independent investigator, even though directors hired the investigator and the investigator failed to interview all interested parties, where the court otherwise found the investigation to be thorough and complete); *Brady v. Calcote*, 2005 WL 65535, at *4-6

(Tenn. Ct. App. Jan. 11, 2005) (trial court's decision to uphold conclusion of special litigation committee affirmed where committee members, a lawyer and certified public accountant, were (1) deemed to be independent as they were neither shareholders, directors or officers of the company and had many years experience investigating/auditing unsound banking practices (the issue at hand) and (2) found to have made a good faith effort to investigate the alleged misconduct as they spent "several months" conducting interviews of involved parties, "reviewed various documents including FDIC reports and financial statements of the Bank for the period at issue" and interviewed independent experts by questioning directors for other local banking corporations; the court also found that the committee's conclusion was sound because (1) it was supported by the fact that there was little likelihood that plaintiff would succeed on the merits, (2) there was no evidence of damages suffered by the shareholders or the company, and (3) the benefit of pursuing the claim against the directors would likely outweigh the costs of bringing the derivative action).

(a) *Compare Scalisi v. Grills*, 501 F. Supp. 2d 356, 358, 363, 366-67, 369 (E.D.N.Y. 2007) (Special Committee appointed by the Board to investigate claims in a demand letter concluded that prosecution of the action was not in the best interests of the Fund or its shareholders; subsequently, the shareholders filed a derivative action and the Fund moved to terminate the litigation based on the decision by the Special Committee; the court held that the Special Committee was independent, acted in good faith, its investigation was reasonable and adequate and its recommendation not to pursue a derivative action was entitled to deference under the business judgment rule).

(3) Some courts permit limited discovery to assess the independence and good faith of the special litigation committee members and the reasonableness of the investigation that was undertaken. *See, e.g.*, *Klein*, 2003 WL 22768424, at *8-9; *Evans v. Paulson*, 2006 WL 3702669, at *1 (D. Minn. Dec. 14, 2006) ("The details of an SLC's factual investigation may reveal whether the SLC acted in good faith").

(4) "Under Delaware law, a properly formed special litigation committee of the board of directors is generally entitled to a

stay of derivative litigation for the reasonable period of time necessary to complete its investigation." *St. Clair Shores Gen. Employees Ret. Sys. v. Eibeler*, 2006 WL 2849783, at *2 (S.D.N.Y. Oct. 4, 2006); *see also Kaplan v. Wyatt*, 484 A.2d 501, 510 (Del. Ch. 1984), aff'd 499 A.2d 1184 (Del. 1985). "In fact, Delaware courts have declined to grant such a stay only in unusual circumstances." *St. Clair*, 2006 WL 2849783, at *2. *But see Biondi v. Scrushy*, 820 A.2d 1148, 1150 (Del. Ch. 2003) (declining to apply the "sensible general rule" to stay discovery after formation of a special litigation committee because the "strange conduct and troubling composition" of Healthsouth's SLC was "too confidence-undermining" to ever meet the independence requirement of *Zapata*).

(a) The *Biondi* court concluded that the SLC was "fatally compromised" based on: (i) the SLC members' strong friendship with the key defendant; (ii) the board's inadequate delegation of authority to the committee; and (iii) the SLC's chairman publicly and prematurely issued statements exculpating the key defendant before the committee finished its investigation.

b. Formation of a Special Litigation Committee in the Demand-Excused Context

(1) A special litigation committee may also be appointed to review and make a binding determination with respect to a pending derivative action where a demand has been excused.

(a) Most courts and legislatures that have considered the use of special litigation committees in the demand-excused context have concluded that such a committee may, under certain circumstances, terminate the pending derivative suits. *See e.g., Auerbach v. Bennett*, 47 N.Y.2d 619 (1979); *Zapata Corp.*, 430 A.2d at 779; *see also Ferrara*, et al., § 8.01 n.10.

(b) The special litigation committee may negotiate a settlement of the derivative action with the derivative plaintiff and defendants and seek court approval of the settlement. *See In re UnitedHealth Group, Inc. S'holder Deriv. Litig.*, 591 F. Supp. 2d 1023, 1027 (D. Minn. 2008).

(c) The special litigation committee may also seek to take over the litigation from the derivative plaintiff and pursue the corporation's claims against the individual defendants. *In re Brocade Comm'ns Sys. Inc. Deriv. Litig.*, ___ F. Supp. 2d ___, 2009 WL 35235 (N.D. Cal. Jan. 6, 2009) (granting in part and denying in part defendants' motion to dismiss the complaint filed by the special litigation committee after it took over backdating derivative suit from the original shareholder plaintiffs).

(d) *See Ferrara*, et al., § 8.01 n.10 for cases and statutes approving the appointment of such committees; *but see Miller v. Register & Tribune Syndicate, Inc.* 336 N.W.2d 709 (Iowa 1983) (holding that a tainted board lacks the authority to pass on a shareholder's demand).

(2) Unlike a committee formed in response to a demand, which makes a recommendation to the full board, a special litigation committee in the demand-excused context must be given the authority to make a binding determination as to the derivative suit without seeking approval from the full board. Absent such delegation, the special litigation committee is an ineffective means of insulating the corporation's response to the derivative suit from the taint of interested directors. *See e.g.*, *In re Par Pharm. Inc.*, 750 F. Supp. 641, 646 (S.D.N.Y. 1990).

(3) Courts that allow a special litigation committee in the demand excused context have adopted a number of approaches. The following are the New York and Delaware approaches. For other approaches *see Ferrara*, et al., §§ 8.04, et seq.

(a) The New York Approach

(i) Under New York law, a court may review the procedures used by the special litigation committee, but the conclusions reached by the committee are "outside the scope" of the court's review. To that decision, the business judgment rule attaches. *Auerbach*, 47 N.Y.2d at 633-34 (Review of the merits of the special litigation committee's decision "would go to the very core of the business judgment made by the committee. To permit judicial probing of such issues would be to emasculate the business judgment doctrine as applied to the actions and determinations of the special litigation committee.”).

(ii) This approach has been adopted by a number of courts. *See Atkins v. Hibernia Corp*., 182 F.3d 320 (5th Cir. 1999) (predicting Louisiana law); *Genzer v. Cunningham*, 498 F. Supp. 682 (E.D. Mich. 1980) (predicting Michigan law); *Lewis v. Anderson*, 615 F.2d 778 (9th Cir. 1979) (predicting California law); *Desaigoudar v. Meyercord*, 108 Cal. App. 4th 173 (2003); *Roberts v. Alabama Power Co.*, 404 So. 2d 629 (Ala. 1981); *Hirsch v. Jones Intercable, Inc.*, 984 P.2d 629 (Colo. 1999); *Curtis v. Nevens*, 31 P.3d 146, 153 (Colo. 2001) (affirming the New York approach and adding that in a pre-investigation context, the trial court “may determine the independence of the SLC but may not, absent extraordinary circumstances . . . review the reasonableness of the SLC’s proposed procedures”); *Drilling v. Berman*, 589 N.W.2d 503 (Minn. Ct. App. 1999); *Miller v. Bargaheiser*, 591 N.E.2d 1339 (Ohio Ct. App. 1990).

(b) The Delaware Approach

(i) Under Delaware law, a court retains the ability to review the substantive merits of a decision by a special litigation committee to dismiss an action. *Zapata Corp.*, 430 A.2d at 779.

(ii) The court first looks at the good faith and independence of the committee in its investigation as well as the reasonableness of the information on which it relied.

(iii) If this has been met, the court either grants the committee’s motion to dismiss or may, at its discretion, apply its own independent business judgment to determine whether the committee’s decision is valid. *Id.* at 789. “[T]he discretionary second-step analysis . . .

contemplates the balancing of two potentially off-setting premises, namely, the good faith and reasonably supported view of an independent Committee that it would be in the best interests of the corporation and its shareholders to dismiss the derivative action versus a theoretical valid cause of action." *Kaplan v. Wyatt*, 484 A.2d 501, 509 (Del. Ch. 1984), *aff'd* 499 A.2d 1184 (Del. 1985).

(iv) A recent Delaware decision has held that shareholders could not voluntarily dismiss a derivative action once the corporation's special litigation committee was involved and opposed the dismissal. *In re Oracle Corp. Derivative Litig.*, 808 A.2d 1206, 1213 (Del. Ch. 2002).

(v) The Delaware approach has been followed by other states. *Strougo v. Padegs*, 27 F. Supp. 2d 442, 447 (S.D.N.Y. 1998) (applying Maryland law); *Rosengarten v. Buckley*, 613 F. Supp. 1493 (D. Md. 1985) (applying Maryland law); *Abella v. Universal Leaf Tobacco Co.*, 546 F. Supp. 795 (E.D. Va. 1982) (applying Virginia law); *Peller v. Southern Co.*, 707 F. Supp. 525 (N.D. Ga. 1988), *aff'd* 911 F.2d 1532 (11th Cir. 1990) (applying Georgia law); *Allied Ready Mix Co. ex rel Gobel Mattingly v. Allen*, 994 S.W.2d 4 (Ky. Ct. App. 1998); *Alford v. Shaw*, 358 S.E.2d 323 (N.C. 1987), *withdrawing* 349 S.E.2d 41 (N.C. 1986), *aff'g and modifying* 324 S.E.2d 878 (N.C. App. 1985); *but compare Atkins v. Topp Comm, Inc.*, 874 So. 2d 626, 627-28 (Fla. Dist. Ct. App. 2004) ("[T]rial courts in [Florida] are not required to evaluate the reasonableness of an independent investigator's final recommendation, pursuant to the second-step analysis in Zapata").

c. Characteristics of a Special Litigation Committee

(1) The following guidelines should be followed in setting up a special litigation committee:

(a) The committee should be vested with full and unconditional authority to act on behalf of the board to investigate the allegations and to determine if litigation is in the company's best interest. *See Abbey*, 457 A.2d at 368.

(b) The board needs to appoint truly independent and disinterested directors. *See, e.g., Melton v. Blau*, 2004 WL 2095317, at *6 (Conn. Super. Ct. Aug. 26, 2004) ("Without a statutory definition, the court looks to the common and ordinary meaning of 'independent.' Basically, to be 'independent' means that one is free from the influence, control or determination of someone or something. . . . [T]o be 'independent,' a director should be 'disinterested.'") Courts are reluctant to accept a special litigation committee's recommendation when it suspects that personal interests motivated the committee's determination. *See, e.g., Lewis v. Fuqua*, 502 A.2d 962, 966 (Del. Ch. 1985); *Biondi v. Scrushy*, 820 A.2d 1148, 1156-1157 (Del. Ch. 2003) (holding that committee was "fatally compromised" because of members' strong friendship with key defendant, inadequate delegation of authority to the committee, and fact that chairman of the committee publicly and prematurely issued statements exculpating one of the key defendants before the committee finished its investigation).

(c) In *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003), the Court broadened the basis for questioning a special litigation committee's independence. In *Oracle*, shareholders brought a derivative action alleging insider trading by certain of the company's officers and directors. The special litigation committee appointed to investigate the matter subsequently moved for dismissal after conducting an investigation which the Court acknowledged was, "by any objective measure, extensive." *Id*. at 925. The Court stated that in order for the committee to prevail in its motion to dismiss, it must show that: "(1) its members were independent; (2) that they acted in good faith; and (3) that they had reasonable bases for their recommendations" (citations omitted). *Id*. at 928. Basing its decision solely on the independence factor, the Court held that the two-member committee had failed to demonstrate its independence. *Id*. at 942-945. This decision was based on the fact that both members were professors at Stanford University, and all of the defendant directors and officers accused of wrong doing in the derivative action had important ties to the University. *Id*. The Court arrived at this conclusion despite acknowledging that the committee members were not in key fundraising positions that would call into question their impartiality, and were both tenured professors whose current jobs would not be threatened by whatever good faith decision they made as committee members. The Court, instead, emphasized the following relationships between the committee members and defendants: (1) one of the defendants, also a Stanford professor, taught one of the committee members when the committee member was a Ph.D. candidate and both individuals currently serve on the same economic research committee at Stanford; (2) another defendant, a Stanford alumnus, is chair of the advisory board of the same economic research committee mentioned above and has made substantial monetary donations to departments and committees at Stanford that are closely affiliated to one of the committee members and from which the member has directly benefited; and (3) another defendant, Oracle's CEO, has made millions of dollars in donations to Stanford, and was considering donating his $100 million house and a $170 million scholarship program to Stanford at around the time that the committee members were added to Oracle's board. *Id*.

(d) The Court, broadening the independence analysis by using a "contextual approach," which takes into account all relevant facts and circumstances that may affect a committee member's impartiality, focused on "bias-creating" factors beyond the usual economic factors in coming to its decision. *Id*. The Court ultimately found that even though the committee members were not "dominated" or "controlled" by any of the defendants in the traditional economic sense, the members were not independent due to other social and collegial factors, such as the difficulty of accusing a fellow professor, whom one might see at the faculty club or at academic conferences, of insider trading. *Id*. The Court also suggested that these types of relationships might be of particular concern when committee members are called upon to make subjective determinations about defendants' state of mind or when the committee's decision can result in potentially severe consequences. *Id*.

(e) A special litigation committee should also consist of two or more members. In a jurisdiction where a one-member special litigation committee is permitted, that member must, "like Caesar's wife, be above reproach." *Houle v. Low*, 556 N.E.2d 51 (1990). Committee members should be qualified. Qualifications depend on (1) the nature of the issues involved; (2) the complexity of the information obtained during the course of the investigation; and (3) the extent that the committee obtained expert advice. *See Lewis*, 502 A.2d at 966.

(f) The committee should retain independent counsel to assist it in its investigation. *See In re Par Pharm. Inc.*, 750 F. Supp. at 647 ("Both New York and Delaware law contemplate that a special litigation committee be represented by independent counsel."). To avoid the appearance of a conflict of interest, outside counsel is preferable to in-house counsel. Counsel should be free of any conflicts that might interfere with its ability to render unbiased legal advice to the committee. *See, e.g., General Electric Co. v. Rowe*, 1992 WL 277997 (E.D. Pa. Sept. 30, 1992); *In re Par Pharm. Inc.*, 750 F. Supp. at 647.

(g) The committee must fully and thoroughly investigate the allegations underlying the derivative suit and draft a report of its findings of fact and conclusion of law, which should address the merits of the plaintiff's claims and provide sufficient information to demonstrate that the investigation was reasonable and thorough. *See, e.g., Electra Inv. Trust PLC v. Crews*, 1999 WL 135239 (Del. Ch. Feb. 24, 1999).

13. Special Review Committee

a. Use of a Special Review Committee to Review a Demand

(1) Where a Board feels strongly that it is disinterested and independent, it may not want to appoint a Special Litigation Committee because some courts have held that the

appointment of a Special Litigation Committee is tantamount to a concession that the Board is not independent. In the alternative, a Special Review Committee, or Special Committee, can be formed to look into a demand without conceding a lack of independence or disinterestedness. *See Madvig v. Gaither*, 461 F. Supp. 2d 398, 402-03, 410-11 (W.D. N.C. 2006) (special committee formed to investigate shareholder's allegations of malfeasance or misfeasance was found to be independent and acted in good faith). A Special Committee might also be formed to investigate claims of potential wrongdoing by officers or directors in response to a government investigation or derivative action. *See, e.g., Edmonds v. Getty*, 524 F. Supp. 2d 1267, 1269 (W.D. Wash. 2007) (Special Committee was formed "in response to an informal inquiry by the SEC"). A Special Review Committee has many of the characteristics and all of the investigative powers of a Special Litigation Committee and it would make a recommendation to the Board about whether or not to pursue litigation, but the Board would retain the right to make the final decision. This is a useful tool when there are simultaneous demand-futility and demand-refused cases pending, and a concession in the latter could be used as an admission in the former.

(a) In 2006, the use of Special Committees to investigate potential stock-option backdating became quite prevalent. *See In re KLA-Tencor Corp. S'holder Derivative Litig.*, 2008 WL 2073936, at *1 (N.D. Cal. May 14, 2008) (Special Committee was appointed by the Board of Directors to investigate allegations of stock-option backdating, before the appointment of the SLC; the Special Committee "reviewed internal documents, considered memoranda drafted by counsel following witness interviews, and consulted with forensic accountants"); *In re Bed Bath & Beyond Inc. Deriv. Litig.*, 2007 WL 4165389, at *1 (D.N.J. Nov. 19, 2007) (Board of Directors formed a Special Committee of two directors to conduct an investigation of suspected stock-option backdating; the Special Committee retained "independent legal counsel to conduct an investigation" and counsel engaged "independent accounting advisors;" in response to the Committee's recommendations the company reformed its "policy regarding stock options grants through the adoption of new controls”).

(b) In one stock-options derivative action, UnitedHealth Group, Inc. formed a special litigation committee in response to pending derivative actions. After the committee completed its investigation, it recommended that the action be settled. *In re UnitedHealth Group, Inc. S’holder Deriv. Litig.*, 591 F. Supp. 2d 1023, 1027 (D. Minn. 2008). Having received the proposed settlement, the U.S. District Court certified a question to the Minnesota Supreme Court seeking guidance on the degree of deference that should afforded to an SLC’s settlement decision under Minnesota law. *See In re UnitedHealth Group Inc. S’holder Deriv. Litig.*, 754 N.W.2d 544, 561 (Minn. 2008) (holding that under Minnesota law, a court should defer to an SLC’s settlement recommendation when the SLC establishes that it was sufficiently independent and that its investigation procedures were adequate, appropriate, and pursued in good faith). Applying this standard, the District Court granted the SLC’s motion to grant preliminary approval to the derivative settlement, and directed adequate notice to be sent to UnitedHealth’s shareholders. *UnitedHealth*, 591 F. Supp. 2d at 1028-31.

II. THE ABILITY TO REMOVE DERIVATIVE ACTIONS TO FEDERAL COURT UNDER THE SECURITIES LITIGATION UNIFORM STANDARDS ACT OF 1998

A. SLUSA Background

1. In 1998, Congress enacted the Securities Litigation Uniform Standards Act (“SLUSA”) in an effort to prevent litigants from strategically pursuing frivolous class-action suits in state court under state law in order to evade the heightened pleading requirements and restrictions established under federal law. SLUSA attempts to curtail these abuses by preempting and requiring that any “covered class action” based on state law that alleges a misrepresentation or omission of a material fact or act of deception in connection with the purchase or sale of a covered security be removed to federal court. *See* 15 U.S.C. § 77p; 15 U.S.C. § 78bb. SLUSA’s removal provision, however, does not appear to extend to shareholder claims based on holders, as opposed to purchasers and sellers, of a covered security. *See, e.g.*, *Meyer v. Putnam Int’l Voyager Fund*, 220 F.R.D. 127, 129 (D. Mass. 2004). There also seems to be a split in authority on whether the provision

extends to claims based exclusively on the Securities Act of 1933. *See, e.g.*, *In re Tyco Int'l, LTD. Multidistrict Litig.*, 2004 WL 1403009, at *4 n.1 (D.N.H. June 21, 2004).

2. SLUSA explicitly states that actions that are "exclusively derivative" in nature are excluded from the definition of "covered class actions." 15 U.S.C. § 77p(f)(2)(B); 15 U.S.C. § 78bb(f)(5)(c). "[T]he common understanding of an 'exclusively derivative' action is an action that asserts only derivative claims." *Coykendall v. Kaplan*, 2002 U.S. Dist. LEXIS 22483, at *9 (N.D. Cal. Aug. 1, 2002); *see Proctor v. Vishay Intertech., Inc*., 2007 WL 518616, at *6 (N.D. Cal. Feb. 13, 2007) (because plaintiffs' complaint included a shareholder derivative action and two claims of relief on behalf of a class it was not an "exclusively derivative" action). Recently, several federal courts have interpreted the application of SLUSA in the context of shareholder derivative suits and have decided to remand these suits back to state court.

3. In *Coykendall v. Kaplan*, 2002 U.S. Dist. LEXIS 22483, at *9-11, defendants argued that the "exclusively derivative" exemption under SLUSA should be given a broad functional construction and that if a complaint could have alleged claims that would be subject to SLUSA, SLUSA should apply. The court rejected this argument and held that even though plaintiffs' complaints could have been actionable as securities fraud, the fact that plaintiffs sought relief on behalf of the corporation rather than for a class of injured investors was determinative and remanded the case back to state court. *See also Arlia v. Blankenship*, 234 F. Supp. 2d 606, 612-13 (S.D. W.Va. 2002) (remanding case back to state court because "statute itself makes clear that the shareholder derivative action was not one of the mass actions that Congress intended to cover" under SLUSA).

4. In *Shen v. Bohan*, 2002 U.S. Dist. LEXIS 22485, at *6-7 (C.D. Cal. 2002), the court rejected the defendants' argument that plaintiffs' request for damages made the action a "covered class action" within the purview of SLUSA. The court held that since plaintiffs' requests for damages clearly related to their shareholder derivative actions, the request for damages did not render the action removable under SLUSA. The court also found that removal to federal court was improper because plaintiffs' allegations regarding improper dilution of shareholder interests were not misrepresentations "in connection with" the purchase or sale of a security and there was no indication that plaintiffs were "fraudulently pleading to circumvent SLUSA." *Id*. at 11.

5. In *Greaves v. McAuley,* 264 F. Supp. 2d 1078 (N.D. Ga. 2003), the court found that some of plaintiffs' claims were specifically preempted by SLUSA because they were a "covered class action" and the alleged misrepresentations were "in connection with" the purchase or sale of a covered security. *Id*. at 1082-83. The court, however, also found that

plaintiffs' claims, which alleged that a proxy statement provided by defendant directors contained material misstatements and omissions concerning a proposed merger, were expressly preserved by the Delaware carve-out exception under SLUSA.[2] In resolving this conflict, the court held that according to the "plain language of the statute, the court is to consider the propriety of remand after determining the propriety of removal. . . If remand is appropriate, the entire lawsuit must be returned to state court, irrespective of the court's decision regarding removal . . . the remand provision trumps the removal provision, and the entire lawsuit must be remanded." *Id*. at 1085-86. Moreover, the court supported its decision by stating that "[b]ecause removal jurisdiction raises significant federalism concerns, federal courts are directed to construe removal statutes strictly . . . [and] all doubts about jurisdiction should be resolve in favor of remand to state court." (citations omitted). *Id*. at 1086. Thus, the entire cause of action was remanded to state court.

6. In *Young v. Antioco*, 2003 WL 23201342, at *2-3 (N.D. Tex. Aug. 6, 2003), the court—in addressing whether plaintiff's references to the federal securities laws and claim for damages due in part to the pendency of the federal class action suits implicates those federal statutes to such a degree as to federalize the derivative suit such that the SLUSA removal provision attached—held that removal was improper because the alleged federal securities laws violations served solely to illuminate the alleged state law derivative claims. *See also, Fathergill v. Rouleau*, 2003 WL 21467570 (N.D. Tex. June 23, 2003) ("fact that conduct that violates federal law serves as a basis for a state-law claim does not make a federal right an essential element of that claim" necessitating removal under SLUSA).

   a. In *Landers v. Morgan Asset Management, Inc.*, the court held that SLUSA does not provide a basis for the defendants to remove the state court derivative action. 2009 WL 962689, at *10-11 (W.D. Tenn. Mar. 31, 2009). The court, however, nonetheless upheld the removal and denied plaintiffs' motion to remand because the breach-of-fiduciary-duty and negligence claims were based on the defendants' alleged failure to comply with the federal securities laws; as a result, the district court had subject-matter jurisdiction over the action because the complaint—which did not plead any causes of action under the federal securities laws—implicated the substantial federal question doctrine because its claims required the resolution of a federal question to establish the standard of care. *Id.*, at *8-10.

[2] The Delaware carve-out exception preserves actions that involve "(1) any recommendation, position, or other communication with respect to the sale [of securities of] any issuer; (2) that is made by or on behalf of the issuer or an affiliate of the issuer to holders of equity securities of the issuer; and (3) concerns decisions of such equity holders with respect to voting their securities, acting in response to a tender or exchange offer, or exercising dissenters' or appraisal rights." (citations omitted). *Id*. at 1083.

b. In another recent opinion, a district court denied a plaintiff's motion to remand a derivative action alleging only state law claims based on diversity jurisdiction because complete diversity existed and the removing party established by a preponderance of the evidence that the amount in controversy exceeded the $75,000 jurisdictional requirement. *Cucci v. Edwards*, 510 F. Supp. 2d 479, 485 (C.D. Cal. 2007).

B. Exercising SLUSA Power to Stay Discovery

1. Under SLUSA, "a court may stay discovery proceedings in any private action in a State court, as necessary in aid of its jurisdiction, or to protect or effectuate its judgments, in an action subject to a stay of discovery pursuant to this paragraph." 15 U.S.C. § 78u-4(b)(3)(D). Courts have applied this provision with mixed results.

2. *In re DPL Inc., Sec. Litig.*, 285 F. Supp. 2d 1053, 1062 (S.D. Ohio 2003), the court refused to vacate its prior stay of discovery because the purpose of the stay had not yet been realized. The purpose of the stay in the state court proceeding was to "ensure that a motion to dismiss the federal securities claims could be filed, heard and decided before discovery had commenced." *Id.* In addition, the court initially issued the stay so that the plaintiffs would "not use discovery in the state court litigation to acquire information in order to 'resuscitate a complaint that [would] otherwise [be] subject to dismissal'" under the PSLRA. *In re DPL Inc., Sec. Litig.*, 247 F. Supp. 2d 946, 951 (S.D. Ohio 2003).

3. In *City of Austin Police Ret. Sys. v. ITT Educ. Servs., Inc.*, 2005 WL 280345, at *1 (S.D. Ind. Feb. 2, 2005), the court held that SLUSA does not warrant a stay in a shareholder action to inspect defendants' records pursuant to Section 220 of the Delaware Corporation Code even with a parallel federal securities fraud action. *Id.* Although the court had the authority under SLUSA to stay the state inspection suit, as a type of "discovery proceeding," the defendants failed to make a "proper showing" that the state action would interfere with the federal action. *Id.* The defendants argued "that a federal court should stay discovery in a state case when a defendant shows that discovery is being conducted or attempted in a state court proceeding any time the facts at issue and the discovery are related to and overlap with the federal securities fraud case." *Id.* at 9. The court rejected this argument, finding that the "defendants' proposed standard would apply far too broadly, reaching state court cases in which the claims would be entirely different, and in which the federal defendants would not even need to be parties." *Id.*

4. In *Cardinal Health, Inc. Sec. Litig.*, 365 F. Supp. 2d 866 (S.D. Ohio 2005), the court came to a different conclusion, exercising its power under SLUSA

to allow a stay of discovery in the state derivative action. *Id.* at 867. In deciding to stay discovery, the court relied on the fact that the state derivative claim was "predicated almost entirely on the gravamen of the complaints pending [before the] Court: securities fraud." *Id.* at 875. "Thus, were discovery to reach accidentally the federal Plaintiffs, the information would likely be applicable to the federal case because both involve the same substantive arguments." *Id.*

5. In *In re Crompton Corp. Sec. Litig.*, 2005 WL 3797695 (D. Conn. July 22, 2005), the district court overseeing a securities class action granted the defendants motion to stay the parallel state court derivative action under SLUSA. The district court found that the defendants demonstrated a likelihood that the federal plaintiffs will obtain discovery produced in the state action based on the following factors: (1) over 100 paragraphs in the amended state complaint were nearly identical to the allegations in the federal consolidated complaint; and (2) the derivative plaintiff, whose counsel briefly also represented the plaintiffs in the class action, was a putative class member in the federal action, "and her receipt of discovery without a showing that it is necessary to preserve evidence or prevent undue prejudice violates the PSLRA." *Id.*, at *3. The court also cited the extreme burden on the defendants to produce the same discovery that had been stayed in the federal action, and the risk of inconsistent rulings between the state and federal actions given the significant overlap in their allegations. *Id.*

    a. Three weeks later, the district court issued a follow-up opinion requiring the state plaintiff to return or destroy all the discovery she recently received from the state action defendants, several of whom were also named as defendants in the federal class action. *In re Crompton Corp. Sec. Litig.*, 2005 WL 3797697, at *2 (D. Conn. Aug. 16, 2005) ("By refusing to return discovery produced to date, [the derivative plaintiff] violates the letter and the spirit of the PSLRA and SLUSA, and thereby circumvents this Court's determination to preserve its jurisdiction.)

III. IMPACT OF THE SARBANES-OXLEY ACT OF 2002 ON DERIVATIVE ACTIONS

A. Sarbanes-Oxley

1. Congress enacted the Sarbanes-Oxley Act ("SOX") on July 30, 2002, in an effort to restore public confidence in the securities market after a series of high-profile corporate accounting scandals and to protect investors from improper business conduct. *In Re Enron Corp. Sec., Derivative & Erisa Litig.*, 258 F. Supp. 2d 576, 588 (S.D. Texas 2003). SOX seeks to accomplish this task by enacting procedural and structural reforms in corporate governance, auditor independence, and auditor oversight and greatly increasing the responsibilities and obligations of officers and

directors of public companies. *See, e.g.*, 15 U.S.C. §§ 7211-19; §§ 7231-34 and §§ 7241-46. These new rules and regulations consists of some of the most intense corporate governance reforms since the post-Depression activities that led to the Securities Act of 1933 and the Securities Exchange Act of 1934, and will consequently have an impact on the litigation of future derivative actions.

B. SOX Impact on Derivative Actions

1. There are several provisions in the Act that may have an impact on shareholder derivative actions. The most substantial provision requires lawyers who are practicing or appearing before the SEC to report evidence of a material violation of the securities laws or breach of fiduciary duty to the corporation's chief legal counsel or chief executive officer. 15 U.S.C. §-7245(1). Moreover, if the lawyer finds that appropriate remedial measures or sanctions have not been taken, the lawyer must report the evidence to the corporation's audit committee or another comparable committee composed of independent directors or board members. 15 U.S.C. § 7245(2). The Act also requires corporations to have audit committees composed only of independent directors with at least one member who is financially sophisticated. 15 U.S.C. § 78j-1; *see also* SEC Release No. 33-8177. These new provisions will likely increase the number of civil actions, including derivative actions that are filed against public companies, directors and officers, and may provide derivative plaintiffs with added incentive and opportunity to engage in discovery.

2. For example, a shareholder derivative action was brought, in part, on the claim that company directors failed to address the impropriety of the company's payment of split-dollar insurance policy premiums to the company's Chairman and CEO, Martha Stewart. *Beam*, 833 A.2d at 975. Because the premiums for these policies are paid entirely or in large part by the employer, some have suggested that this type of insurance policy constitutes an interest-free loan to the employee on whose behalf the policy is purchased. *Id*. at 970. As such, these policies *may* run afoul of the SOX provisions that ban loans to corporate executives and directors. *See* Sarbanes-Oxley Act of 2002, Pub.L. No. 107-204 § 402(a), 15 U.S.C. §-78m(k). The Court, however, dismissed the claim because plaintiff failed to plead facts to show that the payment of these premiums were in fact unlawful. Moreover, the company had disclosed the existence of the policy, and the company's lawyers and accountants were looking into whether the policy should be discontinued in light of the new SOX provisions. *Beam*, 833 A.2d at 975.

3. In *Neer v. Pelino*, 389 F. Supp. 2d 648 (E.D. Pa. 2005), shareholders filed a derivative action against the company's current and former officers and directors alleging breaches of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets, unjust enrichment, and

violations of Section 304 of the Sarbanes-Oxley Act. The plaintiffs filed the action in federal court asserting that Section 304 provided a basis for federal jurisdiction. *Id*. Defendants moved to dismiss for lack of subject matter jurisdiction, arguing that Section 304 does not provide a private right of action for plaintiffs. *Id*.

a. Section 304 of the Sarbanes-Oxley Act provides: "If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for (1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and (2) any profits realized from the sale of securities of the issuer during that 12-month period." 15 U.S.C. § 7243.

The court agreed with defendants, finding that "Section 304 does not explicitly afford a private right of action." *Id*. at 652. The court's analysis included a comparison of Sections 304 and 306 since "[b]oth address wrongdoing of officers and both provide for the issuer's reimbursement." *Id*. at 655. The court reasoned that "[b]ecause Congress explicitly created a private right of action in Section 306 and did not do so in Section 304, the natural inference is that Congress did not intend to create a private right of action in Section 304." *Id*. Especially since, "Congress was at pains in Section 306(a)(2)(B) to spell out who could enforce that section and how long the enforcer had to do it." *Id*. "Section 304 is silent on both subjects," thus, the court concluded that "it [was] fair to say that implying a private right would . . . require [the court] to rewrite Congress's statute," which they could not do. *Id*.

4. In *In re Bisys Group Inc. Derivative Action*, 396 F. Supp. 2d 463, 464 (S.D.N.Y. 2005), shareholders filed a derivative action alleging violations of Section 304 and various state law theories. Similar to the *Neer* action, plaintiffs sued in federal court basing jurisdiction on Section 304. *Id*. Based on the plaintiffs' admission that "there [was] nothing in the legislative history to suggest an intention to create a private right of action," as well as the court's own analysis of the issues, the court held that "[Section 304] does not expressly create a private cause of action in favor of the issuer or, for that matter, anyone else." *Id*.

5. In *Kogan v. Robinson*, directors and officers filed a motion to dismiss a shareholder derivative action seeking recovery under Section 304 of the Sarbanes-Oxley Act. 432 F. Supp. 2d 1075, 1077 (S.D. Cal. 2006). The plaintiff argued that Section 304 of the Sarbanes-Oxley Act expressly, and

implicitly, created a private right of action in favor of issuers to seek reimbursement from top officers of certain bonuses and profits. *Id*. The court disagreed, finding that "Congress did not explicitly authorize a private right of action," noting that the language in the Section 304, "shall reimburse the issuer," does not address the matter of enforcement. *Id*.

6. The court also found that "Section 304's rights-creating language does not, standing alone, imply a private remedy." *Kogan*, 2006 WL 1495065, at *3. The court determined that "Congressional intent to grant such a remedy is not evident in the text and structure of the statute, particularly where Congress has explicitly created a private remedy in a neighboring provision but did not do so in Section 304." *Id*. at *6. In the absence of statutory intent to create a private remedy, the court held that "a cause of action does not exist and courts may not create one, no matter how desirable that might be as a policy matter, or how compatible with the statute." *Id.* (citations and quotations omitted); *see In re Whitehall Jewelers, Inc. S'holder Derivative Litig.*, 2006 WL 468012, at *7 (N.D. Ill. Feb.27, 2006) ("§ 304 does not give rise to a private right of action"); *In re Goodyear*, 2007 WL 43557, at *7 (although "[t]he United States Court of Appeals for the Sixth Circuit ha[d] not ruled on th[e] issue," held "that no private right of action exists under Section 304 of the Sarbanes-Oxley Act of 2002.").

IV. DERIVATIVE ACTION SETTLEMENT CONSIDERATIONS

A. Basic Settlement Issues

1. Most derivative actions that survive dismissal are resolved through settlement. Settlements of derivative actions are particularly favored because the cases are "notoriously difficult and unpredictable." *Maher v. Zapata Corp*., 714 F.2d 436, 455 (5th Cir. 1983).

B. The Settlement Agreement

1. Generally, derivative cases do not settle until plaintiffs have an opportunity to investigate the underlying claims. But if the facts are not in dispute, or only legal issues are involved, negotiations may commence immediately following the filing of a complaint. The parties to early talks may enter into a memorandum of understanding establishing preliminary settlement terms. The memorandum of understanding should contain the terms of the proposed settlement; outline any confirmatory discovery necessary to permit the parties to evaluate the settlement; and set forth the proposed form of notice to shareholders and who will pay for the notice campaign. The plaintiffs can then engage in discovery to validate those settlement terms.

   a. The plaintiff serves as a fiduciary to his fellow shareholders and must have sufficient discovery to permit him to represent to the court that the settlement is fair, reasonable and adequate based on an adequate investigation. The board, likewise, must have sufficient information to exercise its business judgment and determine whether the settlement is fair to the corporation.

2. The settlement agreement may contain a variety of terms including a payment to the corporation or its shareholders, modification or abandonment of a corporate transaction, or changes in corporate governance (often referred to as corporate therapeutics). Because the plaintiff shareholders are suing on behalf of the corporation, they are fiduciaries and cannot seek a personal benefit for themselves or their attorneys. *See Weid v. Valhi, Inc.*, 466 A.2d 9 (Del. 1983).

   a. By definition, a derivative action is one brought on behalf of the corporation for a harm suffered by all shareholders in common. Therefore, in general any recovery in judgment or in settlement belongs to the corporation. The cost of any settlement or judgment should be borne by the alleged wrongdoers, not the company or its shareholders. *See Strategic Asset Mgmt. v. Nicholson*, 2004 Del. Ch. Lexis 67 (Del. Ch. 2004) (Rejecting derivative settlement, in part, where proposed settlement costs were to be borne by the company, not the defendant directors).

      (1) In one recent settlement, rather than pay a settlement into the corporate treasury, Oracle CEO Larry Ellison agreed to pay $100 million on the company's behalf to charities he selected and Oracle approved. But the settlement called for Oracle to pay $24 million in fees to plaintiffs' counsel. A shareholder objected to the fee payment, arguing it would waste corporate assets. The California court agreed and rejected the settlement because Oracle, which would not receive any money in the settlement, should not be the one to pay plaintiffs' fees. The court eventually approved a settlement in which Ellison agreed to pay the plaintiffs' attorneys fees. *In re Oracle Cases*, 2005 WL 3278775 (Cal. Super. Nov. 22, 2005).

   b. In lieu of, or in addition to a monetary settlement, the parties often will agree to corporate governance reforms. The reforms enhance corporate governance at no cost to the company and therefore are in line with the purpose of a derivative suit. They also let the plaintiffs claim credit for achieving reforms and can be used in justifying a fee award before the court.

   c. Examples of "corporate therapeutics" changes made in recent settlements include:

- Increasing the number of independent directors;
- Compensating directors with company stock;
- Reforms to prevent awards of backdated options;
- Amendments to the compensation committee's charter;
- Limiting number of boards a director may serve on;
- Increasing shareholder's ability to replace or remove directors;
- Requiring an independent chair.

d. These changes by the company do not require any admission of wrongdoing by the director defendants and are generally not considered a loss that would obligate them to pay plaintiffs' fees. Because the reforms benefit the company and are not considered a legal obligation of the defendant directors they should not trigger the prohibition on indemnification applicable to derivative settlements.

C. Court Approval Required

1. A derivative action "shall not be dismissed or compromised without the approval of the court." Fed R. Civ. P. 23.1; *see also* Del. Ch. Ct. R. 23.1; N.Y. Bus. Corp. L. § 626(d); *Gaillard v. Natomas Co.*, 173 Cal. App. 3d 410, 419 (1985) (citing *Whitten v. Dabney*, 171 Cal. 621, 630-32 (1915); *Ensher v. Ensher, Alexander & Barsoom, Inc.*, 187 Cal. App. 2d 407, 410 (1960)) ("California courts have found that shareholder derivative plaintiffs may be considered as trustees or guardians ad litem to the corporation's right of action[;] [s]uch plaintiffs have no power to settle or compromise the corporation's action absent court approval.").

a. The court must determine that the settlement is fair, reasonable and adequate in light of the claims being settled. *See Rosenfeld v. Bear Stearns & Co.*, 237 A.D.2d 199, 199, 655 N.Y.S.2d 473, 473 (App. Div. 1997); *Nuanes v. Insignia Fin. Group, Inc.*, 2005 WL 639657, *3 (Cal. App. 1 Dist. Mar 21, 2005) ("In passing on the propriety of a settlement [of a derivative action], the court must determine whether the proponents of the settlement have shown that it fairly and adequately serves the interests of the [entity] on whose behalf the derivative action was instituted."). The strong policy in favor of settling such suits is balanced against the policy of ensuring that shareholders are protected. *In re MAXXAM, Inc.*, 659 A. 2d 760 (Del. Ch. 1995); *Robbins v. Alibrandi*, 127 Cal. App. 4th 438, 449 (2005) ("A court reviews the settlement of a derivative suit as a means of protecting the interests of those who are not directly represented in the settlement negotiations."); *Nuanes*, 2005 WL 639657, *4 ("While settlements are generally favored, they may not be approved if the negotiations are biased or skewed by a conflict of interest.").

b. The settling parties bear the burden of proof on the fundamental fairness of the settlement. The burden then shifts to any objectors who must show that the claims would be worth more if litigated than the value of the settlement. The court sits as trier of fact and applies its business judgment to determine the fairness of the settlement. *Nottingham Partners v. Dana*, 564 A.2d 1089, 1102 (Del. 1989); *but see Feder v. Harrison*, 58 F.R.D. 171 (S.D.N.Y. 1972) (Court should not substitute its business judgment for the parties' judgment). The court need not reach ultimate conclusions on issues of law or fact in the underlying litigation. The court has broad discretion in deciding whether or not to approve a settlement. *Polk v. Good*, 507 A.2d 531, 536 (Del. 1986).

c. In settlement, former adversaries join together seeking approval. The court must therefore also be vigilant to avoid the taint of collusion between the settling parties. *See Levy v. General Electric Capital Corp.*, 50 F. Supp. 2d 931, 932 (S.D.N.Y. 2001) (explaining need for judicial approval of derivative settlement). Where different attorneys represent the same or overlapping classes, and not all participate in the settlement, there is particular cause for concern. The defendants may choose to negotiate with plaintiff's counsel they believe will be more accommodating in exchange for fees. *See Stepak v. Tracinda Corp.*, No. 8457, 1989 Del Ch. Lexis 95 (Del. Ch. 1989) ("Where there are two or more attorneys purporting to act on behalf of the same or overlapping classes, there is a special risk that a defendant will seek advantage in choosing the adversary with whom it will negotiate, and a risk that a plaintiff will be accommodating [sic] in exchange for an agreement that includes legal fees."); *In re MAXXAM, Inc.*, 659 A. 2d 760 (Del. Ch. 1995) (where settling parties freeze out competing plaintiffs, "little, if any, deference is given to the views of the settling plaintiffs."); *Robbins*, 127 Cal. App. 4th at 449 ("When the settlement includes a negotiated fee, the reviewing court must be cognizant that derivative-suit counsel might urge an undesirable settlement as a means of avoiding the risk of recovering no fees, or fees substantially less than those that counsel might recover as part of, or because of, the settlement. In addition, the defendants and their attorneys, wishing to contain damages, may be tempted by a settlement placing the major financial burden on the corporation itself. A court reviewing a negotiated fee, therefore, should review the circumstances leading up to the settlement to ensure that the process was fair and free from fraud or collusion.")

d. An appellate court reviewing the settlement will examine the record for an abuse of discretion by the trial court in approving the settlement. *Kahn v. Sullivan*, 594 A.2d 48, 51 (Del. 1991)*; see also Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279 (Del. 1989) ("Because the Court of Chancery is in the best position to evaluate the factors that support a settlement, we will not second guess its business judgment on appeal. Rather, if there is evidence in the record to support the Chancellor's findings and if his conclusions are not the product of errors of law, we must affirm the settlement on appeal.")

e. When a proposed settlement is negotiated by a Special Litigation Committee ("SLC"), there is a split in the approach used to review the agreement. Some states will only examine the independence, good faith, and procedures of the committee, and will not scrutinize the decision itself. *See e.g. Auerbach v. Bennett*, 47 N.Y.2d 619 (1979). Others require a two step approach, first analyzing the independence and procedures of the committee, and then exercising the court's own business judgment to determine whether the settlement should be approved. *See e.g. Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

2. Factors Courts Consider

a. The approving court will consider a variety of factors including: (1) the probable validity of the claims; (2) the apparent difficulty in enforcing those claims; (3) the collectibility of a judgment; (4) the delay, expense and difficulty associated with the litigation; (5) the value of the compromise as compared with the collectible amount of a judgment; (6) the views of the parties; and (7) the stage of the proceedings and the discovery reviewed by the settling parties. *See City of Detroit v. Grinnell Corp*., 495 F.2d 448 (2d Cir. 1974); *Polk v. Good*, 507 A.2d 531 (Del. 1986); *In re Maxxam, Inc.*, 659 A.2d 760, 768 (Del. Ch. 1995).

b. In addition to these factors, the court may take into account the number of objectors. The court disapproved a settlement in *In re FLS, Inc. Shareholders Litigation*, in part based on the substantial number of objectors who voiced dissatisfaction with the settlement. No. 12,623, 1993 Del. Ch. Lexis 57 (Del. Ch. 1993) ("the refusal of a large holder of class claims to accept the settlement combined with its desire to itself facilitate the adjudication of its rights, is a factor I can properly take into account on this motion.").

c. In the class action context, the court must also make findings that the prerequisites for certifying a settlement class are also met. *In re Infinity Broadcasting Corp. S'holders Litig.*, 802 A.2d 285 (Del.

2002). "Whether [a] class has been fairly and adequately represented by the class representative during settlement negotiations has been deemed [a] critical factor in determining whether a settlement is worthy of court approval." *Nuanes*, 2005 WL 639657, *5 (court overruled lower courts approval of settlement agreement because there was no finding that the interests of the corporation were protected with respect to the representation of the derivative claims) (quotations and citations omitted).

3. Notice to Shareholders

a. Rule 23.1 requires shareholder be given notice of a proposed settlement or dismissal and have opportunity to be heard. *See also*, N.Y. Bus. Corp. L. § 626(d). Notice of a dismissal to all shareholders permits absent shareholders to intervene and continue the action if they deem it necessary. Under the Delaware rule notice is unnecessary if the dismissal is without prejudice to the plaintiffs. *See* Del Ch. Ct. R. 23.1.

b. Typically, the parties agree on a form of notice and submit it to the court for approval. The court may direct that the notice be mailed to all shareholders, and may also require some form of publication notice. The notice must disclose the nature of the action; the factual evidence; the parties' positions; the terms of the proposed settlement, including any monetary recovery and the attorneys' fees; the time and manner in which objections must be made; and the date for the hearing. *See Prince v. Bensinger*, 244 A.2d 89, 92 (Del. Ch. 1968); *In re Four Seasons Securities Laws Litig*., 525 F. 2d. 500 (10th Cir. 1975).

c. Shareholders are entitled to "the best notice practicable." While publication notice may be sufficient under the Constitution, a mailing to all shareholders is the preferred method. Shareholders who do not object to the settlement are bound by its terms and cannot appeal its approval. *Selfe v. Joseph*, 501 A.2d 409, 411 (Del. 1985) (objecting shareholder cannot raise new arguments on appeal). But if notice is not given to non-party shareholders, they are not bound by the dismissal. *See Papilsky v. Berndt*, 45 F.2d 251 (2d Cir. 1972) (finding notice necessary where plaintiffs claims were dismissed for failure to answer interrogatories; otherwise a collusive settlement could be disguised).

4. Objections to the Settlement

a. A derivative settlement or judgment has a preclusive effect on the covered claims. Unlike a class action where a representative is asserting claims on behalf of absent class members, in a derivative action, the representative shareholder is asserting claims that belong to the corporation. Thus, there are no opt-outs allowed. *See Maher v. Zapata Corp.*, 490 F. Supp 348 (S.D. Tex 1980); *Geller v. Tabas*, 462 A.2d 1078 (Del. 1983). Shareholders who have objections to the settlement must be given the opportunity to apprise the court of their objections.

b. Objectors may seek limited discovery to support their objections. Objectors may take discovery of the plaintiff to probe his good faith in entering into the settlement, the settlement negotiations and the terms of the settlement, and how they were reached. Absent a showing of bad faith or that the plaintiff failed to investigate the merits before settling, the objectors may not delve into the merits of the case. *In re Cellular Communications Int'l S'holders Litig.,* 2000 Del. Ch. Lexis 2 (Del. Ch. 2000).

c. There is a split among the circuits over whether a shareholder who does not object to the settlement may appeal its approval. *See Bell Atlantic Corp. v. Bolger*, 2 F.3d 1304, 1310 (3d Cir 1993) (non-objecting shareholder may appeal approval of settlement); *accord Rosenbaum v. MacAllister*, 64 F.3d 1439, 1443 (10th Cir 1995); *but see Valley Bank v. Ginsburg*, 110 Nev 440, 874 P2d 729, 735 (Nev. 1994) (non-party shareholder who failed to intervene lacks standing to appeal derivative settlement approval). A class member who timely objects without intervening will have standing to appeal. *See Devlin v. Scardelletti*, 536 U.S. 1 (2002).

5. Attorneys' fee approval

a. Plaintiffs' counsel who successfully litigate a derivative action are entitled to an award of attorneys' fees and expenses. *See, e.g.*, *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970); *Donner Mgmt. Co. v. Schaffer*, 139 Cal. App. 4th 615 (2006) (Proper test for determining prevailing party for purposes of attorneys' fees award in shareholder derivative suit dismissed without prejudice was which party prevailed on a practical level. Award of attorneys' fees was appropriate where there was no reasonable possibility the suit would have benefited corporation; a showing that the lawsuit was frivolous was not necessary.). Plaintiffs need not confer a pecuniary benefit on the corporation, changes in corporate governance or other non-monetary relief will suffice. *See, e.g.*, *Mills*, 396 U.S. at 396 (fact that case may never produce a monetary recovery does not bar attorneys' fee award; "corporate therapeutics" suffice to justify an award); N.Y. Bus. Corp. § 626(e).

b. The factors a court considering an award of attorneys' fees will focus on include: (1) the benefit achieved; (2) the efforts and number of hours spent by the attorneys in legal activities; (3) the contingent nature of success; (4) the difficulty of the litigation and skill required to handle it; (5) the customary fee charged; and (6) the standing, ability and reputation of counsel involved. *See, e.g.*, *Sugarland Indus., Inc. v. Thomas*, 420 A.2d 142, 149-150 (Del. 1980); *Gaffney* v. *Village of Maramoneck* (*In re Gaffney*), 801 N.Y.S.2d 400, 401 (App. Div. 2005).

c. Courts have awarded attorneys' fees, even in the absence of a favorable judgment or settlement, provided that it was the plaintiff's actions that led the corporation to cure the wrong complained of. *Mintz v. Bohen*, 210 A.2d 569, 570 (Del. Ch. 1965). *But see Kaufman Malchman & Kirby, P.C. v. Hasbro, Inc.*, 897 F. Supp. 719, 724 (S.D.N.Y. 1995) (holding that where plaintiff's only action was making a demand on the corporation that resulted in a cure of the wrong, plaintiff is not entitled to attorneys' fees). But the plaintiff's initial complaint must have merit at the time it is filed. It is not enough to amend the complaint to include claims that are meritorious, the plaintiff's lawsuit must have merit at the time it is filed. *In re Bea Systems, Inc. Deriv. Litig.*, 2009 WL 815452 (N.D. Cal. 2009).

d. Often, similar cases arising from the same set of events are filed in multiple jurisdictions. When they are settled, the court approving settlement must also allocate any fee award among the counsel prosecuting the various actions. Delaware courts will apply the *Sugarland* factors to determine the relative contributions made by counsel and apportion the fee award accordingly. The result can mean some counsel do not recover fees where they are unable to demonstrate specific contributions made towards settlement. *See In re William Lyon Homes S'holders Litig.*, 2006 WL 3860916, at *3-4 (Del. Ch. Dec. 21, 2006). The court may also allocate attorneys' fees among counsel pursuing similar claims in different jurisdictions based on their relative contributions to the ultimate outcome. *In re Cablevision/Rainbow Media Group Tracking Stock Lit.*, 2009 WL 1514925 (Del. Ch. May 22, 2009).

e. Where the parties agree on the amount of attorneys' fees and expenses, the court will give that agreement substantial deference. *See e.g.*, *Hensley v. Eckerhart*, 461 U.S. 424, 437 (1983) (question of fees should not result in a second litigation; agreement is ideal). But *see In re Abercrombie & Fitch S'holders Deriv. Litig.*, 886 A.2d 1271 (Del. 2005) (agreement regarding attorneys' fees does not require blind acceptance by the court); *Fox v. Chase Manhattan Corp.*, 1986 Del. Ch. LEXIS 356 (awarding only $3 million in attorneys' fees after settlement when the motion for $5.7 million had been unopposed by defendant).

6. Settlement Approval Should Be Timely

   a. It should be obvious that where the disputed issue involves a transaction, the transaction should not close without court approval. Failure to timely present the settlement can be grounds for disapproval. *See In Re SS&C Techs., Inc., S'holders Litig.*, 911 A.2d 816, 819 (Del. Ch. 2006) (refusing to approve settlement where parties sought approval one year after settling and closing the transaction).

D. Examples of settlements approved, disapproved

1. Settlements Disapproved

   a. In *Lewis v. Hirsch*, the plaintiff filed a derivative suit against U.S. Surgical and its directors alleging they had received grossly excessive compensation. Fed. Sec. L. Rep. (CCH) P 98,382 at 90,615 (Del. Ch. 1994). The parties engaged in settlement negotiations, then reached an informal agreement which was tentatively approved by the board. Plaintiff then amended the suit to include insider-trading claims. Plaintiff did not review documents or take depositions regarding the insider-trading claims. Objectors at the settlement hearing argued that the plaintiff's investigation of the insider trading claims was insufficient for settlement. The court agreed and rejected the settlement. The court found the record inadequate to permit it to value the claim or compare the claim to the settlement value offered.

   b. In *Noto v. Steiner*, a Delaware Chancery Court judge rejected a settlement reached by Fairchild Corp. that called for CEO Jeffrey Steiner to take a pay cut and pay back $1.5 million. Vice-Chancellor Leo Strine called the settlement "exceedingly modest" and questioned whether it would change Fairchild's corporate culture. Strine rejected the settlement, saying it seeks to end Noto's "ambitious" lawsuit "with what looks like a cosmetic whimper." "You got a poorly performing company over time that pays its CEO as if he's a top slugger," Strine said. The court directed lawyers to return with an agreement that "provides real structural protections" for shareholders.

   c. The court in *Off v. Ross* declined to approve a Delaware settlement where the settling class would sacrifice claims in a related New York action in exchange for inadequate consideration. *See* 2008 WL 5053448 (Del. Ch. Nov. 26, 2008). One objector to the settlement was the plaintiff in a parallel shareholder derivative and federal securities fraud class action filed in New York. The court was concerned that the release contemplated in the Delaware action could materially undermine and complicate the prosecution of the class claims in New York. Rather than approve the settlement, the court stayed the Delaware action pending the outcome of the New York action.

d. In *Robbins*, 127 Cal. App. 4th at 443-44, the parties agreed to settle a derivative suit, and by separate agreement, further agreed that the companies' successor would pay plaintiffs $5 million for attorney fees and expenses incurred in litigating the action. The trial court approved the settlement and negotiated fee award. *Id*. Some of the plaintiffs appealed, not about the substantive terms of the settlement, but that the attorney fees were too high, asserting that they did not accurately reflect the value of the services performed by plaintiffs' attorneys. *Id*. at 444. The appellate court agreed, finding that "plaintiffs' attorneys owe an ethical and fiduciary duty to their clients to limit fees to an amount that represents the value of the work done," and "although a negotiated fee may represent a reasoned business decision to settle, a negotiated fee that exceeds a fair and reasonable fee for the attorneys' contribution may not be approved." *Id*.

2. Settlements Approved

a. In *Carlton Investments v. TLC Beatrice Int'l Holdings, Inc.*, the Chancery Court approved a settlement between the defendant and a SLC appointed by the defendant, over the adamant objections of the plaintiff. 1997 Del. Ch. LEXIS 86 ("This settlement process and result, although not perfect, is in my opinion an example of a fair and reasonable settlement achieved by an independent SLC with the assistance of experienced counsel. While reasonable minds might differ over any number of decisions (and I would) I conclude that the result as a whole is reasonable and the product of independent, informed action of directors acting in good faith. Therefore, I will approve the proposed settlement").

b. The Chancery Court in *In re Triarc Companies, Inc. Class and Derivative Litigation* approved a settlement of derivative and class-action claims that benefited only the corporation, and not those shareholders who had already sold their stock. 791 A.2d 872 (Del. Ch. 2001) ("The fact that the class claims asserted on behalf of the stockholder class had little or no chance of recovering money damages (even nominal damages) leads me to conclude that it is fair and reasonable to release those claims in the context of a proposed settlement that provides substantial recovery on behalf of the corporation").

V. PROTECTIVE MEASURES

There are three types of measures corporations may put in place to protect their directors from potential derivative liability exposure: (1) liability limitation; (2) indemnification; and (3) Directors and Officers (D&O) Insurance.

A. Liability Limitation

1. Some states eliminate liability entirely where the director meets the statutory standard of care. The California statute provides that a director who complies with his duties of care and good faith has no liability for his alleged failure to discharge his duties as a director. Cal. Corp. Code § 12371.

2. Most states permit corporations to include a provision in the corporation's charter or bylaws narrowing or eliminating officer and director liability to the corporation. *See* Del. Gen. Corp. L. § 102(b)(7).

   a. The statutory ability to eliminate liability is not absolute. For example, the Delaware statute prevents corporations from eliminating liability for breaches of the duty of loyalty, or from instances where the director intentionally violated the law, failed to act in good faith, or engaged in a transaction where he received an improper personal benefit. Del. Gen. Corp. L. § 102(b)(7). A liability limiting provision will, however, protect directors who fail to meet their duty of care. *See Emerald Partners v. Berlin*, 787 A.2d 85 (Del. 2001) (Directors may avoid liability where transaction fails entire fairness test if that failure is entirely the result of a failure of the duty of care). The liability limiting provision cannot be retroactive. Del. Gen. Corp. L. § 102(b)(7).

B. Indemnification

1. Depending on the circumstances, indemnification may be prohibited, mandatory, or permissive. Delaware General Corporation Law § 145 mandates indemnification where the directors are "successful on the merits or otherwise" in a derivative suit. It also permits indemnification of expenses (including attorney's fees) actually or reasonably incurred in connection with the defense of a derivative suit. Indemnification for derivative suits under the DGCL is limited to expenses; it does not permit reimbursement or indemnification of settlements or judgments.

   a. Indemnification Prohibited

      (1) Where a derivative defendant is found to have breached his duties to the corporation, he may not be indemnified. It would be nonsensical to permit a corporation to indemnify a person found to have harmed the corporation. If it did, the

corporation would be entitled to receive a monetary judgment from one or more of its directors, with a counter obligation to pay that money, plus attorneys fees and expenses back to the director found liable to it.

(a) DGCL Section 145(g) permits the corporation to purchase insurance covering such non-indemnifiable amounts.

(2) Likewise, derivative settlements where the directors contribute are not indemnifiable in most states (although PA, VA, NJ, GA, NC, and FL allow it at least to some extent).

b. Mandatory Indemnification

(1) Delaware General Corporation Law § 145 mandates indemnification where the directors are “successful on the merits or otherwise” in a derivative suit.

(a) A director meets the “or otherwise” standard if the claims against him are dismissed with prejudice, without liability and without making a payment. *Waltuch v. Conticommodity Svcs., Inc.*, 88 F.3d 87 (2d Cir. 1996) (director entitled to indemnification where company, not director, made payments on director’s behalf to settle derivative claims).

c. Permissive Indemnification

(1) When indemnification is neither prohibited by statute, nor required by law or corporate charter, bylaw or contract, it may be permitted. These indemnification provisions must be read in harmony with the statutory limitations. *See Biondi v. Beekman Hill House Apt. Corp.*, 94 N.Y.2d 659, 666 (2000).

(2) Generally, indemnification is permitted if three conditions are met: (i) indemnification is not prohibited by statute or the corporation’s governing documents; (ii) the director or officer has met the statutory standard of care or the standard established in the corporation’s governing documents; and (iii) the corporation follows the procedures established for agreeing to indemnify in a specific case. *See* e.g. N.Y. BCL § 723(b).

(3) Indemnification is not automatic; a specific decision must be made that it is proper because the indemnitee has met the necessary standard of conduct. The defendant directors must

have been found to have acted in good faith and in the best interests of the company. That decision may be made by: (i) a majority vote by non-party directors (even if less than a quorum); (ii) a committee of non-party directors designated by a majority of non-party directors (even if less than a quorum); (iii) if there are no such directors, or the directors so direct, upon a written decision by independent counsel; or (iv) the shareholders of the company. *See e.g.* DGCL § 145(d); NY BCL 723.

(4) Compare *TLC Beatrice Int'l Holdings Inc. v. CIGNA Insurance Co.*, No. 97 Civ. 8589, 1999 U.S. Dist. LEXIS 605, at *10-12 (S.D.N.Y. Jan. 27, 1999) (corporation cannot under Delaware law indemnify its directors and officers for settlement of a derivative action but can indemnify them for defense costs and fees) with *Heffernan v. Pacific Dunlop GNB Corp.*, No. 91 C 2494, 1993 WL 3553, at *5 (N.D. Ill. Jan. 5, 1993) (a corporation's indemnification of settlement amounts in a derivative action, without court action, is not prohibited under Delaware law).

C. Directors and Officers Insurance

1. Indemnification may be insufficient protection if a company has assets that may not be adequate to allow the corporation to satisfy its indemnification obligations. Insurance coverage may also be available in some situations where a director or officer does not meet a standard of "good faith" required for indemnification by the corporation (such as where conduct was opposed to the best interests of the corporation but not intentionally dishonest and thus excluded by the D&O policy). There may also be restrictions on the corporation's ability to indemnify directors and officers in some jurisdictions for derivative judgments and settlements.

a. Some plaintiffs' firms have required individual director and officer defendants to contribute settlement amounts from their personal assets where the company has filed for bankruptcy and the D&O insurance proceeds, standing alone, have not been deemed sufficient for a settlement. The General Counsel of CalSTRS, the nation's third-largest public pension fund, reportedly promised its lawyers a 2.5 percent bounty, on top of a 12% base fee, in CalSTRS suit against the former directors of WorldCom. The *WorldCom*, outside directors agreed to pay approximately $18 million out of their own pockets toward a total settlement of $54 million in order to resolve litigation against them. In *Enron*, the outside directors agreed to pay $13 million out of pocket toward a total settlement of $168 million.

b. AIG's D&O carriers reportedly agreed to pay 75% of the record-setting $115 million settlement by four former AIG executives and AIG managing general agent C.V. Starr. The individual officer and director defendants were reported to pay a small portion of the remaining 25% with C.V. Starr paying the bulk of the $29.5 million not covered by AIG's carriers.

c. In the past, D&O insurance could be counted on to fund defense costs, settlement or any judgment. D&O insurance policies typically provide coverage for derivative suit settlements or judgments, subject to various exclusions.

2. There are three basic public-company D&O insuring agreements, often referred to as Side A, Side B, and Side C.

a. Side A coverage applies when the company cannot indemnify directors for claims against them. A company cannot indemnify if it is insolvent. It also is prohibited from indemnifying directors or officers for derivative settlements and judgments. Even the attorneys' fees spent on defending a derivative lawsuit may not be indemnifiable if a director or officer is ultimately held liable to the corporation. Side A coverage does not protect the company, only its directors and officers.

b. Side B coverage does protect the company. Under Side B, the insurer reimburses the company for the expense of indemnifying its directors or officers as a result of claims made against them. Thus, while Side A operates as personal asset protection for the directors and officers, Side B operates as balance-sheet protection for the company.

c. Finally, Side C coverage insures the company for claims made directly against it. In public-company D&O policies, the company is usually only covered for securities law claims, i.e., suits brought by a shareholder against the company in connection with the purchase or sale of securities. In contrast, Side A and B are not limited to claims brought by shareholders, but instead, subject to exclusions, cover claims based on a variety of acts committed by a director or officer in his or her capacity as such.

3. Insured vs. insured exclusion

a. The "insured vs. insured" exclusion originated in the mid-1980s in order to prevent one insured director or officer from filing a lawsuit against another insured to access the D&O policy's proceeds to boost the financial performance of the public company that they served. Over the years, it has evolved so that there are several standard carve-outs from this exclusion - derivative shareholder litigation brought or maintained without the assistance of any directors or officers and claims for indemnity by directors or officers against their public companies, is one.

b. Most D&O insurance policies exclude coverage for claims brought by or on behalf of an insured. Plaintiffs' lawyers are increasingly using current or former officers or directors as confidential witnesses to meet the heightened pleading requirements of the Reform Act. Some carriers argue that the use of such witnesses can trigger a policy's insured vs. insured exclusion.

4. Severability Clause

a. A severability clause makes it possible to "sever" the wrongful conduct between and among the insureds, thus ensuring that the wrongful conduct provides a basis to rescind the policy only with respect to the wrongdoer, not the other insureds. The extent of imputation and the protection the severability clause affords differ from policy to policy. In *Cutter & Buck*, for example, the D&O insurance policy contained a severability clause, but due to its wording and the facts of the case, the court ruled that it did not prevent the carrier from rescinding the policy with respect to all of the insureds including "innocent" directors and officers. 306 F. Supp. 2d 988 (W.D. Wash. 2004). An Alabama district court in *In re Healthsouth Corp. Insurance Litigation*, 308 F. Supp. 2d 1253 (N.D. Ala. 2004), found that a severability provision precluded the D&O insurer from rescinding coverage with respect to all "innocent" insured persons who did not have knowledge that the company's financial statements were false.

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