THE GOOD THE BAD AND THE UGLY: DIRECTOR RISK IN THE POST-ENRON WORLD

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I. INTRODUCTION

As we come together this year there are several interesting issues to consider. Perhaps the most obvious is whether the risks facing officers and directors in today's environment are any greater than they were a few years ago. While there have been a number of concerns raised by a variety of individuals and practitioners, there has also been some recent scholarly analysis questioning whether this concern has an empirical basis. In particular, with the notable exception of Van Gorkum many years ago, and more recently Enron and WorldCom, are directors and officers really that much more at risk than at any other time in the last 25 years? Or have we, as counselors to directors and officers overstated the changing environment, and in particular in the potential risk of liability that a director, officer, issuer, or underwriter faces today?

One way to think about it is to put you in a couple of different hypothetical situations. First, imagine you are the CEO of a leading company in an exciting growth industry. Your company prices its initial public offering ("IPO") at $18 per share, and by the close of the day the company is trading at $29 per share. Less than a year later the Company does another offering, raising an additional $100 million. Within three months of the secondary offering (and 15 months of the IPO) the Company misses its numbers, and within six months of the secondary offering (and 18 months of the IPO) your Company has filed for bankruptcy. The lawsuits, several of which have been filed after the initial miss, are filed again after the bankruptcy, naming you, several of the Company's other officers and directors, as well as the auditors and underwriters, for liability under various state and federal securities laws.

Not surprisingly, the specific claims in the case include numerous accounting allegations. One such allegation is that as CEO you personally agreed to give a large customer extended payment terms. These extended payment terms inflated revenues for particular periods and for the class period overall. In addition, plaintiffs allege that members of your management team agreed to take products back from customers for a full credit, and your chief financial officer severely inflated your accounts receivable. As a result of this "financial manipulation" the Company was able to significantly inflate revenues in periods right before the sale of securities. Finally, as CEO you sold some stock during this period while the market for the Company's stock was near its high.

Based upon these facts, what is the result? Criminal charges against you as CEO? Civil claims by the SEC against you and the other officers and directors? Is your insurance carrier going to move to rescind its policies on your behalf, putting all that you have ever worked for at risk? Should you accept having to pay a multi-million dollar settlement in lawsuits brought by shareholders against you and the other directors for your actions as an officer and director rather than risk taking the case to summary judgment and/or trial?

These facts are, of course, based on an actual case. Yet rather than settling, you—and the other "deep pocket" defendants—have decided to take this case to summary judgment. Having heard all the arguments, some of the conclusions reached by the court in ruling on your motion are as follows:

--the question as to whether revenue was properly recognized is “enormously complex”, with the parties “generat[ing] well over 100 pages of conflicting expert testimony on these issues alone. It is absurd in these circumstances for Plaintiffs to suggest that the other defendants, who are not accountants, possibly could have known of any mistake by [the auditors]. Therefore, even if there are errors in the financial statements, no defendant except [the auditor] can be liable under Section 11 on that basis”;

--with respect to the claim that the company took back product from customers for a full credit, “[g]iving an unsatisfied customer a refund is a normal business method of dealing with an unsatisfied customer. It is not a violation of the securities laws for [the company] to have failed to disclose such an obvious practice to potential investors.”

--plaintiffs’ argument that the company failed to adequately disclose the weakness in its internal controls “ignore[s] the fact the Prospectus included an express disclaimer that ‘there can be no assurances’ that [the company’s] existing internal controls would continue to be adequate given the rapid pace at which the company was growing. The Prospectus made no predictions to the contrary. Thus, the Prospectus adequately bespoke caution regarding this potential risk…[and] [a]s a matter of law, [p]laintiffs cannot have been misled.”

--in response to the Section 10(b) and Rule 10b-5 claims against you and the other officers, the court found that your “overall pattern of conduct…rebuts any inference of knowing or reckless conduct…[because] if [the company's] officers were bent on committing fraud, it is not likely that they would have provided such detailed risk disclosure in the prospectuses. Furthermore, if, as [p]laintiffs allege, the [o]fficers knew that [the company] was heading for financial disaster, they probably would have bailed out of their substantial stock holdings. Each of the [o]fficer [d]efendants, by contrast, held onto most of their [ ] stock and incurred the same large losses as did the [p]laintiffs themselves."

--in conclusion, the court noted that plaintiffs have "submitted hundreds of pages to this court in an effort to create a genuine issue of fact. Using tortured reasoning, convolution of the issues, and the benefit of hindsight, they point to the most innocuous of optimistic language, and the most immaterial of omitted facts, and claim that they were somehow misled as to the nature of their investment. The court has thoroughly reviewed the record, and it concludes that there is no issue on [p]laintiffs' claims under the federal securities laws that can be submitted to the jury. For the reasons set forth above, no defendant is liable for any statement in, or omission from, either [prospectus]. Moreover, there is insufficient evidence, as a matter of law, for the jury to find intent to deceive or defraud on the part of any defendant in connection with [the company's] securities offerings."

The unfortunate company who suffered this fate was Worlds of Wonder (the company that brought us Teddy Ruxpin and Lazer Tag!). In the leading case titled <u>In re Worlds of Wonder Securities Litigation</u>, 814 F. Supp. 850 (N.D. Cal. 1993)—a case decided well before the PSLRA was passed—Judge Samuel Conti rejected all of plaintiffs' claims despite the undisputed fact that the company went bankrupt within 18 months of its IPO.[ii]

The second situation for you to consider has somewhat similar facts. In this situation the company again had a successful IPO, at a price of $18.50 per share, and within a short period its stock rose to $23.50 per share. Unfortunately, and once again within six months of this offering, the company had a severe revenue shortfall and faced allegations of improper revenue recognition. As a result, the company's stock price fell dramatically, to a price of just over $2 per share after all of this information became public.

Not surprisingly, nearly a dozen cases were filed within days of the information becoming public. This time, you are a director (or general counsel) of one of the lead underwriters for the offering, trying to decide whether or not to settle the case. The choice you are facing is to settle now for tens of millions of dollars or to push forward to the summary judgment decision, with the promise that the settlement amount will increase substantially if your company loses its motion for summary judgment. Given these facts, one must wonder in today's environment how many of us would decide to take the risk and go forward to fight the case.

Once again this situation is taken from an actual case. In that case, in responding to the underwriters' motion for summary judgment solely on the basis that the underwriters performed adequate due diligence to meet their obligations under Section 11, the court held as follows:

--the "adequacy of due diligence may be decided on summary judgment when the underlying historical facts are undisputed." Otherwise, leaving the "question of what constitutes due diligence to the jury will lead to a battle of experts…who basically become paid advocates, …express[ing] an opinion based on their own subjective viewpoints, which will be biased by their role. The jurors will then be forced to decide between these paid advocates. The resulting uncertainty will increase litigation against deep pocket defendants (such as underwriters) and encourage collusion between plaintiffs and the issuer, who will often be in a precarious financial situation already….[In contrast] treating due diligence as a question of law, once the historical facts are undisputed, will apportion the risk more appropriately, encourage settlement at early stages and lead to more equitable and consistent results."

--"Section 11 and 12(2) require a 'reasonable' investigation by the [u]nderwriters. This does not, as [p]laintiffs imply, require an audit on the part of the underwriters….[U]nderwriters may reasonably rely on SEC letters and documents as well as representations of management. That is not to say that underwriters may 'tacitly rely on management assertions'; rather, underwriters may rely on management's representations when it is reasonable to do so under the circumstances. It would be unreasonable, for example, to solely rely on management's representations when said representations could have been reasonably verified. It is not unreasonable, however, to rely on management's representations with regard to information that is solely in the possession of the issuer and cannot be reasonably verified by third parties. Underwriters cannot be expected to ferret out everything that management knows about the company; they only need to reasonably attempt to verify and believe the accuracy of the information in the prospectus. If the [u]nderwriter's overall investigation was reasonable under the circumstances, they are entitled to a due diligence defense."

--"The [p]rospectus sets out several risk factors" detailing potential problems the company may face. "These warnings, along with many others in the [p]rospectus, may, by themselves, entitle the [u]nderwriters to summary judgment."

--with respect to a claim that the underwriters failed to perform sufficient diligence on the company's policy on product returns and price protection, the court held that the underwriters not only interviewed several members of management but "then verified management's representations by contacting three major…customers, the [company's] distributors…subjected [the company's] budget to line-by-line scrutiny…reviewed its financial statements with [the company's auditor]…[and] obtained written representations from [the company] *and* selling stockholders that the [p]rospectus was accurate, as well as a comfort letter from [the company's auditor]."

--on the claim that the underwriters failed to uncover the company's improper revenue recognition policies, the court held that "[g]iven the complexity of the accounting issues, the [u]nderwriters were entitled to rely on [the expertise of the company's auditor]." Yet the underwriters went further, and reviewed confirmations from some of the company's customers and "confirmed [the company's] revenue recognition policy with other accounting firms." As a result, their investigation on this issue "was reasonable".

--"[p]laintiffs' contention that had the underwriters done more, they would have revealed problems, is not persuasive. The court cannot evaluate an underwriter's due diligence defense with the benefit of hindsight. The overall investigation performed here was reasonable under the circumstances at the time of the investigation."

--with respect to primary liability under Section 10(b) the court held that plaintiffs "offer no motive for the [u]nderwriters to participate in the alleged fraud, except to point to the fees that they earned from the [o]ffering. This court has previously stated that an allegation that professionals committed fraud in order to obtain professional fees is not a persuasive motive to establish scienter…In fact, the risk of monumental damages against underwriters if found liable for securities fraud more than balances the temptation of ill-gotten gains and makes such a motive implausible. An underwriter's greatest asset is its reputation for careful work. Fees for an offering could not approach the losses the underwriting firm would suffer from a perception that it would muffle a client's fraud."

-- "Nor do the actions of the [u]nderwriters support a pattern consistent with scienter. The extensive risk warnings in the [p]rospectus, for example, negate any inference of scienter. If the [u]nderwriters had intended to mislead investors, they would not have included such warnings, which could have discouraged investors from purchasing [the company's] stock."

--Plaintiffs' claim that the underwriters knew that the company's business was declining. "Plaintiffs' evidence in support of these assertions, however, is not sufficient to infer scienter in this case. Plaintiffs' expert's opinion of what the [u]nderwriters likely did or did not know is far from what is required to infer scienter under the circumstances of this case."

Based upon these conclusions, the court in In re Software Toolworks Securites Litigation, 789 F. Supp. 1489 (N.D. Cal. 1992) granted summary judgment in favor of the underwriters against all claims brought by plaintiffs.[iii]

Worlds of Wonder and Software Toolworks were both decided less than 15 years ago, and before the adoption of the PSLRA, which increased the burden on plaintiffs in securities class actions. Both decisions were authored by well respected judges, and were the subject of significant commentary at the time they were issued.

In today's environment, how many of the potential defendants in these situations would have chosen to proceed to summary judgment? A quick review of any newspaper these days shows very few, as the risks have so increased while the perceptions of the key actors involved—including management, outside directors, investment banks, auditors and anyone else affiliated in any way with a company which has been the victim of fraud—has reached such a point that it is virtually impossible for these individuals and entities to believe that they have any realistic chance of prevailing on a motion *regardless* of the merits of the situation.

The risk ratio seems to be better in Delaware on issues involving the scope of a director's fiduciary duties, although it may just be that the downside risk (i.e. the likelihood of personal liability, significant monetary damages and/or even criminal time) is less in Chancery Court than in district court. It is worth noting, however, that as this article goes to print there are several cases winding their way through the courts which could impact the standards applicable to directors, as well as the risk of liability to directors.

Perhaps most notably the trial over Michael Ovitz's departure from the Walt Disney Company has been completed, and an opinion concerning the "good faith" standard applicable to directors coming out of that case should be issued in the near future. This opinion could have significant implications for directors of Delaware companies for many different reasons, including the fact directors can only be indemnified if they act in "good faith".

Yet one other point must be noted when considering the increased risks to officers and directors: the dramatic increase over the last several years in executive compensation, particularly CEO compensation. According to a recent New York Times article, the CEO of a major company in 2004 received on average a pay package of approximately $10 million, an increase of more than 12% from 2003. Further, this figure does not take into account the pay-out for some CEOs involved in extraordinary transactions, or gains on various forms of equity compensation.

The growth in CEO pay is not, of course, linked in any specific way to the increased risks faced by officers, but it may well be part of the reason why it is generally perceived to be more difficult to defend senior executives today than it was at the time Software Toolworks or Worlds of Wonder were decided. Certainly one factor that helped push Sarbannes-Oxley through Congress was the view that executives receiving such high compensation ought to be responsible for all aspects of their company's financial statements even when, as was recognized in Worlds of Wonder, complicated accounting questions are often the subject of much debate within the accounting profession, and asking a non-accountant to be an expert on these issues is neither realistic nor fair.

This outline briefly reviews some recent cases under Delaware law that discuss the issues facing directors in today's environment, as well as the broader issue of the evolving standards of review for corporate directors. These cases show how some courts are viewing director conduct in today's environment. Yet as discussed above, what is important is not just what these cases are saying but the overall environment for officers, directors and their advisers.

Perhaps the most important issue is whether we will return to an environment which existed less than 15 years ago, when "deep pocketed" defendants who believed they did not act improperly felt that they could afford to take their case to court and not be tarred with the fraud and/or bad judgment of the other parties to the case. A second such issue is whether the growth in executive (and particularly CEO) pay shall continue, and if so what implications that will have on the judicial system. Finally, it is worth considering whether the failures of Enron, WorldCom and the other notorious frauds of the last few years have been sufficiently removed from the front pages to allow a more level-headed discussion about such critical corporate governance issues as the scope of a director's liability, her responsibility to the corporation and what is an appropriate board for today's changing corporate environment.

II. RECENT DEVELOPMENTS IN DELAWARE CASE LAW

a. Director Independence

1. *In re Toys "R" Us, Inc. Shareholder Litigation,* No. Civ. A. 1212-N, 2005 WL 1497205 (Del. Ch. June 22, 2005)

This case arises out of the sale of Toys "R" Us ("TRU") to a buy-out group led by Kohlberg Kravis Roberts & Co. (the "KKR Group"). The facts of the case are not particularly complicated. TRU is a specialty retailer of toys and baby products. The Plaintiffs moved to enjoin a vote of the TRU stockholders to consider approving a merger with an acquisition vehicle formed by the KKR group. *In re Toys "R" Us, Inc. Shareholder Litigation*, No. Civ. A. 1212-N, 2005 WL 1497205, at *1 (Del. Ch. June 22, 2005). The proposed merger provided that the TRU stockholders would receive $26.75 per share, a 123% premium over the $12.00 stock price that their stock was trading at in January 2004, when TRU began pursuing "strategic alternatives." Id.

The Plaintiffs claimed that TRU's board breached its fiduciary duties of care by failing to conduct a proper auction for the company, and more specifically by only seeking whole-company bids from a group of four bidders that had entered a final round of bidders for the primary toy division. As discussed in more detail below, the Court expressly found that the board acted reasonably and with due care in both its process and in accepting the final offer (and also noted that no other bidder had come forward after the final offer had been accepted by the board).

As part of their argument, plaintiffs' alleged that TRU's chief executive officer, John H. Eyler, Jr., and the company's financial advisor in the merger, Credit Suisse First Boston ("First Boston"), improperly dominated the board in favor of their own personal interests. In particular, plaintiffs alleged that Mr. Eyler was motivated by his stock options, while First Boston's primary interest was in the $7 million fee increase it would receive upon a sale of the whole company. Id. at *23. Plaintiffs then challenged the reasonableness of the board's deliberations in accepting the KKR Group's bid of $26.75 per share. Id. at *24.

With respect to the allegedly improper motives of Eyler and First Boston, the Court found that, "the plaintiffs sketch out a picture of a passive board who deferred too easily to the wishes of a CEO ... and financial advisor .... I am told that these agents of the board, who, on the surface, appeared to be making every effort to generate the highest value for Company stockholders, in reality were, consciously or subconsciously, driven by selfish motives antithetical to the stockholders' interests." Id. at *23. According to plaintiffs, Eyler was motivated to cause the sale of the whole company and trigger change of control provisions that were personally lucrative, and supposedly therefore hijacked the process to sell TRU's toys division. Id. He supposedly had additional incentive to sell TRU to the KKR Group because it offered the best, but not certain, prospects for Eyler's continued employment. Id.

The Court summarily rejected these arguments. First, the Court noted that "plaintiffs essentially accuse Eyler of the status crime of being a CEO. They tout the fact that he stands to gain over $60 million from the sale of the Company. They play up the fact that the KKR Group conditioned its original [bid]…on the retention of key (but unspecified) members of management." Id. "But they ignore [many] key realities, [including the fact that] Eyler's compensation from the merger results from the stock and options he holds—he therefore had more incentive than almost anyone to make sure that the board did the best risk-adjusted job it could of getting the best price." Id. As part of this analysis, the Court expressly noted that [c]ommentators on corporate governance have expressed the belief—and Delaware courts have concurred—that stock options, when used and designed prudently, can help align insiders' interests with those of public shareholders, because it gives insiders an incentive to increase the value of the company's shares." Id. at *25 n.42.

The Court concluded that "plaintiffs' challenge to Eyler's fidelity to the Company and its stockholders is not substantiated….A rational person could not, on this record, infer that Eyler's judgment was tainted by a personal desire to advantage himself at the expense of the Company's public stockholders. Indeed, the fact that Eyler was so heavily invested in the Company's equity no doubt encouraged him to take value-maximizing steps without regard for his future employment because he recognized that a good deal for Toys "R" Us stockholders would leave him very wealthy, too." Id. at *25.

The claim that First Boston had tilted negotiations to its own benefit likewise failed. First, the fact that First Boston stood to gain more from a large merger than a smaller acquisition was a function of the agreement it had with TRU, and was designed to provide First Boston with incentive to seek the highest possible value in the sale TRU or its parts. See id. at *25. Second, over the course of the company's entire strategic investigation, First Boston had never advised TRU that a sale of the whole company was the best course of action until a bidder, in March 2005, came to First Boston with a whole-company bid. See id. at *26. And at that point, First Boston "if anything, urged the Company to stay the course and put the [toy division sale] to bed." Id.

The Court also refused to accept that when First Boston acted improperly just because its engagement letter paid it more for a sale of the whole company than if it had just sold a division. The court rejected the argument that when First Boston first learned of an opportunity to sell the entire company, "a light went off in First Boston's head. It was only then that First Boston, a very large investment bank with serious reputational interests at stake, suddenly realized, in an epiphanic blaze of financial acumen, that it might make a full $7 million more by tainting its advice to its client." Id. The Court went on, in typically quotable fashion: "Without indulging in the naive pretense that investment bankers are immune from financial temptation, one can confidently fail to embrace this implausible theory of advisorial disloyalty." Id.

The Court also rejected plaintiffs' claim of Eyler's and First Boston's allegedly pernicious sway over the TRU board. The Court noted that it found no evidence to conclude that the nine independent directors on TRU's ten person board had consciously abandoned a higher value alternative (e.g., selling only the toy division) for personal gains they stood to receive from a merger of the entire company. See id. at *27. Again, the Court noted that the TRU board's stock options helped to align them with the interest of TRU stockholders, and pursue the most lucrative end available. See id. "Put bluntly, if the [TRU] board failed to maximize shareholder value, it did so, not because it or its advisors were improperly motivated, but because it made errors in judgment." Id.

Finally, the Court concluded that "the bottom line is that the public stockholders will have an opportunity tomorrow to reject the merger if they do not think the price is high enough… .[As] the plaintiffs have dropped any claim that the merger vote ought to be enjoined because the proxy statement is materially misleading ... the vote of the stockholders, if affirmative, may well be a fully informed one that will have ratification effect, foreclosing as a practical matter, all claims of breach of fiduciary duty about the process leading to the merger." Id. at 42.

2. *In re Oracle Corp. Derivative Litig.,* 867 A.2d 904 (Del. Ch. 2004), *aff'd* 872 A.2d 960 (Del. 2005).

The action decided here involved claims that two of the top officers at Oracle Corporation ("Oracle") breached their fiduciary duty of loyalty to the corporation by selling stock in the company when they possessed material, adverse, non-public information that Oracle would not meet its projections for that quarter. See In re Oracle Corp. Deriv. Litig., 867 A.2d 904, 905 (Del. Ch. 2004), aff'd 872 A.2d 960 (Del. 2005). The facts of the case are well known, in part because of the court's earlier opinion denying defendants' Special Litigation Committee Defense on the basis that the Special Committee was not independent. In re Oracle Corp. Deriv. Litig., No. Civ. A. 18751, 2004 WL 2756278 (Del. Ch. Nov. 24, 2004).

The case arose out of the supposedly improper trading of Larry Ellison Oracle's founder and chairman and chief executive officer, and Jeff Henley, the company's chief financial officer. According to the Plaintiffs, both Ellison and Henley possessed material financial information before trades in Oracle stock in January 2001 that should have led them to recognize that Oracle would not meet the company's projections. Oracle Corp. Deriv. Litig., *supra*, 867 A.2d at 905. Plaintiffs contended that Ellison and Henley had thus reaped ill-gotten gains on their sales that should be returned to the company. Id. The Delaware Court of Chancery, on Ellison and Henley's motion for summary judgment, rejected the Plaintiffs' argument.

Initially the court considered the applicable standard to apply in an insider-trading case involving an alleged breach of fiduciary duty. As part of this analysis, and despite the Court's and the Defendants' skepticism as to whether Brophy v. Cities Service Co. (70 A.2d 5 (Del. Ch. 1949)), a Delaware common law proscription on insider trading, remains good law, the Court underwent a Brophy analysis, finding that even if Brophy standard applied, the Defendants were entitled to summary judgment. Oracle, supra, 867A.2d at 906-907, 929. The Brophy standard, as applied by the Court, demands that a plaintiff show:

> 1) the corporate fiduciary possessed material, nonpublic company information; and 2) the corporate fiduciary used that information improperly by making trades because she was motivated, in whole or in part, by the substance of that information.

Id. at 934. In resolving this case, the Court concluded that no rational fact finder could find that either condition applied to Ellison, Henley, or their trades. Id. at 906.

In coming to its conclusion, the Court placed reliance on a number of factors:

- The conservative bias of Oracle's financial projection system, resulting in estimates of earnings and license revenues that were more likely to be low than high, and the complete lack of evidence to cast doubt on the integrity of Oracle's estimation process.

- Oracle's estimates of its results at the time of Ellison and Henley's trades continued to predict that the company would either meet or exceed its projections for the quarter.

- The lack of record evidence that Ellison or Henley had received any information from subordinates at the time of their trades that would inform them the company was not in a position to make its numbers.

- The majority of Oracle's quarterly income is generated in the last month of any quarter, and most of the last month's revenue is generated in the last week of the quarter.

- Oracle's prospects for the quarter in question weakened substantially in the last month of that quarter—after the Defendants had made their trades—largely due to customers refusing to close deals in the final days of the quarter.

- The absence of any apparent exigency or rational motive that would lead Ellison or Henley—huge Oracle stockholders—to sell small portions of their Oracle holdings because of fears of a decline in Oracle's performance.

Id. at 906-907.

These factors led the Court to conclude that no one, not even Ellison or Henley, could have seen the drop in Oracle's quarterly numbers coming. See id. at 952. Rather, the Court found that "[i]n the end, the plaintiffs ask me to adopt a Monday-morning quarterback approach to materiality. Because Q3 01 went bad, it must have been reasonably foreseeable at the time. But there is no basis for a rational mind to accept that proposition." Id.

With respect to scienter, the Court held that both Henley and Ellison had reasonable, non-suspicious reasons for making their trades when they made them. See id. at 953-55. Henley made his trades early in the year, and "keeping with a pattern of diversification and his decision to trade in a new calendar (and therefore tax) year was motivated by proper, non-suspicious financial considerations. ... Henley sold 7% of his Oracle position, leaving him a huge stake in the company." Id. at 954.

Likewise, "[w]hat Ellison indicated was quite sensible: he had a number of expiring options that would, when exercised, trigger a huge tax liability and require him to sell shares. Because he would have to enter the market to sell in order to exercise his options, it was a prudent time to finally take his financial advisor's advice to diversity his holdings and to reduce some debt while he was in the market. Therefore, Ellison has advanced entirely reasonable, non-suspicious reasons for his trades. ... In sum, however wealthy Ellison is and however envious that may make some, the fact remains that Ellison sold only 2% of his Oracle holdings." Id. at 954-55.

Finally, in rejecting Plaintiffs' arguments with respect to the proper application of Brophy, the Court held that it would not accept a situation in which a corporate insider would be held strictly liable to return trading profits when the insider possesses information that casts some doubt on a company's ability to make its numbers, and the company then does not, in fact, make its numbers. See id. at 929-30. The Court specifically recognized the benefits of insider ownership: "the idea that many sophisticated commentators believe that it is a good idea that corporate insiders own company stock because having, as Ross Perot would say, 'skin in the game' will tend to align their interests with those of the public stockholders." Id. at 930. In short, "the use of equity as a compensation tool is a legitimate choice under our law and Delaware statutory law permits and its common law creates incentives for stockholders to serve as directors and officers." Id.

3. *Beam v. Stewart,* 845 A.2d 1040 (Del. 2004).

Beam v. Stewart challenged the independence of the directors of Martha Stewart Living Omnimedia, Inc. ("MSO"), claiming that the directors' friendships and personal relationships with Martha Stewart made them incapable of rendering an unbiased decision about whether or not to bring claims against her. The complaint alleged that Stewart's allegedly improper trading of shares of ImClone Systems, Inc. ("ImClone"), as well as other sales of MSO shares by Stewart, constituted a breach of fiduciary duty. The complaint further alleged that demand was futile based on the lack of independence of at least half of MSO's six-member board of directors.

The Court of Chancery dismissed the complaint for failing to make demand. The Court noted that while "some professional or personal friendships, which may border on or even exceed familial loyalty and closeness, may raise a reasonable doubt whether a director can appropriately consider demand . . . [n]ot all friendships, or even most of them, rise to this level. . .". Beam v. Stewart, 833 A.2d 961, 979 (Del. Ch. 2003), aff'd, 845 A.2d 1040 (Del. 2004). The Court held that in order to make a "reasonable inference" that a particular friendship rises to this level, the plaintiff must provide "specific factual allegations" concerning the "closeness or nature of the friendship, details of the business and social interactions between the two, or allegations raising additional considerations ... ." Id. at 979-80.

On appeal, the Delaware Supreme Court affirmed. In one of the last opinions written by former Chief Justice Veasey, the Supreme Court began by noting that "[i]ndependence is a fact-specific determination made in the context of a particular case. The [C]ourt must make that determination by answering the inquiries: independent from whom and independent for what purpose?" Beam, 845 A.2d at 1049-50. The Supreme Court agreed with the Court of Chancery that a director's independence may be questioned for any reason, including "financial ties, familial affinity, a particularly close or intimate personal or business affinity or because of evidence that in the past the relationship caused the director to act non-independently *vis á vis* an interested director." Id. at 1051. The Court held that allegations that directors moved "in the same business and social circles, or a characterization that they are close friends" is not enough to negate independence. Id. Rather:

> [t]o 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.

Id. at 1052. The Court found that none of the Plaintiff's allegations rose to this level.

In a final section of the opinion, titled “A Word About the Oracle Case,” the Delaware Supreme Court advocated a relatively limited reading of the Court of Chancery’s opinion in the first Oracle decision. The Supreme Court first noted that the Oracle case involved the creation of a Special Litigation Committee (“SLC”), and that unlike the demand-excusal context, where the board is presumed to be independent, the SLC has the initial burden of establishing its own independence that must be “like Caesar’s wife—above reproach.” Id. at 1055 (citation omitted). The Court also noted that “the Stanford connections in Oracle are factually distinct from the relationships present” in Beam. Id.

Beam is an example of a court conducting a searching inquiry about a director’s independence, and demonstrates that this inquiry will go beyond financial or work relationships. All aspects of the relationship—be it personal, financial, business, or any other relationship—are open for inquiry and will be reviewed on a case-by-case basis to determine the specific nature of the relationship.

b. The Duties of Care and Good Faith

1. *Official Committee of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins,* No. Civ. A. 20228-NC, 2004 WL 1949290 (Del. Ch. Aug. 24, 2004).

In the mid-1980s, defendant Robert N. Elkins (“Elkins”) founded Integrated Health Services to operate a nation-wide chain of nursing homes. That chain, Integrated Health Services, Inc. (“IHS”) operated successfully until February 2000, when IHS commenced a voluntary bankruptcy proceeding in the wake of certain federal legislation affecting IHS’s profitability. The Official Committee of Unsecured Creditors (the "Creditors") soon commenced actions on behalf of the debtors of IHS, including an action against former and current IHS directors for allegedly breaching their fiduciary duties by approving certain compensation packages for Elkins. The United States Bankruptcy Court for the District of Delaware abstained from hearing the fiduciary duty claims, and the Creditors thus filed suit in the Delaware Court of Chancery. Official Committee of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins, No. Civ. A. 20228-NC, 2004 WL 1949290, at **1, 3 (Del. Ch. Aug. 24, 2004).

In the first case after the Court of Chancery's opinion in In re Walt Disney Company Derivatives Litigation (825 A.2d 275 (Del. Ch. 2003)) to deal with executive compensation, the Creditors challenged eleven compensation agreements—loans, option grants, and loan forgiveness programs—the board had approved for Elkins. Id. at **1, 4-8. The Creditors alleged that the IHS directors, and Elkins, breached their fiduciary duties by "approving or ratifying certain compensation arrangements without adequate information, consideration, or deliberation[.]" Id. at *1. The Creditors also alleged that the Defendants wasted corporate assets by approving the compensation arrangements. Id. The defendant directors, joined by Elkins, filed a motion to dismiss on the grounds that the Creditors had failed to state a claim, and that the directors were entitled to the protection of an exculpatory clause contained in IHS's certificate of incorporation, in accordance with 8 Del. C. § 102(b)(7). Id. at *2.

The Court quickly determined that the challenged compensation arrangements had been approved by a majority of disinterested IHS directors (Id. at **2, 10-12), and moved on to the question of whether the defendants "consciously and intentionally disregarded [their] responsibilities," thus implicating a lack of good faith. Id. at *12. A lack of good faith would prevent the defendant directors from availing themselves of the exculpatory provisions of IHS's certificate of incorporation. Id.

In finding that the Creditors had stated a claim for breach of fiduciary duty with respect to some of the challenged transactions, but not all, the Court drew a distinction between allegations of non-deliberation and not enough deliberation. For example, the Court dismissed a claim that the defendants had breached their fiduciary duties by failing to consult a tax expert on the consequences of a compensation consultant's report on a 1997 loan program, and by failing to set up a monitoring mechanism with regard to that program, because despite such alleged failings, the complaint alleged that the directors engaged in discussion regarding the consultant's report and the loan program. Id. at *13. The court noted that while the directors' actions may or may not have been negligent "(or even grossly negligent), no inference can be drawn that this decision was made without good faith[,]" and therefore, the Section 102(b)(7) provision of IHS's certificate of incorporation precluded the imposition of monetary liability. Id.

In contrast, the Court found that the Creditors had stated a claim for breach of fiduciary duty with respect to a loan when the directors approved the loan without deliberation, and one director justified the action by stating that he knew Elkins would never "pull anything behind anyone's back." Id. at *15 (citation omitted). The court found that "[e]ven for an officer who founded a company and had been with that company for over 10 years, and even for a transaction as proportionately small as this, directors of a public corporation must exercise more than blind faith in approving loans." Id.

The Court also refused to dismiss fiduciary duty of loyalty claims against Elkins. See id. at **16-17. The Court noted that "employees negotiating employment agreements with their employers have the right to seek an agreement containing the best terms possible for themselves. However, once an employee becomes a fiduciary of an entity [(as Elkins was)], he has a duty to negotiate further compensation agreements 'honestly and in good faith so as not to advantage himself at the expense of the [entity's] stockholders.'" Id. at *16, quoting In re Walt Disney Co. Deriv. Litig., 825 A.2d at 290. The Court found:

> That Elkins set out agendas for Board and Compensation Committee meetings; that Elkins attended meetings; that he spoke with directors outside of the meetings; that he negotiated his compensation packages with the Board and Compensation Committee; or even that he spoke with the Board's compensation consultant are all, individually, not enough to show a breach of Elkins's duty of loyalty. But these, taken together, and coupled with the Complaint's allegations that Elkins reviewed and revised every draft of [the board's compensation consultant's] reports before they were submitted to the Board; that Elkins exerted pressure on [the board's compensation consultant] to justify Elkins's compensation; that Elkins's March 19, 1998 letter to the Board stated inaccurate facts as to what the Compensation Committee had previously

> approved in regard to forgiveness of previous loans; that Elkins caused IHS to disburse funds to him without corporate authority; that Elkins insisted on [a] 1999 Loan Program solely because he thought Citibank would seek to eliminate IHS's use of its credit agreement to provide loans to employees; and that Elkins insisted on extending a Five-Year Forgiveness Term to all of his loans, notwithstanding opposition by [the board's compensation consultant]; suggest Elkins "may have breached his fiduciary duties by engaging in a self-interested transaction."

Id. at *16 (citations omitted).

Finally, the Court dismissed the Creditors' waste claim, noting that "[w]aste is a standard rarely satisfied in Delaware courts." Id. at *17. "To succeed in proving waste, a plaintiff must plead facts showing 'an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.'" Id. (citations omitted). The Court further noted that a board's decision on executive compensation is entitled to great deference. Id. Hence, given that IHS's proxy materials had stated that the purpose of the compensation packages was to retain key employees, and Delaware's law recognizes this as a potential corporate benefit, the waste claim was dismissed because the compensation agreements subject to the waste claim could have induced Elkins to stay with IHS—a potential benefit to the company. Id. at **17-18.

2. *In re The Walt Disney Co. Deriv. Litig., No. Civ. A. 15452,* 2004 WL 2050138 (Del. Ch. Sept. 10, 2004).

In *Disney*, plaintiffs filed a derivative action against The Walt Disney Company's ("Disney") board of directors in connection with the company's hiring and termination of Michael Ovitz, the former President of Disney. Plaintiffs alleged that the company's directors breached their duty of care by blindly approving Mr. Ovitz's employment agreement and non-fault termination benefits. Plaintiffs claimed that, as a result, Mr. Ovitz received approximately $140 million for just over one year of employment.

The Plaintiffs also claimed that Mr. Ovitz himself had violated his fiduciary duties as an officer of the company in negotiating, arranging, and finalizing the terms of his employment contract. On Ovitz' motion for summary judgment, the Delaware Court of Chancery dismissed the breach of fiduciary duty claims against Ovitz with respect to his actions before he was officially installed as Disney's President, on October 1, 1995. The Court did not dismiss the Plaintiffs' claims that Ovitz breached his fiduciary duties in receiving the non-fault termination benefits provided for in his termination agreement.

Ovitz officially became Disney's President on October 1, 1995 – the date he filled that position—even though at that time Ovitz did not have a finalized and duly executed employment agreement. In re The Walt Disney Co. Deriv. Litig., No. Civ A. 15452, 2004 WL 2050138, at *1 (Del. Ch. Sept. 10, 2004). His final agreement was signed on or about December 16, 1995, with an effective date of October 1, 1995. See id. Nevertheless, the Plaintiffs claimed that because a letter from Disney's CEO, Michael Eisner, outlining the key points of Ovitz' employment agreement was made public in August 1995, Ovitz' eventual official installation as President, and status as a fiduciary, were foregone conclusions. Id. at *3.

The Court soundly rejected Plaintiffs' theory on a number of grounds. First, the Court set forth the simple conclusion that because Ovitz was not a fiduciary before October 1, 1995, he was free to negotiate the terms of his employment to his greatest advantage. Id. at *4. According to the Court, it was simply not within Ovitz' responsibility to ensure that Eisner had authority to extend an offer in the form it was presented to Ovitz, as Eisner was Disney's CEO at the time, vesting Eisner with apparent authority to take such actions. Id. The Court also held that finding Ovitz to be a fiduciary before he was actually installed as President would lead to uncertainty regarding when one becomes a fiduciary, while the bright-line rule the Court propounds (and upon which its decision ultimately turns) "is a more reasonable and desirable rule." Id.

The Court likewise rejected a Caremark claim against Ovitz. The Plaintiffs claimed that Ovitz, after being installed as Disney's President, should have conducted an investigation into his own hiring to make sure that Disney employed proper processes, and that the other directors and officer complied with their fiduciary duties to the company. Id. at *6. The Court, in rejecting this claim, noted that because Ovitz was not a fiduciary until October 1, 1995, and because no material changes to his employment agreement occurred after that date, as a matter of law Ovitz could not have breached a fiduciary duty he owed to the company by performing under his employment agreement and executing the document which conformed to the agreement. See id. Accordingly, "[b]ecause Ovitz did not breach his fiduciary duties, irrespective of whether other Disney directors and officers may have done so, Ovitz need not show the entire fairness of [his employment agreement], and he is entitled to summary judgment with respect to the claim that he breached his fiduciary duties by entering into [his employment agreement.]" Id.

In contrast, the Court declined to grant Ovitz' summary judgment motion with respect to whether he breached his fiduciary duties in accepting his no fault termination payments, when Ovitz was Disney's President and thus a fiduciary. The decision to offer Ovitz a no-fault termination, and the corresponding large payments, was arguably not mandated by Ovitz' employment agreement. Id. at *7. Plaintiffs alleged that Ovitz colluded with those on the other side of the bargaining process to secure his no fault termination, and in so doing allegedly manipulated corporate processes, thereby violating his duties to the company. See id.

Finally, the Court could not find record support that any group of disinterested members of Disney's board ever authorized the termination payments to Ovitz; and, no shareholder vote was ever taken on the issue. See id. The Court thus found that general issues of material fact remained with respect to whether Ovitz had used his position to obtain the no-fault termination payments in violation of his fiduciary duties. See id.

3. ***In re Emerging Communications, Inc. S'holders Litig.,*** **No. Civ. A. 16415, 2004 WL 1305745 (Del. Ch. June 4, 2004)*.***

Emerging Communications addressed two related actions: an appraisal action and a class action for breach of fiduciary duty, both brought by minority shareholders of Emerging Communications, Inc. ("ECM"). In re Emerging Comms., Inc. S'holders Litig., No. Civ. A. 16415, 2004 WL 1305745, at *1 (Del. Ch. June 4, 2004). At issue in Emerging was the October 1998 two-step "going private" acquisition of ECM by Innovative Communications Corp. ("Innovative"), ECM's majority shareholder. Id. At the time of the acquisition, Jeffrey Prosser, ECM's Chairman and CEO, owned a controlling stake in both ECM and Innovative. Id.

Even before ECM became a publicly-traded company in December 1997, Prosser "indicated that he intended to merge Innovative into ECM, and he began exploring a combination of the two companies in January 1998." Id. at *4. In order to evaluate any potential merger with Innovative, ECM retained Prudential as its financial advisor and Cahill, Gordon and Reindel ("Cahill") as its legal advisor. Id. By the end of February 1998, ECM's board of directors had created a special committee for purposes of evaluating the draft merger agreement proposed by Prosser whereby Innovative would merge into a subsidiary of ECM. Id. at *5.

By May 1998, however, Prosser "began having significant reservations about the Proposed Merger, because the low market interest in ECM's common stock had caused that stock to be undervalued." Id. Prosser then met with Prudential, Cahill, and another member of ECM's board, John Raynor, to discuss the possibility of Innovative acquiring the remaining outstanding shares of ECM (the "Privatization"). Id. In effect, "Prosser switched from being a seller of ECM stock to becoming a buyer of that stock." Id. Significantly, Prosser retained Prudential and Cahill to represent Innovative in this proposed acquisition of ECM, which meant that "the advisors that initially were retained to work for the interests of ECM and its minority stockholders would now be working to serve the interests of Innovative, the party now bargaining against ECM." Id. at *6 (emphasis in original). Shortly thereafter, Prosser, Prudential, and Cahill presented to ECM's board a term sheet for the proposed acquisition of ECM, which valued ECM's shares at $9.125 per share. Id. Innovative's offer "was the first occasion that the ECM board and the First Special Committee (other than Raynor) learned of the abandonment of the Proposed Merger in favor of the Privatization." Id.

In response to Innovative's offer, ECM's board created another special committee to evaluate the fairness of the offer. Id. As part of its review process, the special committee retained Houlihan Lokey Howard & Zukin ("Houlihan") as its financial advisor. Id. Houlihan reviewed ECM's financial projections from March 1998, but was not provided with ECM's financial projections from June 1998, which were prepared at Prosser's request and distributed to Prudential, Cahill, and Innovative's lender, RTFC. Id. at *7. Significantly, these June 1998 projections forecast significantly higher growth than the March 1998 projections. Id. Indeed, based on these June 1998 projections, RTFC concluded that ECM was worth at least $28 per share. Id.

In August 1998, Houlihan presented its findings to ECM's board, and the special committee then rejected Innovative's offer of $9.125 per share. Id. In subsequent negotiations, however, Prosser raised his offer to $10.25 per share, which Houlihan concluded was a fair price, and ECM's board approved the acquisition on August 17, 1998. Id. at *9.

In both the appraisal and class actions, the plaintiffs alleged that the terms of the proposed acquisition were unfair to ECM's minority shareholders. Id. The court noted that the analyses of plaintiffs' two actions overlapped: "In a statutory appraisal action, the court must determine the 'fair value' of the corporation whose stock is being appraised," whereas the applicable standard for the class action breach of fiduciary duty claims was "entire fairness," which "has two aspects: fair dealing and fair price." Id. (citation omitted). In effect, the plaintiffs' "fiduciary 'fair price,' and statutory 'fair value,' contentions converge . . . ." Id. at *10.

In order to determine the "fair price" / "fair value" of ECM, the court discussed at length the relevant case authorities and the various approaches and methodologies proffered by each party's experts. Id. at **12-24. Ultimately, the court calculated 'the fair value of ECM on the merger date . . . to be $416,996,000, or $38.05 per share." Id. at *24. This conclusion, however, "did not address whether the unfairness was the product of a breach of fiduciary duty or if so, the nature or character of that duty. Accordingly, a 'fair dealing' analysis [was] required in this case, if only . . . for § 102(b)(7) exculpation purposes." Id. at *28. The court also noted that, because the acquisition was "a self-dealing transaction of which the majority stockholder [stood] on both sides, entire fairness is the standard of review *ab initio,*" and the "burden of proving fair dealing remains with the defendants." Id. at **30-32.

For purposes of examining "fair dealing," the court was required to address "'issues of when the transaction was timed, how it was initiated, structured, negotiated, and disclosed to the board, and how director and shareholder approval was obtained.'" Id. at *32 (quotation and citation omitted). In this case, the court held that the fact the "freeze-out merger [was] initiated by the majority stockholder . . . even though not dispositive, [was] evidence of unfair dealing." Id. The court also held that there was additional "evidence of unfair timing" because "Prosser abandoned [his] proposal [to merge Innovative into ECM] at the eleventh hour and 'flipped' the deal for his sole personal benefit to take advantage of the temporarily and artificially depressed stock price," which "benefited Prosser to the same extent that it disadvantaged the minority stockholders who were now being squeezed out of the enterprise." Id. Moreover, "the transaction was also unfairly structured, in that Prudential and Cahill, the firms that had been retained as advisors to ECM in the initially Proposed (but later abandoned) Merger, were co-opted by Prosser to serve as his advisors." Id.

The court also concluded that the minority shareholders were not represented adequately because "a majority of the full board of ECM ... were beholden to Prosser and, thus, were not independent of him," " a majority of the Special Committee ... were beholden to, and therefore not independent of, Prosser," and 'the only arguably independent Committee member" was "inadequate to represent the interests of ECM's minority shareholders effectively" because of "the severe information imbalance that existed between the two 'bargaining' sides." Id. at **33-36.

Accordingly, the court held that the "transaction, and the $10.25 per share merger price that has been adjudicated as unfair, were the product of unfair dealing." Id. at *38. However, "because ECM's §102(b)(7) charter provision exculpates those directors found to have violated *solely* their duty of care from liability for money damages," the court also addressed the nature of the fiduciary duty violated. Id. For Prosser and certain other defendants for whom there was evidence they "affirmatively colluded with Prosser to effectuate the Privatization, or that they otherwise deliberately engaged in conduct disloyal to the minority stockholders' interests . . . [and] knew or had reason to believe, that the merger price was unfair," the court held that these defendants were liable for breaching their fiduciary duty of loyalty. Id. at *41. As for the remaining director defendants, however, the court concluded that there was "no persuasive evidence that . . . [their] conduct [was] more egregious than breaches of their duty of care," particularly since there was no evidence that any of these defendants "intentionally conspired with Prosser . . . to obscure the true purpose of benefiting Prosser at the expense of the minority stockholders," or "acted with conscious and intentional disregard of their responsibilities, or made decisions with knowledge that they lacked material information." Id. at **42-43.

c. Corporate Control Transactions

1. ***In re Cox Communications, Inc. Shareholders Litig.,*** **No. Civ. A. 613-N, 2005 WL 1355478 (Del. Ch. June 6, 2005).**

The Cox decision addresses a request for fees that the Plaintiffs' attorneys allegedly earned in a suit attacking the Cox family's offer to take Cox Communications, Inc. ("Cox") private via merger. The Court, finding that the Plaintiffs took no appreciable risk, and lending no credence to the notion that the Plaintiffs' actions had a substantially important impact on the pricing of the transaction, awarded a substantially smaller fee than the $4.95 million the attorneys requested. In re Cox Comms., Inc. S'Holders Litig., No. Civ. A. 613-N, 2005 WL 1355478, at **1-2 (Del. Ch. June 6, 2005).

As of summer 2004, Cox was a publicly traded company listed on the New York Stock Exchange. Around that time, the Cox family, which controlled 74% of Cox's voting power, decided to take the company private, and on August 1, 2004, the family previewed its plans to buy-out the company's public shareholders for a price of $32 per share with Cox's board. Id. at *3. In a letter to the board following that meeting, the Cox family clarified that it expected Cox to form a Special Committee to respond to and negotiate the proposal, and the proposal itself specifically required approval by the Special Committee. Id.

A public announcement of the proposal the following morning, before the markets opened, set the Special Committee to work in negotiating the proposal, and sent Plaintiffs racing to the court house. By the end of the day, six complaints had been filed claiming that an offer of $32 per share was an unfair price for the public's shares in Cox. Id. at *4. Plaintiffs' counsel was selected after a "food fight" for lead counsel status. See id. at *5.

Over the course of the coming months, the negotiations of the transaction and the progression of the litigation took parallel paths to the same end. In what became a fairly established routine, the Special Committee's representatives dealt directly with the Cox family and its representatives, while Plaintiffs dealt almost exclusively with the Cox family's litigation counsel. See id. at *7. Eventually, negotiations between the Cox family and the Special Committee settled on an offer of $34.75 per share, which the Special Committee agreed to recommend to the Cox board as a whole. After learning of this development, the Cox family's litigation counsel called the Plaintiffs' counsel and relayed $34.75 per share as the family's "best and final offer" to settle the litigation. Id. The next day, Plaintiffs' counsel orally accepted the offer, subject to a Minority Approval Condition. Id. at *8. At the same time, the Special Committee's financial advisors were finalizing their analyses of whether they could provide a fairness opinion on the merger, and the Special Committee was negotiating the terms of a final merger agreement with the Cox family.

The merger agreement was finalized on October 18, 2004; the Special Committee got favorable fairness indications from its advisors that same day; the full Cox board voted to approve the deal that same day; and, the relevant lawyers entered into a memorandum of understanding settling the litigation. The Memorandum of Understanding stated that the Cox family acknowledged the desirability of settling the action, and acknowledged that the efforts of the Plaintiffs' counsel in the action were causal factors leading the Cox family to increase its bid to $34.75 per share. The family also agreed therein to a Minority Approval Condition. The next day, October 19, 2004, the Special Committee, on behalf of the company, and the Cox family signed the merger agreement. See id. at *8.

The parties to the litigation quickly entered into a stipulation of settlement, then negotiated the Plaintiffs' attorneys' fees of $4.95 million. See id. at *8. Upon presentation of the agreement to the Court for approval, no one objected to the terms of the merger, but an objection was interposed with respect to the Plaintiffs' attorneys' fees. See id. at *9.

The Court's analysis began by noting the procedural advantage a plaintiff has in this type of situation as a result of the Delaware Supreme Court's decision in Kahn v. Lynch Communications, Inc., 638 A.2d 1110 (Del. 1994). See Cox at *13. Pursuant to Lynch, and regardless of the procedural protections employed, a merger with a controlling stockholder is always subject to the "entire fairness" standard, even if it was negotiated and approved by a special committee of independent directors and subject to approval by a majority of disinterested shares. See id. at *12. Under such conditions, the best that a Lynch defendant, such as the Cox family, can hope for is a burden shift to the Plaintiffs (see id. at *12), as Lynch makes it impossible for a defendant to obtain dismissal of such claims on the pleadings. See id. at *15. The party filing a Lynch attack on the "entire fairness" of a proposed merger "can satisfy [the] Rule 11 [pleading standard] as to that [Lynch] allegation because financial fairness is a debatable issue and the plaintiff has at least a colorable positions." Id. This, the Objectors claimed and the Court acknowledged, creates an incentive for plaintiffs (or more accurately, Plaintiffs' attorneys) to nominally impede a going private merger transaction despite the safe guards in place. See id. In questioning the utility and motives underlying such suits, the Court twice emphasizes:

> In no instance has there been a situation when the [controlling stockholder's] lawyer told the plaintiffs' lawyer this is my best and final offer and received the answer "sign up your deal with the special committee, and we'll meet you in the Chancellor's office for the scheduling conference on our motion to expedite." Rather, in every instance, the plaintiffs' lawyers have concluded that the price obtained by the special committee was sufficiently attractive, and that the acceptance of a settlement at that price was warranted.

Id. at 17. What benefit, if any, such litigation brings to the merger process is thus seriously in doubt.

The Court's frustration with the procedural limitations enshrined in Lynch led the Court to add a final section to its opinion, titled "A Coda on the Jurisdictional Elephant in the Corner." Id. at *34. There, although not dispositive to the case at bar, the Court espouses "the need to adjust our common law of corporations to take appropriate account of the positive and negative consequences flowing from the standard of review governing going private transactions." Id. Lynch's purported failure to provide additional incentives for the use of Minority Settlement Conditions is "less than useful." Id. As the court noted, a defendant's inability to dismiss a Lynch claim on the pleadings "has generated perverse incentives for both defense and plaintiffs' counsel that cast doubt on the integrity of the representative litigation process." Id.

The Court added that "a relatively modest alteration of Lynch would do much to ensure this type of integrity, while continuing to provide important, and I would argue, enhanced, protections for minority stockholders." Id. at 35 (emphasis in original). In the Court's proposal, if a controller proposed a merger that was subject from its inception to negotiation and approval by an independent special committee and a Minority Approval Condition, the business judgment rule should presumptively apply. Id.

> In that situation, the controller and the directors of the affected company should be able to obtain dismissal of a complaint unless: 1) the plaintiffs plead particularized facts that the special committee was not independent or was not effective because of its own breach of

> fiduciary duty or wrongdoing by the controller (e.g., fraud on the committee); or 2) the approval of the minority stockholders was tainted by misdisclosure or actual or structural coercion.

Id. at 35. Nevertheless, despite the Court's proposal, the Court had to decide the instant case on the law and facts available.

Thus, the Court was "dragged into an academic debate of considerable complexity." Id. at *24. The Court, after examining the differences between going private via merger versus tender offer (which avoids Lynch litigation), largely to buttress its Coda on Lynch described above, settled on application of the standard for awarding attorneys fees set forth in Sugarland Indus., Inc. v. Thomas (420 A.2d 142, 147-50 (Del. 1980)).

In deciding to apply the Sugarland factors, which the Court labeled "the traditional factors that govern the size of the fee that should be awarded to the plaintiffs when they have been party to a settlement that the court found to be fair and reasonable to the class[,]" the Court declined to apply the attorneys' fees standards set forth in Chrysler Corp. v. Dann, 223 A.2d 384 (Del. 1966). Cox at **27-32.

Under the Dann standard, to receive their fees, the Plaintiffs would have had to establish that "the action in which they are sought must have had merit at the time it was filed. ... [And], a claim is meritorious within the meaning of the rule if it can withstand a motion to dismiss on the pleadings if, at the same time, the plaintiff possesses knowledge or provable facts which hold out some reasonable likelihood of ultimate success." Id. at *28. The Court then noted that it agreed with the Objectors "that there is no doubt that the plaintiffs' complaints were not meritorious when filed." Id. The Plaintiffs' complaint contained only conclusory allegations with respect to a moving target (the Cox family's offer, which was still being negotiated as the various complaints were filed), and the negotiations were being handled by a special committee who's integrity had not been attacked. Id. at **28-29. "The only purpose of their complaints was to act as a placeholder for a possible later attack on an actual fiduciary judgment of the Cox board to enter into a formal merger agreement with the Family. The complaints were therefore unripe and without merit." Id. at *29.

Despite its appeal, though, the Court notes that the Dann inquiry is usually applied in circumstances where the Court must decide to what extent a derivative suit actually caused a corporate defendant to act in a manner consistent with those plaintiffs' demands. Id. at *27. "The prior cases, therefore, all arise in the context of situations when the party objecting to the fee—most often, the corporation itself—denies that the plaintiffs' litigation efforts benefited them at all and that it would therefore be inequitable for them to be forced to contribute to a fee." Id. at 30. The court thus ultimately chooses the Sugarland test, refusing to hold "that the rigid Dann standard applies to an objection to a fee made by a party who does not object to the fairness of the settlement itself, will not be forced to bear any of the fee, and who does not contend that the defendants reduced any benefit they would have otherwise provided to the class by the amount of the fee they agreed to pay[.]" Id. at *32.

The "aptly named 'Sugarland' factors, which the Court ultimately applied, include: 1) the benefits achieved in the action; 2) the efforts of counsel and the time spent in connection with the case; 3) the contingent nature of the case; 4) the difficulty of the litigation; and 5) the standing and ability of counsel." Id.

In reference to the Sugarland factors, the Court stated, "I have absolutely no reason to believe that the plaintiffs are responsible for more than a very small amount of the difference between the original offer and the negotiated price." Id. at *32. The Court could discern no appreciable risk that the Plaintiffs' attorneys took in pressing their case when they knew the Cox family would almost certainly raise their bid to satisfy the Special Committee, and that the Cox family knew there was value in resolving the suit, as it could not be dismissed on the pleadings per Lynch. Id. at **32-33. Weighing these factors, the Court denied Plaintiffs' attorneys' the $4.95 million they sought, yet "awarded a fee larger than I otherwise would have. I do so by awarding a total award of fees and expenses of $1.275 million. That could be translated into an award of $500 per hour for 2000 hours worked, plus the full payment of expenses. Given the factors outlined above, that is a more than generous award." Id. at *34.

2. ***Orman v. Cullman,*** No. Civ. A. 18039, 2004 WL 2348395 (Del. Ch. Oct. 20, 2004).

Orman v. Cullman, No. Civ. A. 18039, 2004 WL 2348395 (Del. Ch. Oct. 20, 2004), revisits Delaware law interpreting voting lock-up agreements in the context of going private transactions. Orman is the first decision since the Delaware Supreme Court's ruling in Omnicare, Inc. v. NCS Healthcare Inc., 818 A.2d 914 (Del. 2003), to address the validity of deal protection devices.

Orman involved a claim against the board of General Cigar Holdings, Inc. ("General Cigar") for breach of their fiduciary duties in negotiating a merger transaction with Swedish Match AB ("Swedish Match"). Orman at *1. Swedish Match approached General Cigar in 1999 to propose the possibility of acquiring a significant stake in General Cigar, while leaving Cullman family members in management positions. Id. at *1. In response, the General Cigar board formed a special committee to evaluate the proposal and make recommendations to the full board. Id. at *2. The negotiations resulted in an agreement whereby General Cigar would merge with a Swedish Match subsidiary, and the public stockholders of General Cigar would receive $15.00 per share, a significant premium over the market price. Id.

As a condition to entering into the merger agreement, Swedish Match demanded that the Cullman family enter into a voting agreement in which they agreed to vote their shares against any alternative acquisition for 12 months following termination of the pending merger agreement. Id. at *2. In January 2000, the General Cigar special committee received word that Swedish Match was willing to increase its offer from $15.00 per share to $15.25, but the increase was contingent upon extension of the Cullman family lock-up from 12 months to 18. Id. at *3. General Cigar's investment advisor, Deutsche Bank, was on hand during that meeting, and opined that $15.25 was a fair price to the public shareholders. Id. Thus, on January 19, 2000, the special committee voted unanimously to recommend the merger to the full board, which subsequently met and approved the merger. Id. The merger agreement was announced on January 20, 2005. Id.

The merger agreement allowed General Cigar to entertain unsolicited bids for the business, if, upon recommendation of the special committee, the General Cigar board determined such proposals were *bona fides*, and would be more favorable to the public stockholder than the proposed merger with Swedish Match. Id. at *3. Likewise, the merger agreement permitted the General Cigar board to withdraw support for the merger agreement if they determined, upon consultation with outside counsel, that their fiduciary duties required them to do so. Id. Importantly, the merger agreement required that the merger be put to a vote of General Cigar's stockholders, and provided that the merger was conditioned upon approval by a majority of the public stockholders. Id.

General Cigar filed the proxy statement with respect to the shareholder vote on April 10, 2000, and on May 8, 2000, the public stockholders (i.e., "a majority of the minority") overwhelmingly approved the merger. Id. at *3.

Plaintiff, in reliance on Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1994), and Omnicare, argued that the Cullmans had breached their fiduciary duties "by entering into the voting agreement" (i.e., the lock-up agreement). Orman at *5. In Paramount, the Delaware Supreme Court stated: "To the extent that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable." Paramount, 637 A.2d at 51. The Court noted that Omnicare makes a similar observation.

The Court did not question the validity of this jurisprudence, but noted that such a statement did not apply to the case at bar. Id. at *5. In granting summary judgment in favor of the Defendants, the Court noted that in Paramount and Omnicare, the challenged action was the directors' entering into a contract as directors, while the Cullman family was entering into the voting agreement as shareholders. Id. "Nothing in the voting agreement prevented the Cullmans from exercising their duties as officers and directors." Id. Hence, the Cullmans could still have voted to withdraw their support of the merger agreement if they felt so inclined because of their fiduciary duties as officers and directors of the corporation.

The Court then turned to the question of whether the public shareholders' assent to the merger was "coerced." The Court, by reference to Omnicare, applied the two-step analysis in Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985), as dispositive. The court noted that deal protection devices, even when such devices protect a deal that does not result in a change of control, require enhanced scrutiny. Orman at *6. The Court thus framed the analysis as follows:

> The first stage of the Unocal analysis requires a board to demonstrate "that they have reasonable grounds for believing that a danger to corporate policy and effectiveness existed" without such measures. The second stage of Unocal proceeds in two steps: the board must establish that the deal protection devices are (1) not coercive or preclusive and (2) within a range of reasonable responses to the danger to corporate policy and effectiveness.

Id. at *6 (citations omitted).

In applying the first stage of the analysis (a task the Court labeled "simple") the Court found that during negotiations, Swedish Match required some form of deal protection. See id. at *7. If the General Cigar board had refused to meet Swedish Match's requirements, they would be left with no alternative deal. See id. This lack of alternatives, in and of itself, the Court holds as reasonable grounds to believe that a danger to corporate policy and effectiveness existed, "[a]s in Omnicare itself[,]" justifying some degree of deal protection. Id.

The Court also found application of Unocal's second stage of analysis to be "straightforward." The Court found the standard for determining whether a deal protection device is coercive was set forth in Williams v. Geier, 671 A.2d 1368 (Del. 1995). See Orman at *7 That is, "[t]he measures are improper if they 'have the effect of causing the stockholders to vote in favor of the proposed transaction for some reason other than the merits of that transaction.'" Orman at *7, quoting Williams, 671 A.2d at 1382-83.

The Court found that because the deal would not have occurred without inclusion of the deal protection devices, those devices were an integral part of the merits of the transaction. Orman at *7. As the deal protection devices were thus part of the merits of the transaction—necessary for the transaction to move forward, if at all—"General Cigar's public shareholders were not encouraged to vote in favor of the Swedish Match transaction for reasons unrelated to the transaction's merits. ... [N]othing in this record suggests that the lock-up had the effect of causing General Cigar's stockholders to vote in favor of the proposed transaction for some reason other than the merits of that transaction." Id. at *7. The Court concludes the first prong of the second stage of Unocol analysis as follows:

> Because General Cigar's public shareholders retained the power to reject the proposed transaction with Swedish Match, the fiduciary out negotiated by General Cigar's board was a meaningful and effective one, it gave the General Cigar board power to recommend that the shareholders veto the Swedish Match deal. That is to say, had the board determined that it needed to recommend that General Cigar's shareholders reject the transaction, the shareholders were fully empowered to act upon that recommendation because the public shareholders (those not "locked-up" in the voting agreement) retained the power to reject the proposed merger. For these reasons, I conclude as a matter of law that the deal protection mechanisms present here were not impermissibly coercive.

Id.

In the second prong of the second stage of the Unocal analysis, the Court turned to the question of whether the Cullman's voting agreement fell within a range of reasonable responses to the pending danger to corporate policy and effectiveness. Id. at *8. The Court found that without the lock-up, General Cigar would have lost the Swedish Match deal, the public stockholders would have lost the premium they stood to gain on their shares, and no other suitor was waiting in the wings with an equally attractive offer for the company. See id. Given such circumstances, the

Court found that General Cigar's board "should therefore be afforded the maximum latitude regarding its decision to recommend the Swedish Match merger." Id.

3. *Hollinger Inc. v. Hollinger Int'l, Inc.,* 858 A.2d 342 (Del. Ch. 2004).

In Hollinger Inc. v. Hollinger Int'l, Inc., 858 A.2d 342 (Del. Ch. 2004), the Delaware Court of Chancery examines the bounds of section 271 of Delaware's General Corporations Law with respect to an asset sale by a subsidiary, and the parent corporation's attempt to force a shareholder vote with respect to that sale. Section 271 provides the directors of Delaware corporations with the right to sell "all or substantially all of its property and assets, including goodwill and corporate franchises" only upon approval by stockholder vote. Id. at 376.

In Hollinger, Plaintiff Hollinger Inc. ("Hollinger"), as controlling stockholder, sought to enjoin its subsidiary, Hollinger International, Inc. ("International") from selling the Telegraph Group, Ltd. (the "Telegraph Group"), an indirect subsidiary wholly owned by International that publishes London's Telegraph newspaper. Id. at 346. In addition to its section 271 argument, Hollinger also claimed that equity demanded a stockholder vote, lest Hollinger, as controlling stockholder, be relegated to the position of the average stockholder. The Court rejected both of Hollinger's arguments.

With respect to the section 271 argument, the Court held that selling the Telegraph Group was not tantamount to a sale of all, or substantially all, of International's assets. Under Delaware's jurisprudence, particularly "the seminal § 271 decision, Gimbel v. Signal Cos." (316 A.2d 599 (Del. Ch. 1974) aff'd, 316 A.2d 619 (Del. 1974)) the Court was not free to limit its discussion to balance sheets and economics, but was compelled to pursue the section 271 inquiry down two parallel lines of analysis: whether the Telegraph Group sale represented International selling all of its assets on (a) a quantitative basis, or (b) on a qualitative basis. The Court ultimately decided that the sale triggered neither aspect of section 271.

The Court's "quantitative" interpretation of section 271 with respect to the Telegraph Group sale turned on questions of economics. International, prior to the Telegraph Group sale, controlled four groups of newspapers, in Israel, Canada, Chicago, and the United Kingdom. See id. at 352-354. The Chicago group and the United Kingdom group (i.e., the Telegraph Group) were far and away International's most valuable assets, with 2003 EBITDAs of approximately $80 million and $57 million respectively, compared to slightly negative 2003 EBITDAs for the other two groups. See id. The Court found, using bids that International had received for both the Chicago group and the Telegraph Group as its basis for comparison, that the Telegraph Group accounted for 56-57% of International's asset value, while the Chicago group accounted for 43-44%. Id. at 380.

Despite the Telegraph Group's significance as an asset by that measure, the Court held that by relative contribution to International's total revenues, the Telegraph Group accounted for less than 50% during the preceding three years. Id. at 380. Further, in terms of book value, neither the Telegraph Group nor the Chicago group approached 50% of International's asset value, because International's other operating groups and non-operating assets had value. Returning then to EBITDA, the Court determined, "[t]he picture that emerges is one of rough equality between the two [Chicago and Telegraph] Groups—with any edge tilting in the Chicago Group's direction." Id. at 382. After noting that the future financial prospects of both groups appeared substantially similar, the Court concluded its "quantitative" analysis as follows:

> The evidence therefore reveals that neither the Telegraph Group nor the Chicago group is quantitatively vital in the sense used in the Gimbel test. Although both Groups are profitable, valuable economic assets and although the Telegraph Group is somewhat more valuable than the Chicago Group, International can continue as a profitable entity without either one of them. International is not a human body, and the Telegraph and the Chicago group are not its heart and liver. International is a business. Neither one of the two groups is "vital"—i.e., "necessary to the continuation of [International's] life" or "necessary to [its] continued existence or effectiveness." Rather, a sale of either Group leaves International as a profitable entity, even if it chooses to distribute a good deal of the cash it receives from the Telegraph sale to its stockholders through a dividend or share repurchase.

Id. at 383 (citation omitted) (emphasis in original).

The Court then expressed its frustration with the "qualitative" aspects of the Gimbel test as "more than a tad unclear." Id. at 383. If the assets for sale are not "quantitatively" vital to a corporation's life, "it is not altogether apparent how they can 'substantially affect the existence and purpose of' the corporation within the meaning of Gimbel, suggesting either that the two elements of the test are actually not distinct or that they are redundant." Id. (citation omitted). Nevertheless, the Court endeavored to operate the Gimbel analysis under the following interpretation: "[The qualitative Gimbel] element is not satisfied if the court merely believes that the economic assets being sold are aesthetically superior to those being retained; rather, the qualitative element of Gimbel focuses on economic quality and, at most, on whether the transaction leaves the stockholders with an investment that in economic terms is qualitatively different than the one that they now possess." Id. at 384.

Hollinger's arguments stressed, with respect to Gimbel's qualitative element, the journalistic superiority of the Telegraph Group over International's other publications, and the social cachet associated with the Telegraph. Id at 383. Allegedly, to sell International's most prestigious possession would leave International owning the Chicago Sun-Times, the "Second Paper in the Second City", as its flagship publication. Id. at 384. Hollinger alleged that this would fundamentally, qualitatively transform International. Id. The Court rejected this aspect of Hollinger's argument, and after noting Gimbel's focus on the economic quality of planned asset sale, reminded the reader that "[e]ven with that focus, it must be remembered that the qualitative element is a gloss on the statutory language 'substantially all' and not on an attempt to identify qualitatively important transactions but ones that 'strike at the heart of the corporation's existence.'" Id. at 384, quoting Gimbel, 317 A.2d at 606.

The Court went on to note that when International went public, it did not own the Telegraph Group, and frequently bought and sold a variety of publications. Id. This, the Court notes, indicates that no International investor would assume that any of International's assets were "sacrosanct." Id. In fact, International had been so active in the M&A community that the Court observed the purchase or sale of any particular line of operations had become part of Internationals ordinary course of business. Id.

After noting that selling the Telegraph Group neither stuck at the heart of International, nor significantly deviated from International's common practices in the M&A market, the Court made the following observation: "Even more importantly, investors in public companies do not invest their money because they derive social status from owning shares in a corporation whose controlling manager can have dinner with the Queen. Whatever the social importance of the Telegraph in Great Britain, the economic value of that importance to International as an entity is what matters for the Gimbel test, not how cool it would be to be the Telegraph's publisher." Id. at 384.

The result of the Court's analysis concludes that because International's stockholders will remain, after the Telegraph sale, "investors in a publication company with profitable operating assets, a well-regarded tabloid newspaper of good reputation and large circulation [(i.e., the Chicago Sun-Times)], a prestigious newspaper in Israel, and other valuable assets[,]" the Telegraph sale was not "qualitatively" a sale of all, or substantially all, of International's assets. Id. In short, "[w]hile important, the sale of the Telegraph does not strike a blow to International's heart." Id.

Outside of the section 271 arguments discussed above, the Court also denied Hollinger's argument that principals of equity required a stockholder vote on the telegraph sale. Id at 386. This argument apparently went through a number of iterations over the course of briefing and argument, but can be summarized here in its two core assertions. First, Hollinger argued that because Hollinger's controlling stockholder, Conrad Black, and his affiliates on the International board had been excluded from the board committee reviewing International's options, equity demanded a stockholder vote. Id. at 387.

The Court, in rebuffing this assertion, noted that controlling stockholders have no inalienable right under the law to usurp the authority of the directors they elect. Id. Rather, like all other stockholders, a controlling stockholder must accept the informed, good faith business decisions of the directors unless the Delaware Corporations Law requires a vote. Id. Likewise, with respect to the equitable portion of such analysis, the Court noted that there is no reason why a controlling stockholder should hold veto power over asset sales when other, dispersed stockholders lack such rights. Id. After all, the controlling stockholder is often (and in this case was) able to participate directly in the identification and selection of the board. Id. The Court also notes that Hollinger apparently offered no means by which to resolve just when equity would demand recognition of a controlling stockholder's "special, natural law right to vote[.]" Id.

Further fatal to Hollinger's demand for a vote premised on equity was the fact that Hollinger was essentially trying to "undermine the decisions of independent directors its own controlling stockholder, Conrad Black, selected." Id. at 387-88. Hollinger, at the time, was suffering under an injunction and judicial orders that would have opened it to significant liability if it interfered with International's board or operations, so it was not as free as it otherwise would have been to influence the International board's actions. Id.

Nevertheless, these restrictions on Hollinger's influence were brought about because it, along with and at the insistence of Black, "posed a legally cognizable threat to the rights and best interests of International and its public stockholders." Id. at 388. Hollinger thus "[had] only itself and its controlling stockholder, inside management, and directors to blame." Id.

Given the obvious tensions in Hollinger's first equitable argument, in its reply brief the argument had transformed into a Van Gorkum argument. See id. at 388, citing Smith v. Van Gorkum, 488 A.2d 858 (Del. 1985). Hollinger grounded this claim in the idea that the International board had acted in a grossly negligent manner in agreeing to sell the Telegraph Group rather than retain it and focus on improving returns from continuing operation. Hollinger at 388. The Court faulted Hollinger's position for slighting a "mountain" of evidence to the contrary. Id. In analyzing the evidence before it, the Court noted that Van Gorkum had involved "a finding that independent directors who accepted a large premium for selling an entire company were grossly negligent because they did not shop the company first, did not obtain a banker's opinion, and supposedly did not retain sufficient leeway to do a post-signing market check." Id. at 390. Noting that the Van Gorkum opinion stuck many commentators as "wrong-headed," the Court decided that enjoining the sale at issue "would represent a vigorous tightening of the Van Gorkum screw[,]" which the Court was not willing to tighten on the facts as it read them:

> By stark contract [to Van Gorkum], here, a group of independent directors worked with an interim CEO, who bears every indicium of independence ... , to fully expose International to the marketplace in a process designed by qualified

> investment bankers. The independent directors did not simply market the asset they ultimately sold; they marketed the whole company and every one of its assets. During that process, the investment banker did as it should have and tried to convince potential buyers to pay an even higher price for both the company and the Telegraph group than was finally approved. ... In the course of their process, the independent directors considered the risks facing the operations they were selling and a detailed financial analysis of the worth of those operations ... . Only after doing that and concluding that the price they were receiving ... was an attractive one when compared to the utility of retaining those assets did the [review committee] vote. I cannot call such a process irrational or grossly negligent without distorting the meaning of those concepts.

Hollinger, at 390-91.

d. Duty of Oversight

1. *Saito v. McCall,* No. Civ. A. 17132-NC, 2004 WL 3029876 (Del. Ch. Dec. 20, 2004).

In Saito v. McCall the Delaware Court of Chancery provided insight with respect to directors' duty of oversight by demonstrating a willingness to impute knowledge from individual directors to the board as a whole. This presumption of collective knowledge formed the basis of the Court's refusal do dismiss a claim that the Defendant board of directors failed to fulfill its oversight responsibilities, and further lays the foundation for the Plaintiffs' assertion of demand futility with respect to a board interconnected by the knowledge of accounting impropriety.

In January of 1999, McKesson Corporation ("McKesson"), a healthcare supply management company, merged with HBO & Company ("HBOC"), a provider of healthcare software. See Saito v. McCall, No. Civ. A. 17132-NC, 2004 WL 3029876, at *1, 2 (Del. Ch. Dec. 20, 2004). The transaction, whereby McKesson paid $14 billion in McKesson stock to acquire HBOC closed on January 12, 1999, following the approval of the HBOC and McKesson shareholders. Id. at **2, 3.

Upon acquiring HBOC, McKesson changed it's name to McKesson HBOC, Inc. ("McKesson-HBOC"), but the merged entity was soon forced to face accounting improprieties it inherited from HBOC. See id. at *2. The public learned of these alleged improprieties through a series of disclosures between April and July of 1999. See id. at *4. These improprieties included the following:

- On April 28, 1999, McKesson-HBOC announced that it would restate its earnings from previous quarters. Id. at *4.

- On May 25, 1999, McKesson-HBOC announced that it would further revise its results downward. Id.

- On June 21, 1999, McKesson-HBOC announced that Richard Hawkins, the CFO of McKesson-HBOC both before and after the merger, and Mark Pulido, the CEO of McKesson-HBOC both before and after the merger, had resigned from their positions; and, that Charles McCall, the former CEO of HBOC and chairman of McKesson-HBOC's board following the merger, had been stripped of his position. Id.

- On July 14, 1999, the Company announced that its previously reported restatements would be larger than originally revealed. Id.

- On July 16, 1999, McKesson-HBOC submitted an SEC filing concededing that HBOC's financial statements were inaccurate because of improper accounting. Id.

It took plaintiffs only two days from the first of these announcements to file the original complaint in Saito ("the product of a race to the courthouse[.]" Id. at **1, 4 n.25.). Following multiple attempts, plaintiffs ultimately filed a fourth amended complaint (the "Complaint"), which was the target of a variety of motions to dismiss. Id.

The central allegations of the Complaint were: "(1) that HBOC's directors and senior officers presided over a fraudulent accounting scheme; (2) that McKesson's officers, directors, and advisors learned of HBOC's fraudulent scheme during their due diligence into the proposed Merger, but nonetheless McKesson's board approved the Merger; and (3) that the McKesson-HBOC board acted too slowly in rectifying the accounting problems at HBOC after the Merger was completed." Id. at *1. Of the thirteen counts of alleged wrongdoing, the Court dismissed or stayed the majority (Counts I-IV, VI-VIII) on procedural grounds (generally lack of standing, ripeness, or failure to properly alleged demand futility), with the exception of Count V against McKesson-HMOC's directors, alleging violations of their

Caremark duty of oversight. See Saito at **11, 6; see also, In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959 (Del. Ch. 1996).

Count V of the Complaint sought redress against the McKesson-HBOC directors for "'failing to timely correct HBOC's false financial statements, monitor the accounting practices of McKesson-HBOC following the merger, implement sufficient internal controls to guard against the wrongful practices they knew about before the Merger and disclose HBOC's false financial statements.'" Saito at *6 (citation omitted). The Court had dismissed this claim before, without prejudice, encouraging the Plaintiffs to "'use the tools at hand' to 'develop additional particularized facts in order to allege properly an oversight claim that will meet the demand futility standard and to avoid the standing requirement of Delaware's continuing ownership rule.'" Id. at *1, quoting Ash v. McCall, No. Civ. A. 17132, 2000 WL 1370341, at *58 (Del. Ch. Sept. 15, 2000). The Court introduced its analysis of this claim by noting that "[h]ere, after using the 'tools at hand,' the complaint appears—barely—to state a claim under Caremark." Id. at *6 (citation omitted).

In framing its analysis, the Court noted Plaintiff's admission that in order for the Caremark claim to survive in the instant context, plaintiff had to show that the McKesson-HBOC board "(1) should have known that the unlawful accounting improprieties were occurring or had occurred; and (2) made no good faith effort to remedy the unlawful accounting improprieties." Id. at *6.

In resolving the first part of this inquiry, the court held that the following facts demonstrated sufficient knowledge on behalf of McKesson-HBOC's board to survive a motion to dismiss:

- The HBOC audit committee knew, through a 1998 meeting to discuss its 1997 audit with its auditor, Arthur Anderson ("Anderson"), that the 1997 audit was "high risk." The committee discussed the accounting-related risks inherent to the software industry, and specifically discussed risks arising from certain HBOC sales practices. Id. at **7, 2.

- At a July 10, 1998, meeting, the McKesson board came to learn that HBOC had some problems with its accounting practices. Id. at **7, 2.

- Later that fall, after a stall in negotiations, the McKesson board knew that the issues highlited in the July 10, 1998, board meeting had not been resolved, and that HBOC's accounting practices presented at least a $40 to $55 million problem. Id. at *7.

The Court reasoned that the knowledge of HBOC's accounting improprieties could be imputed to the board of the merged McKesson-HBOC through the following chain of relationships: at least four members of HBOC's board knew of the accounting improprieties. See id. at *7 n.68 And, "[a] reasonable inference, which the Court is entitled to draw at this procedural stage, is that that information [(i.e., knowledge of the audit committee about the accounting problems)] was communicated to the other HBOC board members who later served on McKesson-HBOC's board." Id. Likewise, approaching the question of McKesson-HBOC's board from the McKesson side of the merger, the Court notes that after the McKesson board had approved the merger on October 16, 1998, they learned the HBOC fired its CFO, Jay Gilbertson. See id at *7, 2.

Furthermore, shortly after the merger closed, the combined McKesson-HBOC audit committee met on January 27, 1999, with its advisers to discuss the transaction. Id. at *7. That discussion concerned accounting adjustments made to HBOC's financial statements in the same areas that had been highlighted to McKesson's board in a July 12, 1998, conference call among McKesson's CFO, Bear Stearns & Co., and Deloitte & Touche LLP (Bear Stearns rendered a fairness opinion on the merger to McKesson's directors, and Deloitte & Touche served as McKesson's auditor and also conducted due diligence on the merger for McKesson). See id. at *7, 2, 1.

As a result, the Court concluded the "knowledge" prong of its Caremark analysis, as it applied to the facts then at bar, as follows:

> Thus, viewing the above facts in a light most favorable to plaintiffs, it can be argued that the McKesson-HBOC board, a board comprised of directors from both sides of the transaction, knew or should have know that the HBOC accounting problems were unlawful. At a minimum, the new board's audit committee was comprised of directors from McKesson who should have known HBOC accounting practices were problematic. Those directors, regardless of their pre-Merger knowledge of the accounting problems, now had the benefit of serving with former HBOC directors who also should have known not only the existence

> of those problems but the extent of the problems.

*Saito, at *7.*

Having satisfied itself (for purposes of surviving a motion to dismiss) that the McKesson-HBOC board had knowledge of HBOC's accounting problems upon, or shortly following the merger, the Court turned to the several months that passed between gaining this knowledge and revealing it to the public in piecemeal fashion, from April through July of 1999. See id. While recognizing the tenuous nature of this claim, the court found that "[a]lthough the facts later adduced may prove otherwise, the procedural posture of the case requires [the Court] to focus of the plaintiffs' complaint and read it generously. Viewed in that manner, [the oversight count] survives defendants' motion to dismiss." Id.

Finally, with respect to demand futility, the Court proposed the following question: "[W]hether the plaintiffs can refute the presumption that McKesson-HBOC's board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." Id. at *7 n.71. Citing its conclusion that the combined McKesson-HBOC board had enough resources ("namely each other") to discover the extent of HBOC's accounting deficiencies once the merger was consummated, and concluding that a demand on the board in April 1999 would directly implicate the McKesson-HBOC audit committee's good faith, "[t]he substantial likelihood of liability these directors faced for a breach of their duty of good faith disabled the entire McKesson-HBOC board from mustering an independent and disinterested majority." Id. By imputing knowledge of HBOC's accounting improprieties from former HBOC board members to the April 1999 board of McKesson-HBOC, and finding a delay of three and a half months before public disclosure unacceptable, the Court concluded that the board's poor exercise of its duty of oversight carried with it the implicit presumption that the board could not exercise good faith in responding to a demand for action at that time. This conclusion validated Plaintiffs' claims of demand futility. Id.

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[ii] Wilson Sonsini Goodrich & Rosati represented several of the individual defendants in the Worlds of Wonder Securities Litigation.

[iii] Wilson Sonsini Goodrich & Rosati represented the underwriters in the Software Toolworks Securities Litigation.