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RECENT DEVELOPMENTS IN DELAWARE CORPORATE GOVERNANCE

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SHAREHOLDER'S STANDING

A. DIRECT OR DERIVATIVE?

In *Feldman v. Cutaia*,¹ the Delaware Supreme Court addressed the circumstances under which a shareholder's claim should be characterized as derivative or direct. In affirming the Chancery Court's dismissal of plaintiff's breach of fiduciary duty claim,² the Court held that because a shareholder no longer owns shares in a corporation after a cash-out merger, a former shareholder may sue other former directors only if the claim is direct, or in other words, where the plaintiff alleges an injury that is independent and distinct from the harm suffered by the corporation.³

Peter Feldman, a shareholder of Telx, brought a derivative suit against Telx's board of directors alleging that stock options issued to certain board members were invalid.⁴ After the litigation commenced, Telx merged with GI Partners Fund in a cash-out merger⁵ pursuant to which Feldman ceased owning Telx stock.⁶ The defendants moved to dismiss Feldman's complaint alleging that he lacked standing to bring a derivative claim because he no longer owned shares of Telx stock.⁷ In response, Feldman amended his complaint to assert a direct claim against the directors alleging that the issuance of the invalid stock options "resulted in Telx issuing stock for inadequate consideration, and that his holdings in the company were thereby diluted."⁸

To determine whether a claim is direct or derivative a court must ascertain (1) "who suffered the alleged harm" and (2) "who would receive the benefit of any recovery."⁹ A derivative claim is brought on behalf of the corporation for a harm suffered by the corporation alone, such as a claim alleging mismanagement resulting in a decrease in the value of the corporation's stock.¹⁰ Thus, a shareholder only has standing to bring a derivative claim while he owns stock in the corporation.¹¹ Conversely, a claim

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is direct if the shareholder has incurred a harm that is individualized and distinct from the harm suffered by the corporation, such as a claim attacking the fair dealing and fair price in a given transaction.¹² Accordingly, a shareholder has standing to bring a direct claim even after he no longer owns stock in the corporation because his standing is not dependant on his status as a shareholder.¹³

In affirming the Chancery Court's decision, Justice Holland held that Feldman's dilution claim was derivative "because any dilution in value of the corporation's stock is merely the unavoidable result . . . of a reduction in the value of the entire corporate entity."¹⁴ As such, the claim did not allege "a harm that [was] distinct from that suffered by the corporation as a whole."¹⁵ The Court rejected Feldman's argument that the claim was direct, affirming the Chancery Court's determination that it was merely a creative "attempt to recast a derivative claim by alleging the same fundamental harm in a slightly different way."¹⁶ *Feldman* highlights the importance classifying a claim as derivative or direct, a classification that is often outcome determinative. However, there are times where the distinction may not be as clear.

In *Rhodes v. SilkRoad Equity*, the Delaware Chancery Court addressed the circumstances under which a claim may be characterized as both derivative and direct. Specifically, the Court held that where a corporation is harmed, but the "consequences of that harm fall disproportionately upon minority stockholders," a claim may be both direct and derivative.¹⁷ If a claim is found to be both direct and derivative in character, it can be brought as a direct claim, even if the shareholder no longer owns stock in the corporation.¹⁸

In 2003, SilkRoad Equity ("SilkRoad") became InterAct's primary creditor, purchasing a \$4.2 million loan that InterAct was having difficulty paying off.¹⁹ In 2004, SilkRoad acquired 80% of the equity in InterAct which resulted in the plaintiffs, William Rhodes, III and Wijnant van de Groep, becoming minority shareholders in the company.²⁰ After the acquisition, the defendants engaged in a series of self-dealing transactions including "padding InterAct's payroll with SilkRoad Equity employees, causing InterAct to acquire a SilkRoad Equity entity," and using InterAct funds for personal expenses and massive severance packages for SilkRoad's owners.²¹ In 2006, defendants tried to pressure the minority shareholders into a deal where "\$3 of preferred InterAct shares would be issued to SilkRoad Equity for every dollar that had been borrowed by InterAct."²² Instead of accepting the deal, the minority shareholders brought suit against the defendants for, *inter alia*, breach of their fiduciary duties.²³ The claim alleged that the defendants' conduct was aimed to "diminish the [minority shareholder's interests in SilkRoad] to a level where the defendant[s] could acquire them at a discount."²⁴ After the suit was filed, the minority shareholders were fired and the defendants purchased their remaining shares thereby extinguishing the minority shareholders' ownership interest in the corporation.²⁵ The defendants moved to dismiss the now former shareholders' complaint, alleging that the claim was derivative and that, since the plaintiffs no longer owned stock in the corporation, they did not have standing to bring a derivative suit.²⁶

The Court denied the motion to dismiss holding that the claim was both direct and derivative in nature, and, thus, the former shareholders had standing to bring their suit as a direct claim.²⁷ Vice Chancellor Noble explained that a claim may be both derivative and direct where the corporation is harmed but the "consequences of that harm fall disproportionately upon minority stockholders."²⁸ In making the determination, the court must look at the "true substantive effect of the challenged transaction."²⁹ SilkRoad's self-dealing transactions inflicted a harm upon the corporation which resulted in an "unnecessary and improvident dissipation of corporate assets."³⁰ This harm gave rise to a derivative action, which standing alone, the plaintiffs did not have standing to bring because they no longer owned stock in the corporation.³¹ However, the plaintiffs also were directly harmed because the defendants extracted economic value and residual voting power from the former minority shareholders and redistributed it to themselves, essentially driving out the former shareholders for a bargain price.³² The defendants, as controlling shareholders, directly benefited from this action.³³ Thus, the Court stated that it could infer that "[d]efendant[s]' actions had the 'true substantive effect' of harming the [former

shareholders], as minority shareholders,” in a substantially different fashion than the corporation.³⁴ Accordingly, the Court permitted the plaintiffs to proceed with their breach of fiduciary duty claim as a direct action.³⁵ *Rhodes* highlights the importance of examining the substance of the transaction to determine whether the harm is direct or derivative.

B. DERIVATIVE STANDING DOES NOT EXTEND TO DIRECTORS.

In *Schoon v. Smith*, the Delaware Supreme Court recognized that derivative standing is a judicially created doctrine that the Court has the power to extend, but refused to extend derivative standing to directors who did not also own stock in the corporation because justice did not require it.³⁶ Richard Schoon, a director, but not a stockholder, of Troy Corporation, brought a derivative action on behalf of Troy alleging his fellow directors breached their fiduciary duties to the corporation.³⁷ The Chancery Court dismissed Schoon’s complaint finding the director plaintiff lacked standing to bring the suit derivatively because he was not a shareholder of the company.³⁸ Schoon appealed alleging that derivative standing should be extended to directors because “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.”³⁹ In affirming the Chancery Court, the Delaware Supreme Court held that directors who do not own stock in the corporation, do not have standing to bring derivative claims against other directors, solely by virtue of their status as directors.⁴⁰

The Court explained that derivative standing allows a shareholder to bring suit on behalf of a corporation, giving shareholders a judicial check on corporate misconduct.⁴¹ The purpose behind this judicial check is to give shareholders an effective voice in corporate administration, so as to prevent against a “complete failure of justice on behalf of a corporation.”⁴² The Court held that 8 Del. C. § 327 codifies the judicially created doctrine and actually acts as a restriction on derivative standing by requiring that a plaintiff be a *current shareholder* at the time of the transaction.⁴³ This restriction, sometimes known as the contemporaneous ownership rule, serves the doctrine’s original purpose of protecting against a complete failure of justice because it allows shareholders to challenge corporate misconduct on behalf of the corporation.⁴⁴ Thus, although the Court recognized that it had the power to extend derivative standing, it declined to extend it to directors because such an extension was not needed to “prevent a complete failure of justice.”⁴⁵ *Schoon* confirmed that only a shareholder who owned stock at the time of the transaction has standing to bring a derivative suit challenging the transaction.⁴⁶

C. SHAREHOLDERS MUST OWN STOCK THROUGHOUT THE LITIGATION.

In *Desimone v. Barrows*,⁴⁷ the Delaware Chancery Court examined the parameters of the continuing wrong doctrine, one of the exceptions to the contemporaneous ownership rule. Although the contemporaneous ownership rule requires a derivative plaintiff to have owned shares in the corporation at the time of the challenged transaction, the continuing wrong doctrine grants a shareholder standing in the limited circumstance where he purchased stock after the transaction had begun but prior to its completion.⁴⁸ Vice Chancellor Strine reconfirmed the narrow scope of the continuing wrong doctrine holding that it does not extend derivative standing to transactions that were completed prior to the plaintiff’s purchase of shares even where plaintiff is challenging a set of wrongs that are similar or related.⁴⁹

John Desimone, a shareholder of Sycamore Networks, Inc. (“Sycamore”), brought a derivative action alleging the directors breached their fiduciary duties by backdating stock options. Although the majority of options were granted in 2000 and 2001, the plaintiff did not purchase stock in Sycamore until 2002.⁵⁰ Despite the fact that he did not own stock at the time of the grant of certain stock options, plaintiff argued that under the continuing wrong doctrine, he had standing to challenge all of the option grants because similar backdating occurred both prior to and after the time he became a shareholders.⁵¹ The Court rejected plaintiff’s argument.⁵²

Vice Chancellor Strine explained that the continuing wrong doctrine does not operate to “bestow standing upon a stockholder to challenge transactions occurring before he bought his stock simply because they are similar or related to transactions or other conduct that occurred later.”⁵³ The Court stressed that the doctrine applies only when “the alleged wrongful acts are . . . so inexorably intertwined that there is . . . *one continuing wrong*.”⁵⁴ In other words, the doctrine does not grant standing where there is a set of individual, distinct wrongs simply because the transactions are similar or related.⁵⁵ If the transactions that occurred prior to the shareholder’s stock ownership can easily be segmented from the transactions that occurred during his stock ownership, the continuing wrong doctrine is inapplicable.⁵⁶ Thus, the Court held that the continuing wrong doctrine was inapplicable because a stock option grant is an individual transaction that is completed as of the grant date.⁵⁷ Accordingly, given that the plaintiff did not purchase shares until 2002, he did not have standing to bring a derivative suit challenging the options that were granted in 2000 and 2001.⁵⁸ *Desimone* clarified that option grants should be treated as separate transactions and reinforced that the continuing wrong doctrine will not create standing where a transaction is completed before a shareholder owns stock in the company.

In *Conrad v. Blank*,⁵⁹ the Delaware Chancery Court reaffirmed that the contemporaneous ownership rule is strictly enforced in Delaware and that the continuing wrong doctrine will only be applied in the limited situation noted above. Donna Conrad, a shareholder of Staples, brought a derivative suit purportedly on behalf of Staples. Although Conrad alleged a decade-long backdating scheme from 1994 through 2003, she did not actually own stock in the company until 1998.⁶⁰ As *Desimone* and other Delaware courts have held, each stock option grant is considered to be a separate transaction.⁶¹ Thus, the continuing wrong doctrine was inapplicable because “each of the option grants that occurred during the course of the decade-long scheme alleged in the complaint [was] a separate ‘transaction’ for purposes of section 327.”⁶² Vice Chancellor Lamb refused to allow the allegations of a multi-year scheme to transform the distinct transactions into one continuing wrong.⁶³ Therefore, the shareholder did not have standing to challenge any of the options granted prior to her purchase of stock in 1998.⁶⁴

The Court in *Postorivo v. AG Paintball Holdings, Inc.*⁶⁵ further reinforced that derivative standing is premised not only upon a shareholder owning stock at the time of the transaction, but also on the shareholder continuing to own stock throughout the litigation. Once a shareholder ceases to hold stock in a corporation, whether by merger or otherwise, he no longer has derivative standing to bring suit on behalf of the corporation.⁶⁶

Eugenio Postorivo, the sole former owner and shareholder of National Paintball Supply Inc., sold the assets of the company in an asset purchase agreement to the AJI Intermediate Holdings, Inc., who later formed defendant KEE Action Sports Holdings, Inc. (“KEE Action”). Postorivo remained on the board of the newly formed corporation KEE Action.⁶⁷ After the sale, KEE Action used the assets to operate essentially the same business in a successor company.⁶⁸ Because of a dispute, KEE Action filed a contract indemnity action, terminated Postorivo’s employment and cancelled all of his shares.⁶⁹ Postorivo, the former shareholder, subsequently brought this action both directly and derivatively alleging, *inter alia*, that the directors breached their fiduciary duties.⁷⁰ The former shareholder did not have standing to pursue the derivative claims on behalf of the successor company because he had relinquished his stock ownership in the asset purchase agreement.⁷¹ The shareholder, however, retained standing to assert any direct claim that he had against the corporation because direct standing is not dependent on the plaintiff continuing to be a shareholder.⁷²

The Court in *Postorivo* noted that in *Lewis v. Anderson*, the Delaware Supreme Court articulated two exceptions to the general rule that shareholders lose standing to bring a derivative claim after a merger. Specifically, a shareholder may maintain standing to sue derivatively where: (1) there was fraud in the merger, which was perpetrated solely to deprive the shareholder of standing to bring a derivative action or (2) the merger was simply a reorganization of the company and did not alter the shareholder’s ownership of stocks.⁷³ However, the Court found those exceptions to be inapplicable because the

shareholder's assets were contractually released in the pledge agreement, rather than a merger.⁷⁴ Thus, since the shareholder no longer retained stock in the corporation, he did not have standing to assert his claims derivatively on behalf of the corporation.⁷⁵ *Postorivo* clarifies that the *Lewis v. Anderson* exceptions apply only where there is a merger. Further, it confirms that a shareholder no longer has derivative standing when he ceases to own stock in a corporation, whether his ownership ceases as a result of a contractual release, a merger, or otherwise.

The Delaware Supreme Court in *Appriva Shareholder Litigation Company, LLC v. EV3, Inc.*⁷⁶ examined the circumstances under which a contractual agreement may defeat standing. Two former shareholders of Appriva were appointed to be representatives of all Appriva shareholders after the company was acquired.⁷⁷ Language in the Shareholder Representative Agreement and Merger Agreement suggested that the former shareholders were contractually bound to bring suit together.⁷⁸ However, the two former shareholders brought separate lawsuits in the Superior Court, which were then consolidated for the purposes of appeal.⁷⁹ The complaints in both cases were dismissed by different judges "on the same ground: that the plaintiffs lacked standing to prosecute their respective actions separately and were contractually, obligated to prosecute their claims jointly."⁸⁰ The Supreme Court considered the appeal and remanded the case to determine if the ambiguous language did in fact so bind the former shareholders.⁸¹ In reaching its decision, the Court suggested that if the language was valid, the shareholders would not have derivative standing to bring suit individually.⁸² *Appriva* recognizes the possibility that a plaintiff's standing to individually pursue a derivative action may be relinquished through a contractual agreement.

RECENT DEVELOPMENTS IN PLEADING DEMAND FUTILITY UNDER DELAWARE LAW

A. DEMAND FUTILITY IN OPTIONS MANIPULATION CASES

Since 2006, derivative actions alleging options manipulation by the board of directors have been steadily on the rise, which, in turn, has brought the issue of demand futility under Rule 23.1⁸³ to the forefront of Delaware corporate governance law. The Delaware Chancery Court first addressed demand futility in the options manipulation context in *Ryan v. Gifford*⁸⁴ and *In re Tyson Food, Inc. Consolidated Shareholders Litigation*.⁸⁵ Since the Courts in *Ryan* and *Tyson* examined this issue in early 2007, Delaware Courts have further clarified the standard for pleading demand futility in options manipulation cases.

1. DESIMONE: CONCLUSORY ALLEGATIONS ARE NOT ENOUGH

In *Desimone v. Barrows*, a shareholder brought an action derivatively against the nominal defendant Sycamore and its directors and officers related to its stock option practices.⁸⁶ The Delaware Chancery Court dismissed the complaint, in part, because plaintiff failed to plead demand excusal concerning the allegations challenging option grants to officers and employees, and "failed to state a claim upon which relief can be granted" related to the grants to the outside directors.⁸⁷ This dismissal signaled a departure from the *Ryan* and *Tyson* decisions that found demand to be futile in similar options manipulation cases.

Desimone, a shareholder of Sycamore, filed a derivative action against Sycamore's officers and directors alleging manipulation of stock options. Plaintiff failed to make a demand on the board prior to filing suit but alleged that demand was excused because it would have been futile.⁸⁸ To bring a suit derivatively, the shareholder must satisfy its burden under Rule 23.1 to demonstrate demand futility.⁸⁹ In cases such as *Desimone*, where a business decision of the board is not being challenged, the Court applies the test articulated in *Rales v. Blasband*⁹⁰ to determine whether the shareholder has met this burden. Under *Rales*, the relevant inquiry is whether the company's board could have exercised "independent and disinterested business judgment."⁹¹ Thus, the key issue in *Desimone* was whether, assuming the facts pled to be true, a majority of the board faced a substantial likelihood of personal liability as a result of the alleged options manipulation, which would "compromis[e] their ability to consider a demand impartially," thereby making demand futile.⁹²

In *Desimone*, three distinct types of option grants were challenged: (i) grants to outside directors, (ii) grants to lower employees (non-executives), and (iii) grants to officers. With respect to grants to outside directors, the Court treated such grants differently than the other two types because directors who have received allegedly manipulated stock options are presumed to be interested.⁹³ Thus, since a majority of Sycamore’s board received allegedly manipulated options, the Court excused demand as it related to those options granted to outside directors.⁹⁴

To determine whether demand was excused concerning the other two types of grants—to lower employees and to officers—the Court examined the intent of the directors and the contents of the stock option plans. With respect to the grants to lower employees, the demand excusal analysis focused on whether any of the directors faced a “substantial threat of personal liability.”⁹⁵ Although the plaintiff alleged that the option grants to the employees were backdated to conceal that they were “in the money” as of the actual grant date, the allegations insufficiently pled intent on the part of the directors.⁹⁶ The employee option grants were awarded pursuant to the stock option plan, which expressly allowed the delegation of option-granting duties to non-director executives and contemplated that the board would have a minimal role in the process.⁹⁷ Moreover, the Court emphasized that vague and conclusory allegation that the plan was “administered by the Compensation Committee” did not suggest that the committee “was involved in or had knowledge of any backdating.”⁹⁸

While plaintiff attempted to save his claim by pleading that the board members faced a substantial likelihood of liability due to its lack of oversight, the Court reiterated the reasoning in *Caremark*⁹⁹ that lack of oversight is “possibly the most difficult theory in corporation law upon which a plaintiff must hope to win a judgment” and found that this high threshold was not met.¹⁰⁰ Moreover, the Court rejected plaintiff’s conclusory allegation that because illegal behavior occurred, internal controls must have been deficient, and therefore the board must have known of the misconduct.¹⁰¹ Thus, the Court held that the directors did not face a substantial likelihood of liability concerning the grants to lower employees, and therefore, demand was not excused.

The demand excusal analysis with respect to the officer grants also focused on whether any of the directors faced a “substantial threat to personal liability.” The plaintiff alleged three different theories of options manipulation relating to the officer grants—backdating, spring loading,¹⁰² and bullet dodging.¹⁰³ The Court found that it was not enough to merely plead that backdating, spring loading, or bullet dodging occurred; the plaintiff must plead particularized facts establishing the directors intended to engage in options manipulation.¹⁰⁴

In analyzing the backdating claims, the Court assumed that the options were in fact backdated, but still found that demand was not futile because the plaintiff failed to plead facts establishing that a majority of the board faced a substantial likelihood of liability. Plaintiff admitted that “he ha[d] no idea how, when, or by whom the Officer Grants were issued” and thus failed to plead sufficient facts suggesting an inference that the board knowingly granted backdated options.¹⁰⁵ Although the Court, for the sake of argument, accepted the premise articulated by Chancellor Chandler in *Ryan* that compensation committee membership alone may be enough to establish interestedness, the compensation committee did not make up a majority of the board in *Desimone* and without more, the plaintiff could not show that a majority of the board was interested.¹⁰⁶ The Court held that a derivative complaint “must plead *facts specific to each director*, demonstrating that at least half of them could not have exercised disinterested business judgment in responding to a demand” for a demand to be excused.¹⁰⁷ Because the plaintiff failed to plead these facts with respect to the officer grants, demand was not excused.¹⁰⁸

In determining whether demand is excused for the alleged spring-loading or bullet-dodging options, the Court focused on allegations regarding the directors’ intent and the terms of the plan. The plaintiff alleged, as an alternative contention to his backdating claim, that one of the officer grants was improper “because Sycamore manipulated the release of material non-public information in order for the options

recipients to get the benefit of an artificially low exercise price.”¹⁰⁹ The plaintiff combined allegations of both spring-loading and bullet-dodging in an attempt to “make out a claim of disloyalty under the theory articulated in *Tyson*.”¹¹⁰ In *Tyson*, the Court held that “directors breach their fiduciary duties if they approve spring-loaded or bullet-dodging options in a bad faith effort to circumvent stockholder-approved restrictions on the exercise price of options.”¹¹¹

The Court in *Desimone* distinguished its facts from *Tyson* explaining that unlike in *Tyson*, the plan in *Desimone* had no option exercise price restrictions and, in fact, below market options were *expressly permitted* by the plan.¹¹² Vice Chancellor Strine also questioned the entire theory of liability based on bullet-dodging, stating his skepticism “that a bare allegation that a board of directors made a discretionary issuance of stock options at the market stock price after releasing negative information can ever be sufficient in itself to state a claim of director disloyalty, even when a stockholder-approved option plan requires fair-market-value grants.”¹¹³ The Court explained that the reason for this skepticism is that the market has absorbed the negative information and thus the stock grant price is equal to the price the stock is actually worth.¹¹⁴ The spring-loading allegations also were distinguishable from those in *Tyson*. The *Tyson* complaint alleged a pattern of granting options “just before the release of clearly material, market-moving positive information.”¹¹⁵ Whereas in *Desimone*, the complaint contained only “weak allegations about a single alleged instance of spring loading” involving information that did not clearly affect the stock’s trading price, and further, failed to identify who was responsible for the spring-loading or state a plausible motive for the disinterested board.¹¹⁶ Thus, the plaintiff also failed to plead facts showing that the directors faced a substantial likelihood of liability with respect to the spring-loading allegations.

In *Desimone*, the Court meticulously examines the various allegations of stock manipulation, requires more than vague or conclusory allegations to adequately plead demand futility and suggests that whether a director faces a substantial likelihood of liability is dependent upon the terms of the plan.

2. MOVING FORWARD FROM DESIMONE: THE CONRAD AND WEISS DECISIONS

Since its decision in *Desimone*, the Chancery Court has addressed demand futility in two additional options manipulation cases, *Conrad v. Blank*¹¹⁷ and *Weiss v. Swanson*,¹¹⁸ finding that both cases were factually distinct from *Desimone* and that both plaintiffs had adequately alleged demand futility. In *Desimone*, the plaintiff asserted no particularized allegations that the directors acted in bad faith or had the requisite intent, especially due to the fact that the directors were essentially following the stock incentive plan that the shareholders had approved. The allegations against the directors in *Conrad and Weiss*, in contrast, did not support the conclusion that the directors acted in the same good faith.¹¹⁹

In *Conrad v. Blank*, Conrad, a shareholder, brought a derivative action on behalf of Staples, a Delaware corporation alleging the directors breached their fiduciary duties as a result of a “decade-long scheme” of “backdating option grants to benefit a group of current and former senior executives and directors.”¹²⁰ The complaint further alleged that over this same period, the company “published financial statements and other public disclosures that concealed the practice of backdating options.”¹²¹ Although the plaintiff brought the derivative complaint despite the absence of a pre-suit demand, the Court, applying the *Rales* test,¹²² excused demand finding that half of the board was incapable of impartially considering a demand.¹²³ Of the ten-person board, two directors received options and three others were members of the compensation committee, who faced a “substantial likelihood of liability related to those grants.”¹²⁴

Though the defendants argued the demand should not be excused based on the Court’s analysis in *Desimone* related to the officer grants, the Court distinguished *Conrad* from *Desimone* on the basic premise that the plaintiff in *Conrad* had adequately pled scienter and bad faith. Unlike in *Desimone*, where the stockholder option plan did not require the options to be priced at fair market value, in *Conrad*,

the plan gave no discretion to the compensation committee in setting the exercise price.¹²⁵ These facts made it less likely that the actions taken by the compensation committee were innocent or that the directors unknowingly authorized backdated options.¹²⁶ Thus, the Court in *Conrad* found that plaintiff's allegations were sufficient to support the conclusion that the compensation committee members intended to deliberately backdate options in bad faith and thus faced a substantial likelihood of liability.¹²⁷

Another important distinction between *Desimone* and *Conrad* is that in *Conrad*, the board considered the option backdating and did nothing to remedy "these past 'errors.'"¹²⁸ In *Conrad*, the company made certain public disclosures admitting that it priced some options at "incorrect measurement dates," which was in "clear violation of the stockholder-approved option plans," and that a substantial number of the option grants "were priced at the low for the month, the quarter, or were otherwise favorably timed."¹²⁹ Vice Chancellor Lamb noted that the company "made no effort to explain which options had the erroneous measurement dates, how these errors occurred, or why it concluded that there was no intentional wrongdoing involved in fixing incorrect measurement dates."¹³⁰ Therefore, the Court in *Conrad* held that demand was excused.

In *Weiss v. Swanson*, another recent Chancery Court decision involving options manipulation, the Court also held that demand was excused finding that the facts were more similar to those in *Tyson* than those addressed in *Desimone*. A majority of the board received options, which gave a presumption of interestedness on the part of the board.¹³¹ In *Desimone*, the Court held that the plaintiff failed to state a claim against the directors **despite** the presumption that they were interested by virtue of their receipt of options because the directors were simply following a pre-determined stock option plan.¹³² Whereas in *Weiss*, the plaintiff sufficiently alleged that the directors did not adhere to the terms of the option plan.¹³³ *Weiss* is thus more similar to *Tyson*, where the stock incentive plan was also not followed and material information was withheld from shareholders.¹³⁴

In decisions subsequent to those in *Ryan* and *Tyson*, the Chancery Court has employed a more careful scrutiny of demand futility allegations in stock options manipulation cases. The Court has focused on allegations regarding the defendants' intent as well as the terms of the stock option plans. Going forward, the Court has emphasized that conclusory allegations of manipulating stock options are not enough to excuse demand—the complaint must plead particularized facts that support a strong inference that directors were acting in bad faith with the purpose of withholding information from shareholders.¹³⁵

B. OTHER IMPORTANT DEVELOPMENTS IN DELAWARE DEMAND FUTILITY LAW

1. EXCULPATORY PROVISIONS

In *Wood v. Baum*,¹³⁶ the Delaware Supreme Court analyzed demand futility in the context of a limited liability company and affirmed the Chancery Court's dismissal of the derivative plaintiff's complaint. Plaintiff Paddy Wood brought an derivative action against Municipal Mortgage & Equity, LLC ("MME") and its current board of directors and one former director.¹³⁷ Defendants moved to dismiss the original complaint under Rule 23.1 "for failure to make a pre-suit demand on the Board."¹³⁸ Plaintiff then filed an amended complaint, alleging that defendants breached their fiduciary duties and their Caremark duties.¹³⁹ Defendants renewed their motion to dismiss, and the Chancery Court granted the motion, dismissing the complaint "for failure to allege particularized facts sufficient to establish that demand on the Board would have been futile."¹⁴⁰ The Delaware Supreme Court affirmed the Chancery Court's decision.

The plaintiff attempted to create a "reasonable doubt" that MME's board of directors "would have properly exercised its business judgment" by claiming that the directors faced a "substantial likelihood of personal liability."¹⁴¹ In evaluating whether the directors faced personal liability, the Court considered both the exculpatory clause in the operating agreement and the Delaware Limited Liability Company Act

("LLCA").¹⁴² The operating agreement "exempt[ed] directors from any liability 'except in the case of fraudulent or illegal conduct of such person.'"¹⁴³ However, the LLCA provides that an LLC "may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied covenant of good faith and fair dealing."¹⁴⁴ Thus, MME's directors would only face liability for claims of "fraudulent or illegal conduct or bad faith violation[s]" of that implied covenant.¹⁴⁵

The Court affirmed that the plaintiff did not plead "particularized facts" to support any claim of "fraudulent," "illegal" or "bad faith" conduct.¹⁴⁶ Where directors are exculpated from liability except for certain limited circumstances, the plaintiff must plead particularized facts to show "that the directors acted with scienter, *i.e.* that they had 'actual or constructive knowledge' that their conduct was legally improper."¹⁴⁷ The plaintiff did not meet this burden, as the complaint only contained conclusory allegations that defendants made misrepresentations and engaged in deceit.¹⁴⁸ The Court held that, without more, the board's execution of financial reports did not create an inference that the directors had notice of any illegality.¹⁴⁹ In addition, the Court reiterated that "board approval of a transaction, even one that later proves to be improper, without more, is an insufficient basis to infer culpable knowledge or bad faith on the part of individuals directors."¹⁵⁰ The Court also affirmed "well-settled Delaware law" that audit committee membership is not a sufficient basis "to infer the requisite scienter."¹⁵¹ Further, the complaint neither alleged any "cognizable 'red flags' nor "allege[d] any contractual claims, let alone a 'bad faith' breach of the implied covenant of good faith and fair dealing."¹⁵² Therefore, because the complaint did not contain particularized allegations of scienter, the Court affirmed that dismissal was proper.¹⁵³

In *Wood*, the Court placed a significant amount of weight on the exculpating provision of the LLC's operating agreement. The Court did not discuss the adequacy of the exculpating provision to waive liability for breaches of fiduciary duty; it simply took the provision at face value and determined that the plaintiff did not adequately establish a claim of liability under any exception to that provision.

2. ISSUE PRECLUSION IN THE DERIVATIVE CONTEXT

In *In re Career Education Corporation*,¹⁵⁴ the Court addressed the preclusive effect of a prior federal court decision that dismissed a derivative case under Rule 23.1 for failure to plead demand futility.¹⁵⁵ The issue presented was whether the claims in the prior federal court litigation that had been dismissed for failure to meet Rule 23.1 substantially overlapped the claims in the Delaware case.¹⁵⁶ Finding that this overlap existed, the Court held that the prior case precluded plaintiffs from continuing to litigate the issue of demand futility based on either an alleged lack of director independence or exposure to potential liability based on plaintiffs' *Caremark* claims.¹⁵⁷ The Chancery Court dismissed the Delaware case, affirming the principal that, "when the original decision is in federal court, federal issue preclusion law likely applies."¹⁵⁸

Notably, the Court held that issue preclusion applies to a subsequent action even if it is commenced by a different derivative plaintiff reasoning that the true party in interest in a derivative suit is the corporation, not the shareholder plaintiff.¹⁵⁹ Further, because the complaint contained "all of the key factual allegations that Plaintiffs rely on in this action," the Court still found plaintiffs were precluded from litigating the subsequent case, even though the plaintiffs added another cause of action.¹⁶⁰

3. APPLYING DEMAND FUTILITY TO GENERAL PARTNERS

In *Forsythe v. ESC*,¹⁶¹ the Chancery Court allowed a breach of fiduciary duty claim to proceed holding that demand was excused.¹⁶² The main issue presented to the Court was whether, in the context of demand futility, the scienter requirement articulated by the Court in *Caremark* applied to hold the general partners liable, or whether, alternatively, common law partnership duties governed.¹⁶³ The Court held that the partnership agreement "provides the proper standard of liability" for measuring the general partner's behavior.¹⁶⁴

The Court discussed that though general partner duties are usually governed by a partnership agreement, those duties are less clear when they are delegated to third parties under the agreement.¹⁶⁵ In holding that the partnership agreement provided the relevant standard, the Court reasoned that “[p]articularly in light of the general partner’s full delegation of its managerial duties to conflicted persons, the residual duty of oversight found in the agreement imposes a duty upon the general partner to take active steps to satisfy itself that the conflicted delegates actually discharge their powers loyally to the fund and in conformity with the partnership agreement.”¹⁶⁶ The Court recognized that the fact that the general partner had the authority to delegate to third party managers who clearly had conflicts of interest put the general partner on notice that it had more than just *Caremark* duties the general partner had a duty of a more active inquiry.¹⁶⁷

Another important aspect of *Forsyth* is that the Court applied the same test for determining a substantial likelihood of liability for a general partner in a limited partnership as it would have applied to a board of directors of a corporation, except that liability was determined based on the partnership agreement instead of common law.¹⁶⁸ The Court found that the complaint in *Forsyth* sufficiently alleged that the general partner exercised no oversight over the managers thereby creating a substantial likelihood of liability for the general partner. Thus, demand was excused.¹⁶⁹

RECENT DEVELOPMENTS IN DELAWARE LAW REGARDING SPECIAL LITIGATION COMMITTEES

While the Delaware courts have long held that a shareholder can bring a derivative action against a board of directors when demand is excused, those shareholders may not have complete control over the derivative action after it has been filed. In 1981, the Delaware Supreme Court specifically acknowledged that, as a result of a derivative action, board of directors could (1) designate a Special Litigation Committee to review the merits of an action demanded and, in turn, determine whether the action is in the best interests of the company; and (2) empower such Special Litigation Committee to terminate the derivative action if determined unmeritorious or, if meritorious, detrimental to the best interests of the corporation.¹⁷⁰ Since this formal recognition of the Special Litigation Committee (“SLC”), Delaware courts have refined the requirements for the proper formation of an SLC as well as defined specific actions that SLCs can take with respect to their duties. In the last twelve months, Delaware courts have addressed the requirements of SLCs in four separate cases.

A. DELAWARE CHANCERY COURT FLUNKS A SPECIAL LITIGATION COMMITTEE

In *Sutherland v. Sutherland*,¹⁷¹ a twenty-five percent stockholder brought a derivative action against the board of a closely held corporation.¹⁷² The plaintiff-stockholder claimed that the board of directors, comprised of two other twenty-five percent stockholders who were her brothers, breached their fiduciary duties to the company and engaged in wasteful practices with company funds.¹⁷³ In denying the companies’ motion to dismiss the derivative action, the Court held that the one-man SLC formed by the board of directors did not satisfy “the court that it acted in good faith” in conducting a reasonable investigation.¹⁷⁴

The plaintiff’s derivative claim arose from allegations that the individual defendants, the plaintiff’s brothers, “used the companies’ corporate funds and assets for personal benefit.”¹⁷⁵ Specifically, the complaint asserted that the two defendant brothers caused the two closely held family timber companies to pay for, inter alia, “(1) personal flights they have taken on the corporate airplane; (2) personal tax and accounting services provided to them by Cimmarron Lumber & Home Supply Company, Ltd., . . . (3) use of a facility commonly known as the Maysville Training Center for personal vacations; and (4) things [such] as rental cars, expensive hotels, limousines, club memberships, chartered private railroad cars for extended personal trips, private parties and personal living expenses.”¹⁷⁶ In response to these claims, the board of directors, who oversaw the operations of both family-owned companies, amended the companies’ bylaws and increased the number of directors from three members to four.¹⁷⁷ The newly added fourth member, Bryan Jeffrey, was apparently an outside, independent individual.¹⁷⁸ In addition to

his board member status, the board appointed Mr. Jeffrey as the sole member of an SLC tasked with reviewing the merits of the plaintiff's claims.¹⁷⁹ Mr. Jeffrey was given final and binding authority over the claims and immediately hired independent counsel for assistance in reviewing the claims.¹⁸⁰

After a three-month SLC investigation, Mr. Jeffrey reported to the Court his findings and concluded that the companies should not pursue any of the claims as alleged.¹⁸¹ Relying on the report, both companies moved to dismiss the case.¹⁸² After conducting limited discovery regarding the independence and good faith of the SLC investigation, plaintiff opposed the motion to dismiss by claiming that the SLC was not independent, lacked good faith, conducted an unreasonable investigation, and lacked any bases for its conclusions.¹⁸³ The Court held that while the SLC had met its burden of establishing its independence, it did not act in good faith in conducting its investigation.¹⁸⁴

The parties agreed that the legal standards articulated in *Zapata v. Maldonado*¹⁸⁵ governed this dispute.¹⁸⁶ The first step in the bifurcated inquiry under *Zapata* requires a court to determine (i) whether the members of an SLC demonstrated that they were, in fact, independent and disinterested, (ii) whether the investigation was conducted in good faith, and (iii) whether the SLC had any reasonable basis for its conclusions.¹⁸⁷ The second optional step in the *Zapata* inquiry allows a court to determine, while applying its own independent business judgment, whether the motion to dismiss should be granted, regardless of the findings of the first step.¹⁸⁸ While analyzing the *Zapata* factors, the Chancery Court explicitly stated that an "SLC is not entitled to any presumptions of independence, good faith, or reasonableness."¹⁸⁹ The Court reiterated that it is the corporation who retains the burden of proof under Rule 56¹⁹⁰ which requires the "corporation to establish the absence of any material issue of fact and its entitlement to relief as a matter of law."¹⁹¹

In proceeding with the first step of the *Zapata* inquiry, the Court analyzed whether the SLC, consisting of only Mr. Jeffrey, was truly independent. The Court stated that it was conducting the independence inquiry "without regard to whether the members acted in good faith, or conducted a reasonable investigation. Rather, the court investigates the members' personal interest in the disputed transactions, and scrutinizes the members' relationship with the interested directors."¹⁹² Of note, the Court stated that one-member SLCs "are less insulated from the influence of interested directors" and are therefore closely scrutinized.¹⁹³ Analyzing the plaintiff's claims challenging the SLC's independence, the Court ruled that the SLC met its burden of showing the absence of material fact regarding its independence.¹⁹⁴ The Court rejected all four of the plaintiff's arguments against the independence of the SLC finding Mr. Jeffrey to be sufficiently independent of the other board members in conducting his investigation.¹⁹⁵

However, in analyzing the SLC's good faith in conducting a reasonable investigation, the Court found what it deemed "significant errors or shortcomings" which served to "undermine the court's confidence in the SLC's entire investigation."¹⁹⁶ In holding that the SLC did not act in good faith in conducting a reasonable investigation, the Court highlighted three specific errors: (1) a failure to investigate specific cash payments made on behalf of one of the directors; (2) inadequate interview summaries provided by the SLC after the destruction of interview notes; and (3) the SLC's failure to conduct a reasonable investigation into the payment of personal expenses by the companies.¹⁹⁷ To begin, the Court questioned the SLC's decision to omit any mention of payments made to an individual for improvements made to a board member's home, which totaled nearly \$96,000.¹⁹⁸ In characterizing the SLC's explanation as "entirely insufficient," the Court stated that these omissions raised significant questions regarding the good faith of the SLC's investigation.¹⁹⁹ Next, the Court highlighted the fact that most, if not all, of the highly important interview summaries drafted by the SLC failed to record any witness answers whatsoever.²⁰⁰ This lack of detailed interview summaries led the Court to again question the integrity of the SLC's investigation. Last, the Court questioned the SLC's efforts in reviewing the companies' ledgers regarding personal expenditures.²⁰¹ Attacking the diligence of Mr. Jeffrey's investigation, the Court stated that the SLC's failure to investigate thoroughly the companies' finances amounted to a significant omission.²⁰²

Taking into account all of the questions raised by the SLC's apparent lack of good faith and unreasonable investigatory techniques, the Court denied the companies' motion to dismiss.²⁰³ Highlighting the fact that this case involved a one-man SLC which was seeking to "seize control of litigation from 50% stockholders of the companies," the Court held that the SLC did not carry its burden of proof in showing the reasonableness and good faith of its investigation.²⁰⁴

After the Chancery Court delivered its opinion on May 5, 2008, the nominal defendant-companies moved the Court for the opportunity to reargue their denied motion to dismiss.²⁰⁵ In their motion to reargue, the companies set forth three separate arguments in support of their motion: (1) that the Court misapplied the law by employing a higher standard of review than that articulated in *Zapata*; (2) that the Court's opinion misconstrued the facts in criticizing the SLC's omission of payments made on behalf of a board member to a private company; and (3) that the Court's holding was based on a misunderstanding that the SLC agreed to conduct a forensic investigation into the companies' finances.²⁰⁶ In a terse response, the Court refuted all three arguments. First, Vice Chancellor Lamb stated that the companies' argument that the Court employed an erroneously heightened standard of review "plainly misconstrues the court's opinion."²⁰⁷ Under the *Zapata* standard, an "SLC is not entitled to any presumptions of independence, good faith, or reasonableness" and as such, the companies must carry their burden of proof in showing an absence of material fact with regard to all three aforementioned factors.²⁰⁸ Second, the Court stated that the SLC did not merely omit the evidence of payments made by the companies on a board member's behalf.²⁰⁹ In fact, the Court found that the SLC "worded its report in such a way as to convey the impression that there were no such payments."²¹⁰ As a result, the Court found that the SLC's failure to disclose the evidence of these payments prevented the Court from "concluding that the moving parties carried their burden of showing that this one-man SLC acted reasonably and in good faith."²¹¹ Third, the Court stated that a forensic investigation was never required and clarified its previous opinion by stating that the SLC should have conducted a thorough and reasonable review of the companies' ledgers when in fact it did not.²¹² In denying the companies' motion to reargue, the Court reiterated its previous holding stating that the one-man SLC failed to carry its burden as articulated in *Zapata*.²¹³

B. NOT "TOO LATE" TO FORM AN SLC

In *In re infoUSA, Inc. Shareholder's Litigation*,²¹⁴ the Court addressed an SLC's motion to stay the proceedings.²¹⁵ The SLC was formed in response to a derivative action filed against infoUSA, Inc.'s board in addition to an informal Securities and Exchange Commission investigation.²¹⁶ The Chancery Court, in highlighting past Delaware SLC case law, granted the SLC's motion to stay.²¹⁷

The plaintiffs set forth three distinct arguments against the SLC's motion to stay the proceedings. First, the plaintiffs argued that the SLC was formed "too late" in the proceedings.²¹⁸ Chancellor Chandler, in stating that the plaintiffs' argument "misse[d] the mark," found that "[t]he fact that I have already determined demand is excused demonstrates why the board *must* act by means of a committee; it does not in any way explain why it cannot act through an SLC."²¹⁹ In noting a 1984 Delaware Supreme Court case, the Chancery Court reiterated that it has long been Delaware's custom to grant an SLC's motion to stay even after determining that demand against the board is excused.²²⁰

The plaintiffs' next argument against the stay contended that the board created this five-member SLC as an advisory committee with little or no power over the investigation.²²¹ However, in dismissing the argument as baseless, the Court quoted the following passage from the board's resolution that created the SLC: The SLC shall have "full and exclusive authority to consider and determine whether or not the prosecution of the claims asserted in the Derivative Litigation . . . is in the best interests of the Company and its shareholders, and to further consider and determine what action should be taken on behalf of the Company with respect to the Derivative Litigation and any related governmental inquiry, investigation, or proceeding."²²² In stating that this "language is mandatory," the Court concluded that the SLC had the requisite authority to investigate the plaintiffs' claims.²²³

Finally, the plaintiffs challenged the independence of the SLC under the first prong of the bifurcated *Zapata* inquiry.²²⁴ Relying on a narrow exception to the Delaware general practice of granting stays to SLCs in order to investigate claims, the plaintiffs alleged that the facts surrounding the formation of the SLC amounted to the unusual circumstances as presented in *Biondi v. Scrushy*.²²⁵ In *Biondi*,²²⁶ the Chancery Court, while denying a motion to stay proceedings for a SLC investigation, ruled that the SLC could neither conduct a reasonable investigation nor conduct a reasonable inquiry into the claims because the SLC's integrity had been challenged throughout its formation. In carving out this Biondi exception to granting stays to SLCs, the Chancery Court intended the exception to be narrow and rarely invoked.²²⁷ Rebuking the plaintiffs' challenge to the SLC's independence in this case, Chancellor Chandler found that there were no undisputed facts present that would have made it "impossible for the court later to accept a decision of the special litigation committee to terminate" the litigation.²²⁸ Relying on this reasoning, the Court stated that it would "defer its evaluation of the SLC's independence until the time the SLC moves to dismiss—should it ever do so."²²⁹

As a result, the Chancery Court granted the motion to stay the proceedings for 150 days to allow for the five-member SLC to investigate the merits of the derivative claims to determine what, if any, action would be in the best interests of the company.²³⁰

C. RELIANCE ON SPECIAL COMMITTEE'S FINDINGS MAY REQUIRE PRODUCTION

In *Young v. Klassan*,²³¹ the Chancery Court opened the door slightly to the disclosure of a special committee's findings—even in the absence of a written report.²³² This decision arose from a motion to compel filed by the plaintiffs.²³³ The plaintiffs requested the production of documents upon which the defendants relied when drafting their then-pending motions to dismiss the plaintiff's derivative suit.²³⁴ Relying upon the Chancery Court's decision in *Fleischman v. Huang*²³⁵ from August 2007, the Court granted the motion to compel and permitted limited discovery of all documents that were prepared in connection with the special committee's findings.²³⁶

Sunrise Senior Living, Inc., the nominal defendant in this case, formed a special investigative committee²³⁷ in response to a demand made by institutional stockholders.²³⁸ The demand asked the board of directors to investigate the timing of specific stock option grants.²³⁹ The complaint, filed by two individual plaintiffs, merely mentioned the formation of a special committee but did not discuss the findings of the committee.²⁴⁰ The defendants, including the nominal defendant corporation, then filed motions to dismiss the case along with their opening briefs in support of the motion to dismiss.²⁴¹ In their reply briefs, both the defendant corporation and the individual defendants stated that "in light of the special independent committee's investigation and findings, Plaintiffs must present particularized allegations of demand futility in order to establish derivative standing."²⁴² Additionally, the individual defendants' reply briefs relied heavily on the fact that "an investigation commissioned by a Special Committee of the Board and conducted by independent counsel has found no evidence of backdating or other intentional misconduct" to refute the plaintiffs' claims.²⁴³

These explicit references to the findings of the special committee prompted the plaintiffs to file a motion to compel the production of documents upon which the special committee relied to make these findings and conclusions.²⁴⁴ The plaintiffs argued that the defendants "clearly rely upon the special committee's findings for their truth."²⁴⁵ Also, the plaintiffs defended their reference to the special committee in their complaint by stating that the complaint only references the company's public announcement regarding the formation of the committee.²⁴⁶ Examining the Chancery Court's decision in *Fleischman*, the plaintiffs argued that the defendants' reliance upon the findings of the special committee in their motions to dismiss necessitated the production of the "documents constituting and supporting the purported factual findings and report by the special committee."²⁴⁷

In response to the motion to compel the production of these documents, the defendants put forth two arguments. First, the defendants argued that the plaintiffs' motion to compel amounted to "misdirect[ion]" because the defendants did not rely upon the truth or accuracy of the special committee's findings in their dismissal arguments.²⁴⁸ Second, the defendants argued that even though the references to the special committee's findings were not offered for their truth, the Court and the plaintiffs could take judicial notice of the publicly disclosed findings of the special committee.²⁴⁹

The Chancery Court, noting that this case was almost factually identical to *Fleischman*, rejected both of defendants' arguments.²⁵⁰ As in *Fleischman*, the defendants relied upon an independent committee's findings in their briefs, which were clearly outside of the purview of the complaint.²⁵¹ The Court in *Fleischman* granted limited discovery regarding "reports upon which the audit committee based its publicly announced findings."²⁵² Chancellor Chandler found in *Fleischman* that "the defendants improperly inserted these matters into the litigation by relying on the [audit committee's] favorable findings to support their motion to dismiss."²⁵³

Finding that the defendants' relied upon findings of the special committee to bolster their case for dismissal, the Court granted the plaintiffs' motion to compel the production of the special committee's documents relating to its investigation.²⁵⁴ Because the special committee chose not to prepare a written report, the Court granted "a limited procedural right to plaintiff-access to documents that defendants have expressly relied upon in support of their motion to dismiss," which included any documents related to the special committee's findings.²⁵⁵

D. WHEN PRIVILEGE DISAPPEARS FOR A SPECIAL COMMITTEE

Encouraging a frank and honest conversation between attorney and client is one of the several reasons that courts are protective of the attorney-client privilege. However, when that privilege is violated by improper disclosure of information, Delaware courts do not hesitate to waive such privilege with respect to non-*Zapata* special committees. The Chancery Court waived such privilege in *Ryan v. Gifford*.²⁵⁶ In *Ryan*, a company responded to accusations of stock option backdating claims by forming a "special committee,"²⁵⁷ comprised of a single board director, to investigate the company's stock option grants and practices.²⁵⁸ After the special committee reported its findings to the board of directors, the plaintiffs filed a motion to compel the production of all communications between the committee and its outside counsel, including the presentation of the investigation's final report to the company's board of directors.²⁵⁹ In granting the plaintiffs' motion to compel, the Delaware Chancery Court ruled that the special committee waived any expected privilege over the investigation when it presented its findings to the board directors in their individual—as opposed to fiduciary—capacities.²⁶⁰

In claiming that the Court's decision granting the plaintiffs' motion to compel presented an issue of "first impression" under Delaware law, the individual defendant directors filed an application for interlocutory appeal.²⁶¹ Among many other arguments offered in support of the appeal, the defendants asserted that the decision established a "new legal right of access to internal corporate information," determined a "substantial issue" in the case, and "present[ed] a question of first impression in Delaware."²⁶² However, none of these arguments swayed the Court from its previous decision and the Court denied the defendants' application.

In refuting the defendants' "legal access" argument, the Court relied again on the Chancery Court's decision in *Fleischman*.²⁶³ Quoting *Fleischman*, the Court stated that their decision to grant the motion to compel "simply grants a *limited procedural right* to plaintiff-access to documents that defendants have expressly relied upon."²⁶⁴

Additionally, while dismissing the defendants' "substantial issue" argument, the Court stated that the decision would not affect longstanding Delaware corporate customs and principles of good governance.²⁶⁵ In limiting the impact of the decision, the Court stated that the application of "well-settled precedent" to this particular fact pattern necessitated the ruling.²⁶⁶ The Court went on to outline scenarios under which the decision would not apply.

Most notably, the Court stated that privilege would not have been waived in a situation "in which board members are found to be acting in their fiduciary capacity, where their personal lawyers are not present, and where the board members do not use the privileged information to exculpate themselves."²⁶⁷ More importantly, the Court stated that its decision would have no affect on the "privileges of a Special Litigation Committee formed under *Zapata*, or any other kind of committee that (unlike the Special Committee here) has the power to take actions without approval of other board members."²⁶⁸

Moreover, in arguing that the Court's decision presented a question of first impression, the defendants pointed out that no Delaware Courts have held that "a committee of the board waived privilege over its entire investigation by reporting its findings to the full board."²⁶⁹ However, the Court simply quoted Rule 510 of the Delaware Rules of Evidence stating that privilege "is destroyed whenever the holder of the privilege 'voluntarily discloses or consents to disclosure of any significant part of the privileged matter.'"²⁷⁰ The Court then applied Rule 510 noting that the special committee disclosed its findings regarding the misconduct of the individual defendants to the actual defendants themselves as well as their individual, personal counsel.²⁷¹ Finding that this disclosure was to the directors in their individual—as opposed to fiduciary—capacities, the Court reaffirmed their position that the committee's privilege was indeed waived under Delaware law.²⁷²

While the defendants attempted to declare that the sky was indeed falling due to this waiver of privilege, the Court refuted the defendants' "Chicken Little" argument²⁷³ by narrowly tailoring its decision to affect only non-*Zapata* special committees who make disclosures to board members in their individual capacities.

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1. *Feldman v. Cutaia*, No. 4662007, 2007 WL 2223084 (Del. Supr. May 30, 2008) (Holland, J.).
 2. *Id.* at *1. Although the Chancery Court dismissed the third amended complaint in its entirety, the plaintiff only appealed the dismissal of Count XIII, which alleged "that the defendants breached their fiduciary duties by not reconsidering the validity of the Challenged Stock Options before approving the Merger agreement." *Id.* at *3.
 3. *Id.* at *3. The Court in *Lewis v. Anderson* recognized two exceptions to the rule that a former shareholder cannot sue a corporation after he no longer owns stock. *Id.* at 3 n.20 (citing *Lewis v. Anderson*, 477 A.2d 1040, 1046 (Del. 1984)). However, these exceptions were not relevant in *Feldman* and are discussed *infra* in Section I(C).
 4. *Id.* at *1-2.
 5. *Id.* at *2.
 6. *Id.*
 7. *Id.*
 8. *Id.* at *4.
 9. *Id.* at *3 (citing *Tooley v. Donaldson, Lufkin, Jenrette, Inc.*, 845 A.2d 1031, 1033 (Del. 2004)).
 10. *Id.* at *6 (citing *Kramer v. W. Pac. Indus., Inc.*, 546 A.2d 348, 354 (Del. 1988)).
 11. *Id.*
 12. *Id.* at *3, 6 (citing *Kramer*, 546 A.2d at 354).
 13. *Id.* at *3.

14. *Id.* at *4. The court found that dilution claims are generally not found to be direct. *Id.*
15. *Id.* at *6 (citation omitted).
16. *Id.* at *2.
17. *Rhodes v. Silkroad Equity, LLC*, No. Civ. A. 2133-VCN, 2007 WL 2058736, at *5 (Del. Ch. July 11, 2007) (Noble, V.C.).
18. *Id.*
19. *Id.* at *2 n.4.
20. *Id.* at *2.
21. *Id.* at *4.
22. *Id.* at *3.
23. *Id.*
24. *Id.* at *4.
25. *Id.* at *3.
26. *Id.* at *4.
27. *Id.* at *4-5.
28. *Id.* at *5. At least one transaction has been found to be both derivative and direct: “A breach of fiduciary duty where (1) a stockholder having majority or effective control causes the corporation to issue ‘excessive’ shares of its stock in exchange for 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.” *Id.* (citing *Gentile v. Rossette*, 906 A.2d 91, 99-100 (Del. 2006)).
29. *Id.* (citation omitted).
30. *Id.*
31. *Id.*
32. *Id.*
33. *Id.*
34. *Id.*
35. *Id.*
36. *Schoon v. Smith*, No. 554, 2006, 2008 WL 375826, at *7 (Del. Feb. 12, 2008) (Ridgely, J.).
37. *Id.* at *1.
38. *Id.*
39. *Id.* at *2.
40. *Id.* at *7.
41. *Id.* at *2-3.
42. *Id.* at *2.
43. *Id.* at *4.
44. *Id.*
45. *Id.* at *6. The court found that there was no complete failure of justice shown in this case because a stockholder, who owned stock at the time of the transaction, had already instituted a derivative suit on the corporation’s behalf. *Id.*
46. The Delaware Chancery Court has also recently made another significant decision in *Schoon v. Troy Corp.* relating to the advancement of legal fees for directors defending threatened or pending fiduciary claims. The Court determined that a director’s right to advancement can be lost if the corporation amends its bylaws to remove that right prior to a suit being filed. The Court explained that the right does not vest until a suit has been filed against

the director which would entitle him to the advancement. See *Schoon v. Troy Corp.*, C.A. No. 2362-VCL, 2008 WL 821666, at *6 (Del. Ch. March 28, 2008) (Lamb, V.C.) (holding that a former director had no right of advancement of legal fees where the company amended its bylaws after the director resigned but before litigation ensued to remove such a right).

47. 924 A.2d 908, 912-13 (Del. Ch. 2007) (Strine, V.C.).

48. *Id.* at 924-25.

49. *Id.*

50. *Id.* at 913.

51. *Id.* at 924.

52. *Id.* at 924-26.

53. *Id.* at 925.

54. *Id.* (Internal quotation omitted; emphasis in original).

55. *Id.*

56. *Id.* at 926.

57. *Id.*

58. *Id.* In dismissing the action, the Court recognized that the primary purpose behind § 327 was to prevent plaintiffs from purchasing shares in order to bring a derivative action attacking transactions which occurred before they purchased stocks. Although the court acknowledged that the plaintiff did not have such a culpable state of mind when he purchased stock in the company, the court refused to grant standing on this basis as it would be contrary to the plain language of § 327. *Id.* at 926-27.

59. 940 A.2d 28, 41 (Del. Ch. 2007) (Lamb, J.).

60. *Id.* at 31, 33.

61. *Id.* at 42.

62. *Id.* at 41.

63. *Id.* at 42.

64. *Id.* Noting that this conclusion may prevent shareholders from a “reasonable opportunity to rectify corporate aberrations,” the court invited a stockholder who owned stock at the time of the challenged transactions to intervene and assert claims regarding those transactions. *Id.* (Internal quotations omitted).

65. CA Nos. 2991-VCP, 311-VCP, 2008 WL 553205 (Del.Ch 2008) (Parsons, V.C.).

66. *Id.* at *10.

67. *Id.* at *1-2.

68. *Id.* at *1.

69. *Id.* at *2.

70. *Id.*

71. *Id.* at *10-11.

72. *Id.* at *10.

73. *Id.* (citing Lewis, 477 A.2d at 1046).

74. *Id.* The Court found that even if a merger was involved the *Lewis* exceptions would not apply. The first exception was inapplicable because former shareholders’ allegations were insufficient to support a reasonable inference that the defendants cancelled the former shareholder’s stocks in order to deprive him of derivative standing. *Id.* The second exception was inapplicable because the former shareholder did not retain stock in the corporation. *Id.*

75. *Id.* at *11.

76. 937 A.2d 1275 (Del. 2007) (Holland, J.).

77. *Id.* at 1280.
78. *Id.* at 1289-92.
79. *Id.* at 1279.
80. *Id.*
81. *Id.* at 1292.
82. *Id.* at 1289-92.
83. Del. Ch. Ct. R. 23.1.
84. 918 A.2d 341 (Del. Ch. 2007 (Chandler, C.)).
85. 919 A.2d 563 (Del. Ch. 2007) (Chandler, C.)).
86. 924 A.2d at 912-13.
87. *Id.* at 951. The complaint was also dismissed in part because the plaintiff lacked standing to challenge certain option grants. *Id.* at 951. This aspect of the case is discussed *supra* in Section I(C).
88. *Id.* at 913-14.
89. *Id.*; see Del. Ch. Ct. R. 23. 1 (requiring that in its complaint brought derivatively, the shareholder plaintiff “allege with particularity the efforts, if any, made by the plaintiff to obtain the action [he] desires from the directors or comparable authority and the reasons for the plaintiff’s failure to obtain the action or for not making the effort.”).
90. 634 A.2d 927, 934 (Del. 1993).
91. 924 A.2d at 914.
92. *Id.*
93. *Id.* at 913-14.
94. *Id.* at 917. Although the Court assumed for the purposes of the 12(b)(6) motion that demand was excused, it subsequently dismissed the complaint because the plaintiff could not plead a claim for breach of fiduciary duty. *Id.* at 948-50. The Court based its decision on the fact that the complaint merely alleged that directors followed the non-discretionary plan that granted options to the directors on a particular day, where the options were granted on such date, regardless of whether that date happened to always fall immediately after a regularly-issued quarterly report. *Id.*
95. *Id.* at 938.
96. *Id.*
97. *Id.*
98. *Id.*
99. *In re Caremark Int’l Inc., Deriv. Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996).
100. *Desimone*, 924 A.2d at 939 (quotations omitted).
101. *Id.* at 940.
102. Spring loading means issuing options just before the release of positive information. *Id.* at 943.
103. Bullet dodging means issuing options on the heels of the release of negative information. *Id.*
104. *Id.* at 942-45.
105. *Id.* at 942.
106. *Id.*
107. *Id.* at 943.
108. *Id.*
109. *Id.*
110. *Id.*

111. *Id.* at 944, citing *Tyson*, 919 A.2d at 575-76.
112. *Id.* at 944.
113. *Id.*
114. *Id.* at 944-45.
115. *Id.* at 946.
116. *Id.* at 946.
117. 940 A.2d 28.
118. C.A. No. 2828-VCL, 2008 WL 2267020 (Del. Ch. March 7, 2008) (Lamb, V.C.).
119. See *Conrad*, 940 A.2d at 39; *Weiss*, 2008 WL 2267020, at *2, *5.
120. *Conrad*, 940 A.2d at 31.
121. *Id.*
122. The *Rales* test was applied because “the board of directors upon which demand would be made did not approve the challenged transaction.” *Id.* at 36.
123. *Id.* at 35.
124. *Id.* at 38.
125. *Id.* at 39, citing *Desimone*, 924 A.2d at 942.
126. *Id.* at 39.
127. *Id.*
128. *Id.* at 37.
129. *Id.* at 34.
130. *Id.* at 39 n.28.
131. *Weiss*, 2008 WL 2267020, at *9.
132. *Desimone*, 924 A.2d at 950.
133. *Weiss*, 2008 WL 2267020, at *8.
134. *Id.* The Chancery Court recently has issued another opinion concerning demand futility that closely follows the Chancery Court’s decisions in *Tyson* and *Weiss*. See *London v. Tyrrell*, CA No. 3321-CC, 2008 WL 2505435, at *5 (Del. Ch. June 24, 2008) (Chandler, C.) (excusing demand where the director defendants both granted and received the challenged stock options and knowingly violated the stock option plan).
135. See also *In re infoUSA, Inc.*, No. 1956-CC, 2007 WL 3325921 (Del. Ch. August 20, 2007) (Chandler, C.). In *infoUSA*, the themes of good faith and candor were affirmed in other demand futility case, which did not relate to the manipulation of options. *Id.* at *11-13. The Court reiterated that merely alleging enormous executive compensation packages, no matter how extravagant, would rarely be enough to excuse a derivative plaintiff from making a demand. *Id.* at *11. The motivation or good faith of the directors should be the basis for the analysis.
136. *Wood v. Baum*, No. 621, 2007, 2008 WL 2600981 (Del. July 1, 2008) (Jacobs, J.).
137. *Id.* at *1.
138. *Id.*
139. *Id.*
140. *Id.*
141. *Id.* at *2.
142. *Id.*
143. *Id.* at *1.
144. *Id.* at *2.

145. *Id.* at *3 (quotation omitted).
146. *Id.*
147. *Id.*
148. *Id.* at *2.
149. *Id.*
150. *Id.*
151. *Id.* at *4.
152. *Id.*
153. *Id.*
154. *In re Career Education Corp. Derivative Litig.*, C.A. No. 1398-VCP, 2007 WL 2875203 (Del. Ch. Sept. 28, 2007) (Parsons, V.C.).
155. *Id.* at *6-7.
156. *Id.* at *10.
157. *Id.* at *11.
158. *Id.* at *10 (citing *West Coast Mgmt to Capital, LLC v. Carrier Access Corp.*, 914 A.2d 636, 643 (Del. Ch. 2006)).
159. *Id.* The Court noted that if the adequacy of prior representation was at issue, collateral estoppel will likely not apply to a case involving a different plaintiff.
160. *Id.* at *10 n.58, 14.
161. *Forsythe v. ESC Fund Mgmt. Co.*, CA No. 1091-VCL, 2007 WL 2982247 (Del. Ch. Oct. 9, 2007) (Lamb, V.C.).
162. *Id.* at *6-7.
163. *Id.* at *7.
164. *Id.* at *6.
165. *Id.* at *7.
166. *Id.* at *1.
167. *Id.* at *7.
168. *Id.* at *5-6.
169. *Id.* at *9.
170. *Zapata v. Maldonado*, 430 A.2d 779, 785 (Del. 1981) (Quillen, J.); *Grimes v. Donald*, 673 A.2d 1201, 1216 n.13 (Del. 1996) (Berger, J.).
171. *Sutherland v. Sutherland*, C.A. No. 2399-VCL, 2008 WL 1932374 *7 (Del. Ch. May 5, 2008) (Lamb, V.C.).
172. *Id.* at *1.
173. *Id.*
174. *Id.*
175. *Id.* at *2 (quotations omitted).
176. *Id.* (quotations omitted).
177. *Id.*
178. *Id.*
179. *Id.*
180. *Id.*
181. *Id.*

182. *Id.*
183. *Id.*
184. *Id.* at *7.
185. *Zapata*, 430 A.2d at 788.
186. *Sutherland*, 2008 WL 1932374, at *2.
187. *Id.*
188. *Id.*
189. *Id.* at *3.
190. Delaware Court of Chancery Rule 56 details requirements for a motion for Summary Judgment.
191. *Sutherland*, 2008 WL 1932374 at *3.
192. *Id.* (quotations omitted).
193. *Id.* (citing *In re Oracle Corp. Deriv. Litig.*, 824 A.2d 917 (Del. Ch. 2003) (“a small number of directors feels the moral gravity-and social pressures-of [the duty to decide whether to sue fellow directors] alone.”)).
194. *Sutherland*, 2008 WL 1932374 at *4.
195. *Id.* at *5.
196. *Id.*
197. *Id.* at *5-6.
198. *Id.* at *5.
199. *Id.*
200. *Id.* at *6.
201. *Id.*
202. *Id.* at *7.
203. *Id.*
204. *Id.* at *6-7.
205. *Sutherland v. Sutherland*, C.A. No. 2399-VCL, 2008 WL 2221770 (Del. Ch. 2008) (Lamb, V.C.).
206. *Id.* at *1-3.
207. *Id.* at *1.
208. *Id.* (citation omitted).
209. *Id.* at *2.
210. *Id.*
211. *Id.*
212. *Id.* at *3.
213. *Id.*
214. *In re infoUSA, S’holders Litig.*, Civ. Action No. 1956-CC, 2008 WL 762482, at *3 (Del. Ch. 2008) (Chandler, C.).
215. *Id.*
216. *Id.*
217. *Id.* at *2-3.
218. *Id.* at *1.
219. *Id.* at *2 (emphasis in original).

220. *Id.* (citing *Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984)).
221. *In re info USA*, 2008 WL 762482 at *2.
222. *Id.*
223. *Id.*
224. *Id.*
225. 820 A.2d 1148 (Del. Ch. 2003).
226. *Id.*
227. *Id.* at 1153.
228. *In re infoUSA*, 2008 WL 762482 at *3.
229. *Id.*
230. *Id.*
231. *Young v. Klaassan*, Ca. No. 2770-VCL, 2008 WL 2267021, at *3 (Del. Ch. 2008) (Lamb, V.C.).
232. *Id.* at *3.
233. *Id.* at *1.
234. *Id.*
235. No. Civ. A. 2497-CC, 2007 WL 2410386 (Del. Ch. Aug. 22, 2007) (Chandler, C.).
236. *Young*, 2008 WL 2267021, at *3.
237. This committee was not a *Zapata* SLC.
238. *Young*, 2008 WL 2267021 at *1.
239. *Id.*
240. *Id.*
241. *Id.*
242. *Id.* (quotations omitted).
243. *Id.* (citations omitted).
244. *Id.* at *2.
245. *Id.*
246. *Id.*
247. *Id.*
248. *Id.*
249. *Id.*
250. *Id.*
251. *Id.* (quotation omitted).
252. *Id.*
253. *Id.*
254. *Id.* at *2-3.
255. *Id.* at *3.
256. C.A. No. 2213-CC, 2008 WL 43699, at *7 (Del. Ch. Jan. 2, 2008) (Chandler, C.).
257. The committee was not a *Zapata* SLC.
258. *Ryan*, 2008 WL 43699, at *1.

259. *Id.* at *1, 3-4.
260. *Id.* at *6.
261. *Id.* at *4 (quotations omitted).
262. *Id.* at *5-6.
263. *Id.* at *5.
264. *Id.* (emphasis in original).
265. *Id.*
266. *Id.*
267. *Id.*
268. *Id.*
269. *Id.* at *6.
270. *Id.*; Del. R. Evid. 510.
271. *Ryan*, 2008 WL 43699 at *6.
272. *Id.* See also *In re Fuqua Industries, Inc. S'holders Litig.*, C.A. No. 11974, 1992 WL 296448 (Del. Ch. Oct. 8, 1992) (Chandler, V.C.), applying *Garner v. Wolfenbarger*, 430 F.2d 1093 (5th Cir. 1990) (discussing that the Fifth Circuit developed a theory that allows a shareholder to pierce the attorney-client privilege in certain shareholder litigation, placing the burden on the stockholder to show that the attorney-client privilege should not apply in a particular situation).
273. *Ryan*, 2008 WL 43699, at *6.



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