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SUPPLEMENTAL MATERIALS

FOR

BUSINESS PLANNING FOR MERGERS AND ACQUISITIONS

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I. CHAPTER 1, INTRODUCTION

A. Pages 19 and 21, The Current M&A Scene

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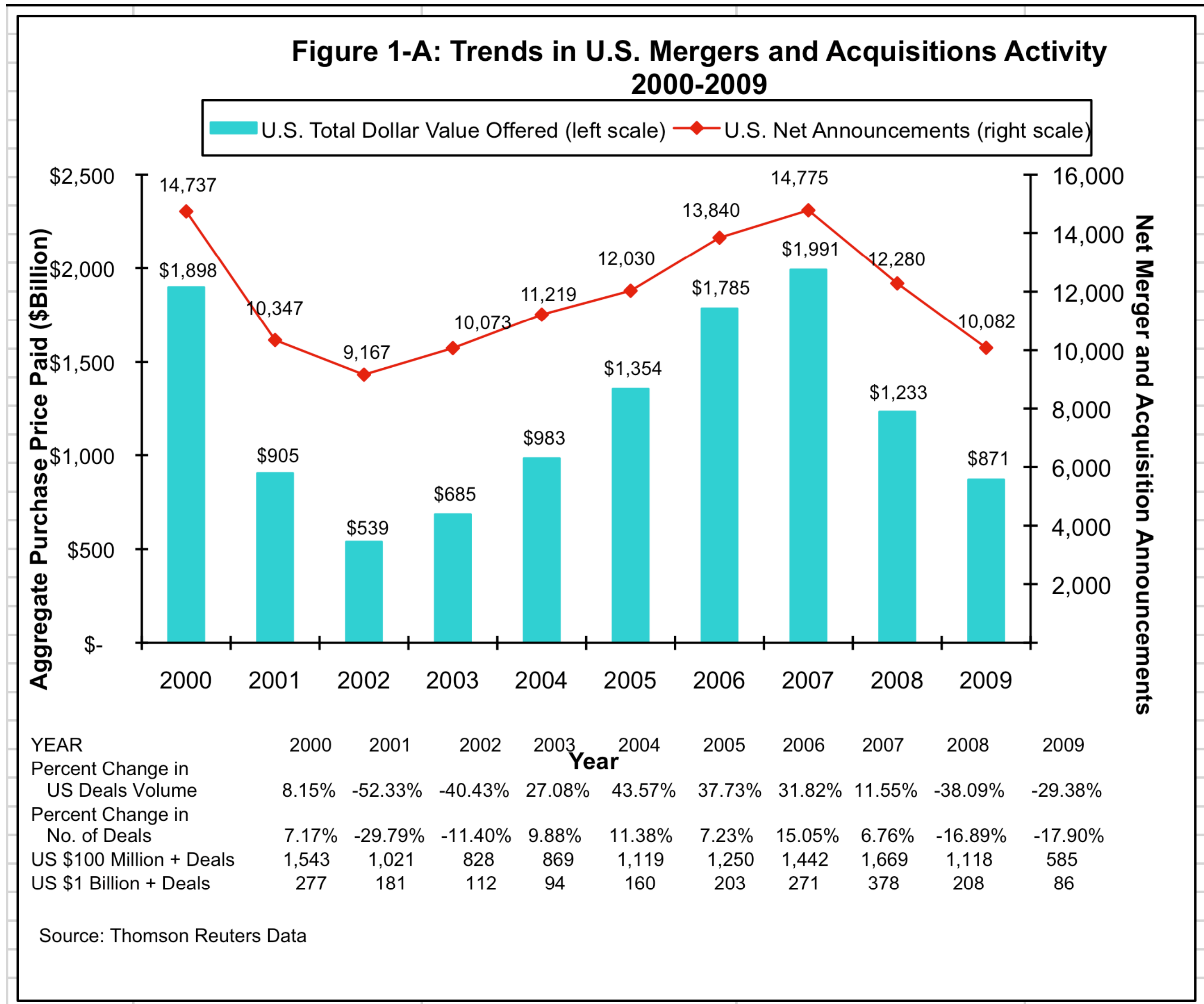

YEAR	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Percent Change in US Deals Volume	8.15%	-52.33%	-40.43%	27.08%	43.57%	37.73%	31.82%	11.55%	-38.09%	-29.38%
Percent Change in No. of Deals	7.17%	-29.79%	-11.40%	9.88%	11.38%	7.23%	15.05%	6.76%	-16.89%	-17.90%
US $100 Million + Deals	1,543	1,021	828	869	1,119	1,250	1,442	1,669	1,118	585
US $1 Billion + Deals	277	181	112	94	160	203	271	378	208	86

Source: Thomson Reuters Data

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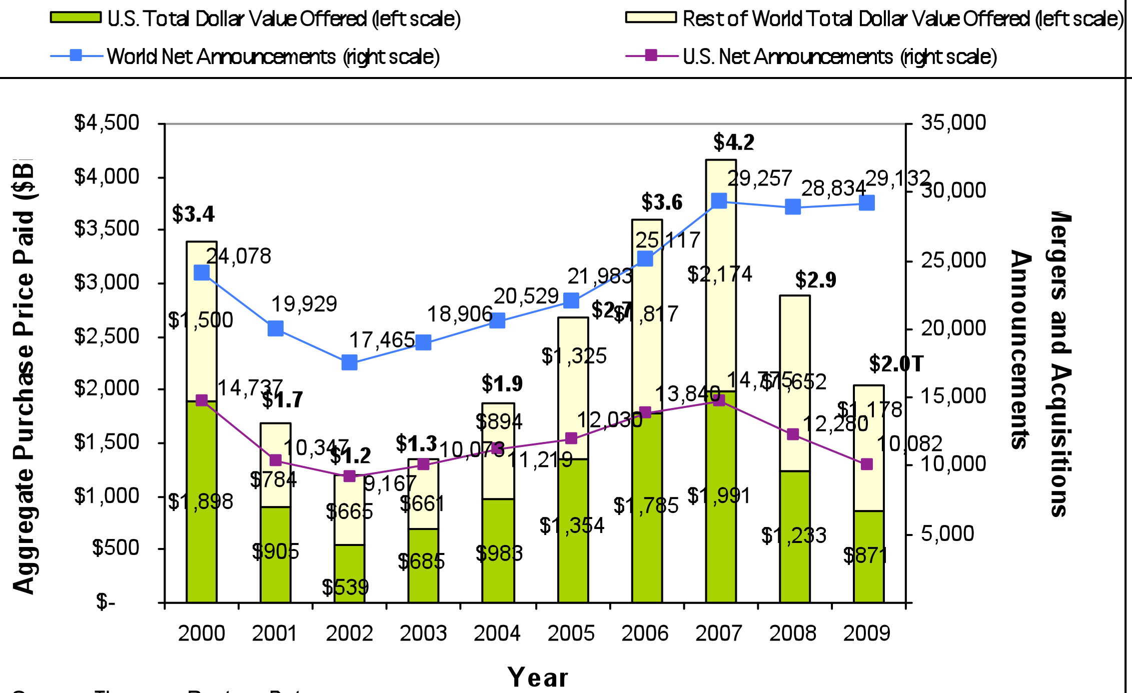

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II. CHAPTER 2, VOTING AND DISSENTING IN MERGERS, ASSET ACQUISITIONS, AND COMPULSORY SHARE EXCHANGES

A. Page 74, New Sec. 2.16.B.3. Delaware Supreme Court's Adoption of the Quasi-Appraisal Remedy--Berger

Page 74, New Sec. 2.16.B.3. Add at the bottom of the page:
New Sec. 2.16.B.3. **Delaware Supreme Court's Adoption of the Quasi-Appraisal Remedy—*Berger***

Berger v. Pubco Corporation
Supreme Court of Delaware, 2009
976 A.2d 132

OPINION

JACOBS, Justice:

The issue on this appeal is what remedy is appropriate in a "short form" merger under 8 *Del. C.* § 253, where the corporation's minority stockholders are involuntarily cashed out without being furnished the factual information material to an informed shareholder decision whether or not to seek appraisal. The Court of Chancery held that because the notice of merger did not disclose those material facts, the minority shareholders were entitled to a "quasi-appraisal" remedy, wherein those shareholders who elect appraisal must "opt in" to the proceeding and escrow a portion of the merger proceeds they received. We conclude that although the Court of Chancery correctly found that the majority stockholder had violated its disclosure duty, the court erred as a matter of law in prescribing this specific form of remedy.

Under *Glassman v. Unocal Exploration Corporation*,[1] the exclusive remedy for minority shareholders who challenge a short form merger is a statutory appraisal, provided that there is no fraud or illegality, and that all facts are disclosed that would enable the shareholders to decide whether to accept the merger price or seek appraisal. But where, as here, the material facts are not disclosed, the controlling stockholder forfeits the benefit of that limited review and exclusive remedy, and the minority shareholders become entitled to participate in a "quasi-appraisal" class action to recover the difference between "fair value" and the merger price without having to "opt in" to that proceeding or to escrow any merger proceeds that they received. Because the trial court declined to order that remedy, we must reverse.

[1] 777 A.2d 242 (Del. 2001) ("Glassman").

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FACTUAL AND PROCEDURAL BACKGROUND

The facts pivotal to this appeal, all drawn from the Court of Chancery's Opinion deciding cross motions for summary judgment, are undisputed. Pubco Corporation ("Pubco" or "the company") is a Delaware corporation whose common shares were not publicly traded. Over 90 percent of Pubco's shares were owned by defendant Robert H. Kanner, who was Pubco's president and sole director. The plaintiff, Barbara Berger, was a Pubco minority shareholder.

Sometime before October 12, 2007, Kanner decided that Pubco should "go private." As the owner of over 90% of Pubco's outstanding shares, Kanner was legally entitled to effect a "short form" merger under 8 *Del. C.* § 253. Because that short form procedure is available only to corporate controlling shareholders,[2] Kanner formed a wholly-owned shell subsidiary, Pubco Acquisition, Inc., and transferred his Pubco shares to that entity to effect the merger. In that merger, which took place on October 12, 2007, Pubco's minority stockholders received $ 20 cash per share.

Under the short form merger statute (8 *Del. C.* § 253), the only relevant corporate action required to effect a short term merger is for the board of directors of the parent corporation to adopt a resolution approving a certificate of merger, and to furnish the minority shareholders a notice advising that the merger has occurred and that they are entitled to seek an appraisal under 8 *Del. C.* § 262. Section 253 requires that the notice include a copy of the appraisal statute, and Delaware case law requires the parent company to disclose in the notice of merger all information material to shareholders deciding whether or not to seek appraisal.[3]

In November 2007, the plaintiff received a written notice (the "Notice") from Pubco, advising that Pubco's controlling shareholder had effected a short form merger and that the plaintiff and the other minority stockholders were being cashed out for $ 20 per share. The Notice explained that shareholder approval was not required for the merger to become effective, and that the minority stockholders had the right to seek an appraisal. The Notice also disclosed some information about the nature of Pubco's business, the names of its officers and directors, the number of its shares and classes of stock, a description of related business transactions, and copies of Pubco's most recent interim and annual unaudited financial statements. The Notice also disclosed that Pubco's stock, although not publicly traded, was sporadically traded over-the-counter, and that in the twenty two months preceding the merger there were thirty open market trades that ranged in price from $ 12.55 to $ 16.00 per share, at an average price of $ 13.32. Finally, the Notice provided telephone, fax and e-mail contact information where shareholders could request and obtain additional information.

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[2] The short form merger procedure authorized by 8 Del. C. § 253 is available only where "…at least 90% of the outstanding shares of each class of the stock of a corporation…is owned by another corporation…."
[3] Glassman, 777 A.2d at 248. See also McMullin v. Beran, 765 A.2d 910, 920 (Del. 2000) (minority shareholders must be able to make an informed decision whether to accept the tender offer price or seek an appraisal of their shares.).

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In its summary judgment opinion, the Court of Chancery found that except for the financial statements, the disclosures in the Notice provided no significant detail. For example, the description of the Company comprised only five sentences, one of which vaguely stated that "[t]he Company owns other income producing assets." No disclosures relating to the company's plans or prospects were made, nor was there any meaningful discussion of Pubco's actual operations or disclosure of its finances by division or line of business. Rather, the unaudited financial statements lumped all of the company's operations together. The financial statements did indicate that Pubco held a sizeable amount of cash and securities, but did not explain how those assets were, or would be, utilized. Finally, the Notice contained no disclosure of how Kanner had determined the $ 20 per share merger price that he unilaterally had set.

As our law required, the company attached to the Notice a copy of the appraisal statute, but the copy attached was outdated and, therefore, incorrect. The appraisal statute had been updated by changes that became effective in August 2007--two months before the Notice was sent to shareholders--but the version attached to the Notice did not reflect those changes. Pubco never sent a corrected copy of the updated appraisal statute to its former minority stockholders.

On December 14, 2007, the plaintiff initiated this lawsuit as a class action on behalf of all Pubco minority stockholders, claiming that the class is entitled to receive the difference between the $ 20 per share paid to each class member and the fair value of his or her shares, irrespective of whether any class member demanded appraisal. Pubco and Kanner then moved to dismiss the complaint under Court of Chancery Rule 12(b)(6). The plaintiff responded to that motion, and simultaneously filed an opening brief in support of her counter-motion for summary judgment under Court of Chancery Rule 56. Thereafter, the defendants abandoned their motion to dismiss, and filed a cross-motion for summary judgment. Briefing on the cross-motions was completed on April 22, 2008, and the Court of Chancery handed down its Memorandum Opinion on May 30, 2008, granting the cross-motions in part and denying them in part. The rulings in that Opinion were embodied in a final order and judgment entered on July 18, 2008.

THE COURT OF CHANCERY OPINION

In its Opinion, the Court of Chancery addressed two issues. They were: (1) whether the Notice contained material misstatements or omissions that constituted disclosure violations, and (2) if so, what was the appropriate remedy.

The court found two separate disclosure violations. The first, which was not contested, is that the wrong version of the appraisal statute had been attached to the Notice. That violated "the Delaware appraisal statute [which] explicitly requires its inclusion in any notice of a merger giving rise to appraisal rights." The second violation, which was disputed, was that the Notice did not disclose how Kanner set the $ 20 per share price. The defendants argued that that nondisclosure was not material, because Kanner could

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have used whatever valuation methodology he desired, including even "rolling the dice." Rejecting that argument, the trial court held:

> Defendants argue that it cannot be material, because … in a short form merger the parent has no obligation to set a fair price and, therefore, has no obligation to explain how or why the price set is fair…. Because Kanner…did not have to set a fair price and, therefore, could have used any method--no matter how absurd--to set the merger consideration [,] Defendants argue that disclosure of [Kanner's] methodology is unnecessary.

Defendants' argument entirely misses the mark, however, because the issue is not about necessity--it is about materiality. In the context of Pubco, an unregistered company that made no public filings and whose Notice was relatively terse and short on details, the method by which Kanner set the merger consideration is a fact that is substantially likely to alter the total mix of information available to the minority stockholders. Where, as here, a minority shareholder needs to decide only whether to accept the merger consideration or to seek appraisal, the question is partially one of trust: can the minority shareholder trust that the price offered is good enough, or does it likely undervalue the Company so significantly that appraisal is a worthwhile endeavor? When faced with such a question, it would be material to know that the price offered was set by arbitrarily rolling dice. In a situation like Pubco's, where so little information is available about the Company, such a disclosure would significantly change the landscape with respect to the decision of whether or not to trust the price offered by the parent. This does not mean that Kanner should have provided picayune details about the process he used to set the price; it simply means he should have disclosed in a broad sense what the process was, assuming he followed a process at all and did not simply choose a number randomly.

Having adjudicated these disclosure violations, the Court of Chancery next considered the question of remedy. The court reasoned that in a short form merger, rescissory remedies (*i.e*., rescission or rescissory damages) are unavailable for disclosure violations, because under Section 253 a short form merger becomes effective before any disclosures to the minority stockholders are made. Instead, therefore, "minority shareholders have a statutory right to appraisal in a merger under section 253, so a proper remedy would preserve that right…. Such a remedy is a 'quasi-appraisal.'" The issue flowing from that ruling, which the parties hotly disputed, was what the content of that quasi-appraisal remedy should be.

Each side advocated a different form of quasi-appraisal and relied upon one or both of two Court of Chancery decisions that involved disclosure violations in short form, cash-out mergers. The plaintiff relied upon *Nebel v. Southwest Bancorp., Inc.*,[4] a *pre-Glassman* decision. In *Nebel*, the court determined that the appropriate remedy for the adjudicated disclosure violation was that the minority shareholders should receive the difference between the merger consideration and the fair value of their shares, to be determined in a parallel appraisal proceeding in which the shareholders were not required to "opt in." The defendants advocated the quasi-appraisal remedy awarded in *Gilliland v.*

[4] 1995 Del. Ch. LEXIS 80, 1995 WL 405750 (Del. Ch. July 5, 1995).

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Motorola, Inc.,[5] a *post-Glassman* decision where the court "attempted to mirror as best as possible the statutory appraisal remedy [,]"[6] by requiring the minority shareholders seeking that remedy to "opt in" and to escrow a portion of the merger consideration they received.[7]

In the instant case, the Court of Chancery concluded that the remedy should be modeled upon that previously awarded in *Gilliland*:

> The quasi-appraisal remedy fashioned in *Gilliland* attempted to mirror as best as possible the statutory appraisal remedy. Because I agree that *Nebel* does not directly address the issue of defining the contours of the quasi-appraisal remedy, and because I believe the *Gilliland* approach wisely follows the General Assembly's instructions by patterning itself after the statute, I conclude this case is governed by *Gilliland*.

The Court directed the parties to submit "an order calling for a quasi-appraisal remedy based on the *Gilliland* decision," and that should require four things:

> First, Pubco must make supplemental disclosures to address the violations discussed above; namely, Pubco must disclose the method, if any, used by Kanner to set the merger consideration and must include a correct and current copy of the appraisal statute. Second, the order should "require minority stockholders to make a choice to participate in the action, in order to replicate the situation they would have faced if they had received proper notice." As in *Gilliland*, these "opt-in procedures…will not be as stringent as those under the statute[, and] stockholders seeking to opt-in will need to provide only proof of beneficial ownership of the [Pubco] shares on the merger date. Third, "this quasi-appraisal action should be structured to replicate a modicum of the risk that would inhere if this were an actual appraisal action, *i.e*., the risk that the Court will appraise [Pubco] at less than [$ 20] per share and the dissenting stockholders will receive less than the merger consideration…. Finally, the order should then call for a valuation of the Pubco shares as of the date of the merger using the method prescribed by the appraisal statute.

These requirements were embodied in a final order and judgment entered by the Court of Chancery on July 18, 2008, from which the plaintiff has timely appealed.

ANALYSIS

The Claims, Issues, and Standard of Review

Because the plaintiff challenges a short form cash-out merger under Section 253, the starting point for analysis is *Glassman*, which holds that in a short-form merger there is

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[5] 873 A.2d 305 (Del. Ch. 2005).
[6] Chancery Opinion, 2008 Del. Ch. LEXIS 63, 2008 WL 2224107, at *5.
[7] Gilliland, 873 A.2d at 313.

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no "entire fairness" review and that the exclusive remedy is a statutory appraisal. *Glassman* cautions, however, that those limited review and exclusive remedy protections are not absolute or unqualified. They are available only "absent fraud or illegality." Moreover, "[a]lthough fiduciaries are not required to establish entire fairness in a short-form merger, the duty of full disclosure remains…. Where the only choice for the minority stockholders is whether to accept the merger consideration or seek appraisal, they must be given all the factual information that is material to that decision."

The question not reached, and therefore not addressed, by *Glassman* is: what consequence should flow where the fiduciary fails to observe its "duty of full disclosure"? That is the only issue before us and it is one of first impression.

The Court of Chancery held that where minority shareholders who are cashed out in a short form merger are deprived of information material to deciding whether or not to seek appraisal, they are entitled to a "quasi-appraisal" remedy with the following features. First, the shareholders must be furnished the material information of which they were deprived. Second, the shareholders must then be afforded an opportunity to choose whether or not to participate in an action to determine the "fair value" of their shares. Third, shareholders who choose to participate must formally "opt in" to the proceeding and place into escrow a prescribed portion of the merger consideration that they received. Paraphrasing *Gilliland*, the Court of Chancery identified the purpose of the escrow requirement as to "replicate a modicum of the risk that would inhere" if the proceeding were an actual appraisal.

On appeal, the plaintiff-appellant does not contest the supplemental disclosure requirement of the order awarding the quasi-appraisal remedy, only its opt in and escrow features. The appellant claims that as a matter of law, all minority shareholders should have been treated as members of a class entitled to seek the quasi-appraisal recovery, without being burdened by any precondition or requirement that they opt in or escrow any portion of the merger proceeds paid to them. That, the plaintiff contends, is the only proper application of both *Glassman* and the short form merger statute, 8 *Del. C.* § 253.

The defendants-appellees, not surprisingly, take the opposite position. They contend that the adjudicated remedy, modeled after the Court of Chancery's earlier *Gilliland* decision, is the only outcome that properly implements the policies which underlie the Delaware appraisal statute and animate the rulings in *Glassman*.

Because the Court of Chancery has broad discretion to craft an appropriate remedy for a fiduciary violation,[8] the propriety of a court-ordered remedy is ordinarily reviewed for abuse of discretion. Here, however, the appellant claims that the disputed remedy was erroneous as a matter of law, because the trial court erred "in formulating or applying legal principles" and in granting summary judgment to the defendants.[9]A claim of that

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[8] Shell Petroleum, Inc. v. Smith, 606 A.2d 112, 117 (Del. 1992); Gilliland, 873 A.2d at 312 (citing Cantor Fitzgerald, L.P. v. Cantor, 2001 Del. Ch. LEXIS 70, 2001 WL 536911, at *3 (Del. Ch. May 11, 2001)).
[9] See, e.g., Arnold v. Soc'y for Sav. Bancorp, Inc., 650 A.2d 1270, 1276 (Del. 1994); Arnold v. Soc'y for Sav. Bancorp, 678 A.2d 533, 535 (Del. 1996).

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kind is one that we review *de novo*.[10]

Discussion

The Remedial Alternatives

To repeat, the issue presented here is: in a short form merger where the exclusive remedy is an appraisal, what is the consequence of the controlling stockholder's failure to disclose the facts material to an informed shareholder decision whether or not to elect that exclusive remedy? In the abstract, four possible alternatives present themselves, of which only two are advocated by either side. The remaining two alternatives are advocated by no party. We nonetheless identify and consider them, because to do otherwise would render our analysis truncated and incomplete.

The alternatives advocated by each side, respectively, are the two forms of "quasi-appraisal" remedy earlier described. The defendants argued, and the Court of Chancery agreed, that the appropriate remedy is the quasi-appraisal ordered in *Gilliland*. Under that remedial structure, fully informed minority shareholders who "opt in" and place into escrow a portion of the consideration they received may prosecute an action to recover the difference between adjudicated "fair value" and the merger consideration. The plaintiff advocated the second alternative form of "quasi-appraisal" remedy--a class action to recover the difference between "fair value" and the merger consideration, wherein the minority shareholders are automatically treated as members of the class with no obligation to opt in or to escrow any portion of the merger consideration. Under either structure, the only issue being litigated would be the appraised "fair value" of the corporation on the date of the merger, applying established corporate valuation principles.[11]

Of the remaining two remedial alternatives (those advocated by neither side), the first would be a "replicated appraisal" proceeding that would duplicate the precise sequence of events and requirements of the appraisal statute. Under the "replicated appraisal" approach, the minority shareholders would receive (in a supplemental disclosure) all information material to making an informed decision whether to elect appraisal. Shareholders who elect appraisal would then make a formal demand for appraisal and remit to the corporation their stock certificates and the entire merger consideration that they received. Thereafter, the corporation would have the opportunity, as contemplated by the appraisal statute, to attempt to reach a settlement with the appraisal claimants. Where no settlement is reached, a formal appraisal action could then be commenced by the dissenting shareholders or by the corporation.

Under the fourth alternative (also not advocated by either side), there would be no remedial appraisal proceeding at all. Rather, the consequence of the fiduciary's adjudicated failure to disclose material facts would be to render *Glassman* inapplicable.

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[10] Arnold v. Soc'y for Sav. Bancorp, Inc. 650 A.2d at 1276.

[11] Neither side argued before the Court of Chancery, or contends before us, that the recovery in either form of quasi-appraisal should include rescissory damages.

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As a result, the remedy would be the same as in a "long form" cash out merger under 8 *Del. C.* § 251--a shareholder class action for breach of fiduciary duty, where the legality of the merger (and the liability of the controlling stockholder fiduciaries) are determined under the traditional "entire fairness" review standard. [12]

Selecting The Most Appropriate Alternative

The four alternative possibilities having been identified, the question then becomes: which remedy is the most appropriate--the one ordered by the Court of Chancery or one of the three alternative forms? To decide that issue, we must first answer a predicate question: by what analytical standard do we determine which remedial alternative is optimal? We conclude that the optimal alternative would be the remedy that best effectuates the policies underlying the short form merger statute (Section 253), the appraisal statute (Section 262) and the *Glassman* decision, taking into account considerations of practicality of implementation and fairness to the litigants. A reasoned application of that standard permits the remedial alternatives to be ranked in an objective and transparent way.

Applying that standard leads us to conclude that the fourth alternative would merit the lowest priority. Under that alternative, a violation of the disclosure requirement would render *Glassman* inapplicable and deprive the majority stockholder fiduciary of the benefit of *Glassman's* limited review and exclusive remedy. In that setting (to reiterate), the minority shareholders would be entitled to the same remedies as are available in a fiduciary duty class action challenging a long form merger.

The strongest argument favoring this approach would run as follows: under *Glassman*, full disclosure of all material facts is a necessary condition for the fiduciary to enjoy *Glassman's* limited review and exclusive appraisal remedy. Therefore, a violation of that disclosure condition should deprive the fiduciary of those benefits. That argument, although unassailable in terms of logic and equity,[13] is flawed in one highly important respect. To accept it would disregard the intent of the General Assembly, as described in *Glassman* and *Stauffer v. Standard Brands, Incorporated*,[14] that in a legally valid, non-fraudulent, short form merger the minority shareholders' remedy should be limited to an appraisal. Moreover, validating such an approach would disserve the purpose of *Glassman's* disclosure requirement, which is to enable the minority stockholders to make an informed decision whether or not to seek an appraisal. A remedy that sidesteps appraisal altogether would frustrate that purpose.

[12] Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).
[13] More specifically, one could argue that Glassman's interpretation of Section 253 (reflecting a legislative intent to limit the judicial remedy in short form mergers to a statutory appraisal) is expressly made subject to the fiduciary limitation that the majority stockholder fiduciary must disclose to the minority shareholders all material facts that would enable them to decide whether to choose that exclusive remedy. The logic of that argument would run thusly: if the fiduciary fails to do equity (by making the required disclosure), then equity will deprive the fiduciary of the benefit of the limited and exclusive judicial remedy, and subject the fiduciary to the full range of remedies otherwise available to shareholders that were cashed out in a going private merger.
[14] 41 Del. Ch. 7, 187 A.2d 78 (Del. 1962).

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Unlike this approach, the remaining three alternative remedies would give effect (albeit in varying degrees) to that legislative intent. Therefore, in the hierarchy those alternative remedies should rank above the one that abjures appraisal.

That observation brings into focus a second alternative--the "replicated appraisal" remedy that would duplicate precisely the sequence of events and requirements of the appraisal statute. Under that approach, the minority shareholders would receive a supplemental disclosure, to enable them to make an informed decision whether or not to elect an appraisal. Shareholders who elect that remedy must then make a formal demand for an appraisal, and then remit to the corporation their stock certificates and all the merger consideration they received.

This approach would place the minority shareholders in the situation they would find themselves had they received proper disclosure to begin with. The strongest argument favoring this alternative is that it would give maximum effect to the legislative intent recognized in *Glassman*. The flaw of this approach, however, is that it would effectuate that legislative intent at an unacceptable cost measured in terms of practicality of application and fairness to the minority. In *Gilliland*, the Court of Chancery so recognized, implicitly acknowledging the impracticality of such an approach by refusing to order a "replicated appraisal" remedy:

> The opt-in procedures to be followed, however, will not be as stringent as those under the statute. For example, the court will not require beneficial or "street name" owners to "demand" quasiappraisal through their record holder. The court is concerned that, given the substantial passage of time since the merger, it would be difficult for stockholders to secure the cooperation of the former record holders or nominees needed to perfect demand in accordance with the statute. Instead, stockholders seeking to opt-in will need to provide only proof of beneficial ownership of [their] shares on the merger date.

The *Gilliland* court also recognized (again, implicitly) that it would be unfair to require shareholders who desire an appraisal to remit the entire merger consideration they received *to the corporation*, as would occur in a replicated appraisal. Instead, the court required only that "those stockholders who choose to participate in the action to pay *into escrow a portion* of the merger consideration they have already received." The *Gilliland* court thereby acknowledged the unfairness of requiring the minority stockholders to bear the risk of the corporation's creditworthiness, which would result from their having to pay back a portion of the merger proceeds to the company. Instead, the court ordered that the proceeds be placed into an escrow account, with the escrowed funds representing only a portion of the merger consideration the minority actually received.

Implicit in the *Gilliland* remedy is the recognition that it is unfair to the minority shareholders, on whose behalf significant litigation expense and effort were successfully devoted, to limit their relief to requiring the fiduciary merely to fulfill

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the disclosure obligation it had all along. A remedy limited to awarding a second statutory appraisal would deny the minority any credit for that expense and effort, after having been forced to prosecute that litigation solely because the controlling shareholder had violated its fiduciary duty. A replicated appraisal remedy would also give controlling shareholders little incentive to observe their disclosure duty in future cases, since the cost of the remedy to the controllers would be negligible. Both in *Gilliland* and in this case the Court of Chancery eschewed that approach, concluding instead that the appropriate remedy should be a "quasi appraisal." Both parties agree with that conclusion, and so do we.

That requires us to choose between the two dueling forms of quasi-appraisal advocated by the parties on this appeal. Both forms would entitle the minority stockholders to supplemental disclosure enabling them to make an informed decision whether to participate in the lawsuit or to retain the merger proceeds. Both forms would entitle those who elect to participate to seek a recovery of the difference between the fair value of their shares and the merger consideration they received, without having to establish the controlling shareholders' personal liability for breach of fiduciary duty. The difference between the two quasiappraisal approaches is that under the defendants' approach (which the Court of Chancery approved), the minority shareholders who elect to participate would be required to "opt in" and to escrow a prescribed portion of the merger proceeds they received. Under the plaintiff's approach, all minority stockholders would automatically become members of the class without being required to "opt in" or to escrow any portion of the merger proceeds.

As thus narrowed, the final issue may be stated as follows: under the standard we have applied, which remedy is the more appropriate--the one that imposes the opt in and partial escrow requirements or the one that does not? Considerations of utility and fairness impel us to conclude that the latter is the more appropriate remedy for the disclosure violation that occurred here. Because neither the opt-in nor the escrow requirement is mandated as a matter of law and because those requirements involve different equities,[15] we analyze each requirement separately.

We start with the "opt in" issue. The approach adopted by the Court of Chancery

[15] The Court of Chancery imposed the opt in and escrow requirements because that was the relief ordered in Gilliland. The Gilliland court imposed those requirements not because they were required as a matter of law, but because the court viewed them as an appropriate exercise of equitable discretion. Only if the Gilliland court had ordered a remedy taking the form of a "replicated" appraisal would strict adherence to the letter of the appraisal statute have been required. In such a case, the minority shareholders would have to opt in by making the formal demand called for by the appraisal statute, and would have to return all of the merger proceeds they received to the corporation. In Gilliland, however, the court required only that the shareholders remit only a portion of the merger proceeds, and then only to an escrow fund, not the corporation. Clearly, the Gilliland court was attempting to craft a remedy that in some aspects resembled a statutory appraisal, yet eliminated the aspects of appraisal that, in the court's view, would operate inequitably in this remedial setting. 873 A.2d at 311 ("Therefore, the court must look beyond the [appraisal] statute to fashion a proper remedy."). The critical point is that, in analyzing whether the opt in and escrow requirements imposed in Gilliland and this case are remedially appropriate, those requirements are not the subject of any pre-existing legal mandate.

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requires the minority shareholders to opt in to become members of the plaintiff class. The other choice would treat those shareholders automatically as members of the class--that is, as having already opted in. Those shareholders would continue as members of the class, unless and until individual members opt out after receiving the remedial supplemental disclosure and the Rule 23 notice of class action informing them of their opt out right.[16] From the minority's standpoint, the first alternative is potentially more burdensome than the second, because shareholders that fail either to opt in or to opt in within a prescribed time, forfeit the opportunity to seek an appraisal recovery. On the other hand, structuring the remedy as an "opt out" class action avoids that risk of forfeiture, and thus benefits the minority shareholders. To the corporation, however, neither alternative is more burdensome than the other. Under either alternative the company will know at a relatively early stage which shareholders are (and are not) members of the class.

Given these choices, it is self evident which alternative is optimal. As between an opt in requirement that would potentially burden shareholders desiring to seek an appraisal recovery but would impose no burden on the corporation, and an opt out requirement that would impose a lesser burden on the shareholders but again no burden on the corporation, the latter alternative is superior and is the remedy that the trial court should have ordered.

That leaves the requirement that the minority shareholders electing to participate in the quasi-appraisal must escrow a portion of the merger proceeds that they received. The rationale for this requirement, as stated in *Gilliland*, is "to mimic, at least in small part, the risks of a statutory appraisal … to promote well reasoned judgments by potential class members and to avoid awarding a 'windfall' to those shareholders who made an informed decision [after receiving the original notice of merger] to take the cash rather than pursue their statutory appraisal remedy."

The defendants-appellees argue that it is fair and equitable to require the minority shareholders to escrow some portion of the merger proceeds. Otherwise (defendants say), the shareholders would have it both ways: they could retain the merger proceeds they received and at the same time litigate to recover a higher amount--a dual benefit they would not have in an actual appraisal. It is true that the minority shareholders would enjoy that "dual benefit." But, does that make it inequitable from the fiduciary's standpoint? We think not. No positive rule of law cited to us requires replicating the burdens imposed in an actual statutory appraisal. Indeed, our law allows the minority to enjoy that dual benefit in the related setting of a class action challenging a long form merger on fiduciary duty grounds. In that setting the shareholder class members may retain the merger proceeds and simultaneously

[16] Court of Chancery Rule 23(c)(2) relevantly provides that:

> HN7 In any class action maintained under paragraph (b)(3), the Court shall direct to the members of the class the best notice practicable under the circumstances, including individual notice to all members who can be identified through reasonable effort. The notice shall advise each member that:
> (A) The Court will exclude a member from the class if the member so requests by a specified date….

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pursue the class action remedy. The defendants cite no case authority, nor are we aware of any, holding that that in the long form merger context that benefit is inequitable to the majority shareholder accused of breaching its fiduciary duty.

Lastly, fairness requires that the corporation be held to the same strict standard of compliance with the appraisal statute as the minority shareholders. Our case law is replete with examples where dissenting minority shareholders that failed to comply strictly with certain technical requirements of the appraisal statute, were held to have lost their entitlement to an appraisal,[17] and, consequently, lost the opportunity to recover the difference between the fair value of their shares and the merger price. These technical statutory violations were not curable, so that irrespective of the equities the unsuccessful appraisal claimant could not proceed anew. That result effectively allowed the corporation to retain the entire difference between fair value and the merger price attributable to the shares for which appraisal rights were lost. The appraisal statute should be construed evenhandedly, not as a one-way street. Minority shareholders who fail to observe the appraisal statute's technical requirements risk forfeiting their statutory entitlement to recover the fair value of their shares. In fairness, majority stockholders that deprive their minority shareholders of material information should forfeit their statutory right to retain the merger proceeds payable to shareholders who, if fully informed, would have elected appraisal.

In cases where the corporation does not comply with the disclosure requirement mandated by *Glassman*, the quasi-appraisal remedy that operates in the fairest and most balanced way and that best effectuates the legislative intent underlying Section 253, is the one that does not require the minority shareholders seeking a recovery of fair value to escrow a portion of the merger proceeds they received. We hold, for these reasons, that the quasi-appraisal remedy ordered by the Court of Chancery was legally erroneous in the circumstances presented here.

* * *

To summarize: where there is a breach of the duty of disclosure in a short form merger, the *Gilliland* approach does not appropriately balance the equities. If only a technical and non-prejudicial violation of 8 *Del. C.* § 253 had occurred, the result

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[17] See, e.g., Raab v. Villager Indus., Inc., 355 A.2d 888, 892-94 (Del. 1976) (requiring strict compliance with the "demand for payment" and "timely delivery" requirements of the appraisal statute); Tabbi v. Pollution Control Indus., Inc., 508 A.2d 867, 873 (Del. Ch. 1986) (overruled on other grounds by Enstar Corp. v. Senouf, 535 A.2d 1351, 1357 n.7 (Del. 1987)) (persons who were not record shareholders as of the merger date, even though they filed a timely demand for appraisal, held not entitled to appraisal)); Konfirst v. Willow CSN, Inc., 2006 Del. Ch. LEXIS 211, 2006 WL 3803469, at *1 (Del. Ch. Dec. 14, 2006) (holding that appraisal demands postmarked after the statutory deadline were time-barred, despite shareholders' claim that their receipt of a notice of merger was delayed because they moved or were on vacation). Our cases hold that although the requirements of the appraisal statute are to be liberally construed for the protection of objecting stockholders, that must be done within the boundaries of orderly corporate procedures and the purpose of the requirement. Raab v. Villager Indus., Inc., 355 A.2d at 891 (citing Salt Dome Oil Corp. v. Schenck, 28 Del. Ch. 433, 41 A.2d 583 (Del. Ch. 1945); and Carl M. Loeb Rhoades & Co. v. Hilton Hotels Corp., 43 Del. Ch. 206, 222 A.2d 789 (Del. 1986)).

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might be different. In some circumstances, for example, where stockholders receive an incomplete copy of the appraisal statute with their notice of merger, the *Gilliland* remedy might arguably be supportable. But the majority stockholder's duty of disclosure provides important protection for minority stockholders being cashed out in a short form merger. This protection the quasi--appraisal remedy for a violation of that fiduciary disclosure obligation--should not be restricted by opt in or escrow requirements.

CONCLUSION

For the foregoing reasons, the judgment of the Court of Chancery is reversed, and the case is remanded for proceedings consistent with this Opinion.

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III. CHAPTER 3, DIRECTORS' DUTIES IN MERGERS AND ACQUISITIONS

A. Page 117, New Sec. 3.10.D.1. Delaware Supreme Court's View of Caremark Claims and Elaboration on Good Faith--Stone

Page 117, New Sec. 3.10.D.1. Add before Sec. 3.10.E the following:

New Sec. 3.10.D.1. **Delaware Supreme Court's View of Caremark Claims and Elaboration on Good Faith—*Stone***

Stone v. Ritter
Delaware Supreme Court 2006
911 A.2d 362

HOLLAND, Justice:

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

The Court of Chancery characterized the allegations in the derivative complaint as a "classic Caremark claim," a claim that derives its name from In re Caremark Int'l Deriv. Litig.[18] In Caremark, the Court of Chancery recognized that: "[g]enerally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation . . . only a sustained or systematic failure of the board to exercise oversight--such as an utter failure to attempt to assure a reasonable information and reporting system exists--will establish the lack of good faith that is a necessary condition to liability."[19]

In this appeal, the plaintiffs acknowledge that the directors neither "knew [n]or should have known that violations of law were occurring," i.e., that there were no "red flags" before the directors. Nevertheless, the plaintiffs argue that the Court of Chancery erred by dismissing the derivative complaint which alleged that "the defendants had utterly failed to implement any sort of statutorily required monitoring, reporting or information

[18] *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996).
[19] *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d at 971; *see also David B. Shaev Profit Sharing Acct. v. Armstrong*, 2006 Del. Ch. LEXIS 33, 2006 WL 391931, at *5 (Del. Ch.); *Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003).

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controls that would have enabled them to learn of problems requiring their attention." The defendants argue that the plaintiffs' assertions are contradicted by the derivative complaint itself and by the documents incorporated therein by reference.

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

FACTS

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

In 2004, AmSouth and Amsouth Bank paid $40 million in fines and $10 million in civil penalties to resolve government and regulatory

investigations pertaining principally to the failure by bank employees to file "Suspicious Activity Reports" ("SARs"), as required by the federal Bank Secrecy Act ("BSA") [20] and various anti-money-laundering ("AML") regulations. Those investigations were conducted by the United States Attorney's Office for the Southern District of Mississippi ("USAO"), the Federal Reserve, FinCEN and the Alabama Banking Department. No fines or penalties were imposed on AmSouth's directors, and no other regulatory action was taken against them.

The government investigations arose originally from an unlawful "Ponzi" scheme operated by Louis D. Hamric, II and Victor G. Nance. In August 2000, Hamric, then a licensed attorney, and Nance, then a registered investment advisor with Mutual of New York, contacted an AmSouth branch bank in Tennessee to arrange for custodial trust accounts to be created for "investors" in a "business venture." That venture (Hamric and Nance represented) involved the construction of medical clinics overseas. In reality, Nance had convinced more than forty of his clients to invest in promissory notes bearing high rates of return, by misrepresenting the nature and the risk of that investment. Relying on similar misrepresentations by Hamric and Nance, the AmSouth branch employees in Tennessee agreed to provide custodial accounts for the investors and to

[20] 31 U.S.C. 5318 (2006) *et seq*. The Bank Secrecy Act and the regulations promulgated thereunder require banks to file with the Financial Crimes Enforcement Network, a bureau of the U.S. Department of the Treasury known as "FinCEN," a written "Suspicious Activity Report" (known as a "SAR") whenever, *inter alia*, a banking transaction involves at least $5,000 "and the bank knows, suspects, or has reason to suspect" that, among other possibilities, the "transaction involves funds derived from illegal activities or is intended or conducted in order to hide or disguise funds or assets derived from illegal activities. . . ." 31 U.S.C. 5318(g) (2006); 31 C.F.R. 103.18(a)(2) (2006).

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distribute monthly interest payments to each account upon receipt of a check from Hamric and instructions from Nance.

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

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

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

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

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DEMAND FUTILITY AND DIRECTOR INDEPENDENCE

It is a fundamental principle of the Delaware General Corporation Law that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . ." [21] Thus, "by its very nature [a] derivative action impinges on the managerial freedom of directors." [22] Therefore, the right of a stockholder to prosecute a derivative suit is limited to situations where either the stockholder has demanded the directors pursue a corporate claim and the directors have wrongfully refused to do so, or where demand is excused because the directors are incapable of making an impartial decision regarding whether to institute such litigation.[23] Court of Chancery Rule 23.1, accordingly, requires that the complaint in a derivative action "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors [or] the reasons for the plaintiff's failure to obtain the action or for not making the effort."[24]

In this appeal, the plaintiffs concede that "[t]he standards for determining demand futility in the absence of a business decision" are set forth in *Rales v. Blasband.*[25] To excuse demand under *Rales*, "a court must determine whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." The plaintiffs attempt to satisfy the *Rales* test in this proceeding by asserting that the incumbent defendant directors "face a substantial likelihood of liability" that renders them "personally interested in the outcome of the decision on whether to pursue the claims asserted in the complaint," and are therefore not disinterested or independent.

Critical to this demand excused argument is the fact that the directors' potential personal liability depends upon whether or not their conduct can be exculpated by the section 102(b)(7) provision contained in the AmSouth certificate of incorporation. Such a provision can exculpate directors from monetary liability for a breach of the duty of care, but not for conduct that is not in good faith or a breach of the duty of loyalty. The standard for assessing a director's potential personal liability for failing to act in good faith in discharging his or her oversight responsibilities has evolved beginning with our decision in Graham v. Allis-Chalmers Manufacturing Company, [26] through the Court of Chancery's Caremark decision to our most recent decision in Disney. A brief discussion of that evolution will help illuminate the standard that we adopt in this case.

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[21] Del. Code Ann. tit. 8, 141(a) (2006). *See Rales v. Blasband*, 634 A.2d 927, 932 (Del. 1993).
[22] *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984).
[23] *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).
[24] Ch. Ct. R. 23.1. Allegations of demand futility under Rule 23.1 "must comply with stringent requirements of factual particularity that differ substantially from the permissive notice pleadings governed solely by Chancery Rule 8(a)." *Brehm v. Eisner*, 746 A.2d at 254.
[25] *Rales v. Blasband*, 634 A.2d 927 (Del. 1993).
[26] *Graham v. Allis-Chalmers Mfg. Co.*, 41 Del. Ch. 78, 188 A.2d 125 (Del. 1963).

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Graham and Caremark

Graham was a derivative action brought against the directors of Allis-Chalmers for failure to prevent violations of federal anti-trust laws by Allis-Chalmers employees. There was no claim that the Allis-Chalmers directors knew of the employees' conduct that resulted in the corporation's liability. Rather, the plaintiffs claimed that the Allis-Chalmers directors *should have known* of the illegal conduct by the corporation's employees. In *Graham*, this Court held that "*absent cause for suspicion* there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists."[27]

In *Caremark*, the Court of Chancery reassessed the applicability of our holding in *Graham* when called upon to approve a settlement of a derivative lawsuit brought against the directors of Caremark International, Inc. The plaintiffs claimed that the Caremark directors should have known that certain officers and employees of Caremark were involved in violations of the federal Anti-Referral Payments Law. That law prohibits health care providers from paying any form of remuneration to induce the referral of Medicare or Medicaid patients. The plaintiffs claimed that the *Caremark* directors breached their fiduciary duty for having "allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in so doing they violated a duty to be active monitors of corporate performance."[28]

In evaluating whether to approve the proposed settlement agreement in Caremark, the Court of Chancery narrowly construed our holding in Graham "as standing for the proposition that, absent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company's behalf." The Caremark Court opined it would be a "mistake" to interpret this Court's decision in Graham to mean that: corporate boards may satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.

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

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[27] *Graham v. Allis-Chalmers Mfg.* Co., 188 A.2d at 130 (emphasis added).
[28] *In re Caremark Int'l Inc. Deriv. Litig*., 698 A.2d 959, 967 (Del. Ch. 1996).

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directors are unaware of employee misconduct that results in the corporation being held liable:

> Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation, as in Graham or in this case, . . . only a sustained or systematic failure of the board to exercise oversight-such as an utter failure to attempt to assure a reasonable information and reporting system exists-will establish the lack of good faith that is a necessary condition to liability.

Caremark Standard Approved

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

> A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.

The third of these examples describes, and is fully consistent with, the lack of good faith conduct that the *Caremark* court held was a "necessary condition" for director oversight liability, i.e., "a sustained or systematic failure of the board to exercise oversight-such as an utter failure to attempt to assure a reasonable information and reporting system exists …[29]

Indeed, our opinion in *Disney* cited *Caremark* with approval for that proposition.[30] Accordingly, the Court of Chancery applied the correct standard in assessing whether demand was excused in this case where failure to exercise oversight was the basis or theory of the plaintiffs' claim for relief.

It is important, in this context, to clarify a doctrinal issue that is critical to understanding fiduciary liability under *Caremark* as we construe that case. The phraseology used in *Caremark* and that we employ here--describing the lack of good faith as a "necessary condition to liability"--is deliberate. The purpose of that formulation is to communicate that a failure to act in good faith is not conduct that results, *ipso facto*, in the direct

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[29] *In re Caremark Int'l Inc. Deriv. Litig.,* 698 A.2d 959, 971 (Del. Ch. 1996).
[30] *In re Walt Disney Co. Deriv. Litig.,* 906 A.2d at 67 n.111.

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imposition of fiduciary liability.[31] The failure to act in good faith may result in liability because the requirement to act in good faith "is a subsidiary element[,]" i.e., a condition, "of the fundamental duty of loyalty."[32] It follows that because a showing of bad faith conduct, in the sense described in *Disney and Caremark*, is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty.

This view of a failure to act in good faith results in two additional doctrinal consequences. First, although good faith may be described colloquially as part of a "triad" of fiduciary duties that includes the duties of care and loyalty,[33] the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly. The second doctrinal consequence is that the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith. As the Court of Chancery aptly put it in *Guttman*, "[a] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest."[34]

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

Chancery Court Decision

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

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[31] That issue, whether a violation of the duty to act in good faith is a basis for the direct imposition of liability, was expressly left open in *Disney.* 906 A.2d at 67 n.112. We address that issue here.
[32] *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003).
[33] *See Cede & Co. v. Technicolor, Inc.,* 634 A.2d 345, 361 (Del. 1993).
[34] *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003).

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This case is not about a board's failure to carefully consider a material corporate decision that was presented to the board. This is a case where information was not reaching the board because of ineffective internal controls. . . . With the benefit of hindsight, it is beyond question that AmSouth's internal controls with respect to the Bank Secrecy Act and anti-money laundering regulations compliance were inadequate. Neither party disputes that the lack of internal controls resulted in a huge fine--$50 million, alleged to be the largest ever of its kind. The fact of those losses, however, is not alone enough for a court to conclude that a majority of the corporation's board of directors is disqualified from considering demand that AmSouth bring suit against those responsible.[35]
This Court reviews *de novo* a Court of Chancery's decision to dismiss a derivative suit under Rule 23.1.[36]

Reasonable Reporting System Existed

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

The KPMG Report describes the numerous AmSouth employees, departments and committees established by the Board to oversee AmSouth's compliance with the BSA and to report violations to management and the Board:
BSA Officer. Since 1998, AmSouth has had a "BSA Officer" "responsible for all BSA/AML-related matters including employee training, general communications, CTR reporting and SAR reporting," and "presenting AML policy and program changes to the Board of Directors, the managers at the various lines of business, and participants in the annual training of security and audit personnel[;]"

BSA/AML Compliance Department. AmSouth has had for years a BSA/AML Compliance Department, headed by the BSA Officer and comprised of nineteen professionals, including a BSA/AML Compliance Manager and a Compliance Reporting Manager;

Corporate Security Department. AmSouth's Corporate Security Department has been at all relevant times responsible for the detection and reporting of suspicious activity as it relates to fraudulent activity, and William Burch, the head of Corporate Security, has been with AmSouth since 1998 and served in the U.S. Secret Service from 1969 to 1998; and

Suspicious Activity Oversight Committee. Since 2001, the "Suspicious Activity Oversight Committee" and its predecessor, the "AML Committee," have actively overseen AmSouth's BSA/AML compliance program. The Suspicious Activity Oversight

[35] *Stone v. Ritter*, 2006 Del. Ch. LEXIS 20, C.A. No. 1570-N (Del. Ch. 2006) (Letter Opinion).
[36] *Beam ex rel. Martha Stewart Living Omnimedia Inc. v. Stewart*, 845 A.2d 1040, 1048 (Del. 2004).

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Committee's mission has for years been to "oversee the policy, procedure, and process issues affecting the Corporate Security and BSA/AML Compliance Programs, to ensure that an effective program exists at AmSouth to deter, detect, and report money laundering, suspicious activity and other fraudulent activity."

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

The KPMG Report shows that AmSouth's Board at various times enacted written policies and procedures designed to ensure compliance with the BSA and AML regulations. For example, the Board adopted an amended bank-wide "BSA/AML Policy" on July 17, 2003--four months before AmSouth became aware that it was the target of a government investigation. That policy was produced to plaintiffs in response to their demand to inspect AmSouth's books and records pursuant to section 220[37] and is included in plaintiffs' appendix. Among other things, the July 17, 2003, BSA/AML Policy directs all AmSouth employees to immediately report suspicious transactions or activity to the BSA/AML Compliance Department or Corporate Security.

Complaint Properly Dismissed

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

For the plaintiffs' derivative complaint to withstand a motion to dismiss, "only a sustained or systematic failure of the board to exercise oversight-such as an utter failure to attempt to assure a reasonable information and reporting system exists--will establish the lack of good faith that is a necessary condition to liability." As the *Caremark* decision noted:
Such a test of liability--lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight--is quite high. But, a demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a

[37] Del. Code Ann. tit. 8, 220 (2006).

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class, as it is in the board decision context, since it makes board service by qualified persons more likely, while continuing to act as a stimulus to *good faith performance of duty* by such directors.

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

With the benefit of hindsight, the plaintiffs’ complaint seeks to equate a bad outcome with bad faith. The lacuna in the plaintiffs’ argument is a failure to recognize that the directors’ good faith exercise of oversight responsibility may not invariably prevent employees from violating criminal laws, or from causing the corporation to incur significant financial liability, or both, as occurred in *Graham*, *Caremark* and this very case. In the absence of red flags, good faith in the context of oversight must be measured by the directors’ actions “to assure a reasonable information and reporting system exists” and not by second-guessing after the occurrence of employee conduct that results in an unintended adverse outcome. Accordingly, we hold that the Court of Chancery properly applied *Caremark* and dismissed the plaintiffs’ derivative complaint for failure to excuse demand by alleging particularized facts that created reason to doubt whether the directors had acted in good faith in exercising their oversight responsibilities.

CONCLUSION

The judgment of the Court of Chancery is affirmed.

B. Page 117, New Sec. 3.10.D.2. The Business Judgment Rule and the Financial Crisis—Citigroup and AIG

Page 117, New Sec. 3.10.D.2. Add after the New Sec. 3.10.D.1 the following:
New Sec. 3.10.D.2. **The Business Judgment Rule and the Financial Crisis—Citigroup and AIG**

In Re Citigroup Inc. Shareholder Derivative Litigation,
Delaware Chancery Court, 964 A.2d 106, 2009
(**The AIG case is discussed in Citigroup**.)

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CHANDLER, Chancellor

This is a shareholder derivative action brought on behalf of Citigroup Inc. ("Citigroup" or the "Company"), seeking to recover for the Company its losses arising from exposure to the subprime lending market. Plaintiffs, shareholders of Citigroup, brought this action against current and former directors and officers of Citigroup, alleging, in essence, that the defendants breached their fiduciary duties by failing to properly monitor and manage the risks the Company faced from problems in the subprime lending market and for failing to properly disclose Citigroup's exposure to subprime assets. Plaintiffs allege that there were extensive "red flags" that should have given defendants notice of the problems that were brewing in the real estate and credit markets and that defendants ignored these warnings in the pursuit of short term profits and at the expense of the Company's long term viability.

Plaintiffs further allege that certain defendants are liable to the Company for corporate waste for (1) allowing the Company to purchase $ 2.7 billion in subprime loans from Accredited Home Lenders in March 2007 and from Ameriquest Home Mortgage in September 2007; (2) authorizing and not suspending the Company's share repurchase program in the first quarter of 2007, which allegedly resulted in the Company buying its own shares at "artificially inflated prices;" (3) approving a multi-million dollar payment and benefit package for defendant Charles Prince, whom plaintiffs describe as largely responsible for Citigroup's problems, upon his retirement as Citigroup's CEO in November 2007; and (4) allowing the Company to invest in structured investment vehicles ("SIVs") that were unable to pay off maturing debt.

Pending before the Court is defendants' motion (1) to dismiss or stay the action in favor of an action pending in the Southern District of New York (the "New York Action") or (2) to dismiss the complaint for failure to state a claim under Court of Chancery Rule 12(b)(6) and for failure to properly plead demand futility under Court of Chancery Rule 23.1. For the reasons set forth below, the motion to stay or dismiss in favor of the New York Action is denied. The motion to dismiss is denied as to the claim in Count III for waste for approval of the November 4, 2007 Prince letter agreement. All other claims are dismissed for failure to adequately plead demand futility pursuant to Rule 23.1.

BACKGROUND * * *

MOTION TO DISMISS OR STAY IN FAVOR OF THE NEW YORK ACTION * * *

THE MOTION TO DISMISS UNDER RULE 23.1

THE LEGAL STANDARD FOR DEMAND EXCUSED

The decision whether to initiate or pursue a lawsuit on behalf of the corporation is

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generally within the power and responsibility of the board of directors.[38] This follows from the "cardinal precept of the General Corporation Law of the State of Delaware . . . that directors, rather than shareholders, manage the business and affairs of the corporation."[39] Accordingly, in order to cause the corporation to pursue litigation, a shareholder must either (1) make a pre-suit demand by presenting the allegations to the corporation's directors, requesting that they bring suit, and showing that they wrongfully refused to do so, or (2) plead facts showing that demand upon the board would have been futile.[40] Where, as here, a plaintiff does not make a pre-suit demand on the board of directors, the complaint must plead with particularity facts showing that a demand on the board would have been futile.[41] The purpose of the demand requirement is not to insulate defendants from liability; rather, the demand requirement and the strict requirements of factual particularity under Rule 23.1 "exist[] to preserve the primacy of board decisionmaking regarding legal claims belonging to the corporation."[42]

Under the familiar *Aronson* test, to show demand futility, plaintiffs must provide particularized factual allegations that raise a reasonable doubt that "(1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." Where, however, plaintiffs complain of board inaction and do not challenge a specific decision of the board, there is no "challenged transaction," and the ordinary *Aronson* analysis does not apply. Instead, to show demand futility where the subject of the derivative suit is not a business decision of the board, a plaintiff must allege particularized facts that "create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."

In evaluating whether demand is excused, the Court must accept as true the well pleaded factual allegations in the Complaint. The pleadings, however, are held to a higher standard under Rule 23.1 than under the permissive notice pleading standard under Court of Chancery Rule 8(a). To establish that demand is excused under Rule 23.1, the pleadings must comply with "stringent requirements of factual particularity" and set forth "particularized factual statements that are essential to the claim." "A prolix complaint larded with conclusory language . . . does not comply with these fundamental pleading mandates."

Plaintiffs have not alleged that a majority of the board was not independent for purposes of evaluating demand. Rather, as to the claims for waste asserted in Count III, plaintiffs allege that the approval of certain transactions did not constitute a valid exercise of business judgment under the second prong of the *Aronson* test. Plaintiffs allege that demand is futile as to Counts I, II, and IV because the director defendants are not able to exercise disinterested business judgment in responding to a demand because their failure

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[38] 8 *Del. C.* § 141(a).
[39] *Aronson v. Lewis,* 473 A.2d 805, 811 (Del. 1984).
[40] *See Stone v. Ritter,* 911 A.2d 362, 366-67 (Del. 2006).
[41] Ct. Ch. R. 23.1(a); *see Stone,* 911 A.2d at 367 n.9; *Brehm v. Eisner,* 746 A.2d 244, 254 (Del. 2000).
[42] *Am. Int'l Group, Inc., Consol. Derivative Litig.,* C.A. No. 769-VCS, 2009 Del. Ch. LEXIS 15, 2009 WL 366613, at *29 (Del. Ch. Feb. 10, 2009).

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of oversight subjects them to a substantial likelihood of personal liability. According to plaintiffs, the director defendants face a substantial threat of personal liability because their conscious disregard of their duties and lack of proper supervision and oversight caused the Company to be overexposed to risk in the subprime mortgage market.

Demand is not excused solely because the directors would be deciding to sue themselves. Rather, demand will be excused based on a possibility of personal director liability only in the rare case when a plaintiff is able to show director conduct that is "so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists." [43]

DEMAND FUTILITY REGARDING PLAINTIFFS' FIDUCIARY DUTY CLAIMS

Plaintiffs' argument is based on a theory of director liability famously articulated by former-Chancellor Allen in *In re Caremark.*[44] Before *Caremark,* in *Graham v. Allis-Chalmers Manufacturing Company,* the Delaware Supreme Court, in response to a theory that the Allis-Chalmers directors were liable because they should have known about employee violations of federal anti-trust laws, held that "absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists." Over thirty years later, in the context of approval of a settlement of a class action, former-Chancellor Allen took the opportunity to revisit the duty to monitor under Delaware law. In *Caremark,* the plaintiffs alleged that the directors were liable because they should have known that certain officers and employees were violating the federal Anti-Referral Payments Law. In analyzing these claims, the Court began, appropriately, by reviewing the duty of care and the protections of the business judgment rule.

With regard to director liability standards, the Court distinguished between (1) "*a board decision* that results in a loss because that decision was ill advised or 'negligent'" and (2) "an *unconsidered failure of the board to act* in circumstances in which due attention would, arguably, have prevented the loss." In the former class of cases, director action is analyzed under the business judgment rule, which prevents judicial second guessing of

[43] *Aronson,* 473 A.2d at 815. The Complaint appears to allege that demand on defendants Rubin and Ramirez would be futile because 1) Rubin faces a substantial threat of personal liability because he benefited personally by wrongfully selling stock while in possession of material non-public information; 2) Rubin is beholden to defendants Belda, Derr, and Parsons due to the extraordinary monetary compensation and other benefits they approved for him while he was a director and despite his lack of operational responsibility; and 3) Ramirez is not independent because he ran a subsidiary of Citigroup and received security and other services valued at more than $ 2 million from Citigroup while doing so. *See* Compl. PP 181-82. The Court does not need to determine the adequacy of these demand futility allegations because plaintiffs have not made similar individualized allegations regarding the other director defendants. Thus, even if the allegations in the Complaint are sufficient to excuse demand as to Rubin and Ramirez, plaintiffs have still failed to properly plead demand futility for a majority of the director defendants. As further explained below, instead of providing similar individualized assertions for the other director defendants, plaintiffs rely on the "group" accusation mode of pleading demand futility. Had plaintiffs provided individual allegations as to each of the director defendants, the outcome of this case may have been different.

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

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the decision if the directors employed a rational process and considered all material information reasonably available--a standard measured by concepts of gross negligence. As former-Chancellor Allen explained:

> What should be understood, but may not widely be understood by courts or commentators who are not often required to face such questions, is that compliance with a director's duty of care can never appropriately be judicially determined by reference to *the content of the board decision* that leads to a corporate loss, apart from consideration of the good faith *or* rationality of the process employed. That is, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through "stupid" to "egregious" or "irrational", provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in *a good faith* effort to advance corporate interests. To employ a different rule--one that permitted an "objective" evaluation of the decision--would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests. Thus, the business judgment rule is process oriented and informed by a deep respect for all *good faith* board decisions.

In the latter class of cases, where directors are alleged to be liable for a failure to monitor liability creating activities, the *Caremark* Court, in a reassessment of the holding in *Graham,* stated that while directors could be liable for a failure to monitor, "only a sustained or systematic failure of the board to exercise oversight--such as an utter failure to attempt to assure a reasonable information and reporting system exists--will establish the lack of good faith that is a necessary condition to liability."

In *Stone v. Ritter,* the Delaware Supreme Court approved the *Caremark* standard for director oversight liability and made clear that liability was based on the concept of good faith, which the *Stone* Court held was embedded in the fiduciary duty of loyalty and did not constitute a freestanding fiduciary duty that could independently give rise to liability. As the *Stone* Court explained:

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

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Thus, to establish oversight liability a plaintiff must show that the directors *knew* they were not discharging their fiduciary obligations or that the directors demonstrated a *conscious* disregard for their responsibilities such as by failing to act in the face of a known duty to act.[45] The test is rooted in concepts of bad faith; indeed, a showing of bad faith is a *necessary condition* to director oversight liability.[46]

Plaintiffs' Caremark Allegations

Plaintiffs' theory of how the director defendants will face personal liability is a bit of a twist on the traditional *Caremark* claim. In a typical *Caremark* case, plaintiffs argue that the defendants are liable for damages that arise from a failure to properly monitor or oversee employee misconduct or violations of law. For example, in *Caremark* the board allegedly failed to monitor employee actions in violation of the federal Anti-Referral Payments Law; in *Stone,* the directors were charged with a failure of oversight that resulted in liability for the company because of employee violations of the federal Bank Secrecy Act.

In contrast, plaintiffs' *Caremark* claims are based on defendants' alleged failure to properly monitor Citigroup's *business risk,* specifically its exposure to the subprime mortgage market. In their answering brief, plaintiffs allege that the director defendants are personally liable under *Caremark* for failing to "make a good faith attempt to follow the procedures put in place or fail[ing] to assure that adequate and proper corporate information and reporting systems existed that would enable them to be fully informed regarding Citigroup's risk to the subprime mortgage market." Plaintiffs point to so-called "red flags" that should have put defendants on notice of the problems in the subprime mortgage market and further allege that the board should have been especially conscious of these red flags because a majority of the directors (1) served on the Citigroup board during its previous Enron related conduct and (2) were members of the ARM Committee and considered financial experts.

Although these claims are framed by plaintiffs as *Caremark* claims, plaintiffs' theory essentially amounts to a claim that the director defendants should be personally liable to the Company because they failed to fully recognize the risk posed by subprime securities. When one looks past the lofty allegations of duties of oversight and red flags used to

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[45] *See Guttman v. Huang,* 823 A.2d 492, 506 (Del. Ch. 2003) ("[T]he [*Caremark*] opinion articulates a standard for liability for failures of oversight that requires a showing that the directors breached their duty of loyalty by failing to attend to their duties in good faith. Put otherwise, the decision premises liability on a showing that the directors were conscious of the fact that they were not doing their jobs.") (footnote omitted).

[46] *Stone,* 911 A.2d at 369; *Desimone v. Barrows,* 924 A.2d 908, 935 (Del. Ch. 2007) ("*Caremark* itself encouraged directors to act with reasonable diligence, but plainly held that director liability for failure to monitor required a finding that the directors acted with the state of mind traditionally used to define the mindset of a disloyal director--bad faith--because their indolence was so persistent that it could not be ascribed to anything other than a knowing decision not to even try to make sure the corporation's officers had developed and were implementing a prudent approach to ensuring law compliance. By reinforcing that a scienter-based standard applies to claims in the delicate monitoring context, *Stone* ensured that the protections that exculpatory charter provisions afford to independent directors against damage claims would not be eroded.") (footnotes omitted).

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dress up these claims, what is left appears to be plaintiff shareholders attempting to hold the director defendants personally liable for making (or allowing to be made) business decisions that, in hindsight, turned out poorly for the Company. Delaware Courts have faced these types of claims many times and have developed doctrines to deal with them--the fiduciary duty of care and the business judgment rule. These doctrines properly focus on the decision-making process rather than on a substantive evaluation of the merits of the decision. This follows from the inadequacy of the Court, due in part to a concept known as hindsight bias, to properly evaluate whether corporate decision-makers made a "right" or "wrong" decision.

The business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." The burden is on plaintiffs, the party challenging the directors' decision, to rebut this presumption. Thus, absent an allegation of interestedness or disloyalty to the corporation, the business judgment rule prevents a judge or jury from second guessing director decisions if they were the product of a rational process and the directors availed themselves of all material and reasonably available information. The standard of director liability under the business judgment rule "is predicated upon concepts of gross negligence."

Additionally, Citigroup has adopted a provision in its certificate of incorporation pursuant to 8 *Del. C.* § 102(b)(7) that exculpates directors from personal liability for violations of fiduciary duty, except for, among other things, breaches of the duty of loyalty or actions or omissions not in good faith or that involve intentional misconduct or a knowing violation of law. Because the director defendants are "exculpated from liability for certain conduct, 'then a serious threat of liability may only be found to exist if the plaintiff pleads a *non-exculpated* claim against the directors based on particularized facts.'" Here, plaintiffs have not alleged that the directors were interested in the transaction and instead root their theory of director personal liability in bad faith.

The Delaware Supreme Court has stated that bad faith conduct may be found where a director "intentionally acts with a purpose other than that of advancing the best interests of the corporation, . . . acts with the intent to violate applicable positive law, or . . . intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." More recently, the Delaware Supreme Court held that when a plaintiff seeks to show that demand is excused because directors face a substantial likelihood of liability where "directors are exculpated from liability except for claims based on 'fraudulent,' 'illegal' or 'bad faith' conduct, a plaintiff must also plead particularized facts that demonstrate that the directors acted with scienter, *i.e.,* that they had 'actual or constructive knowledge' that their conduct was legally improper." A plaintiff can thus plead bad faith by alleging with particularity that a director *knowingly* violated a fiduciary duty or failed to act in violation of a *known* duty to act, demonstrating a *conscious* disregard for her duties.

Turning now specifically to plaintiffs' *Caremark* claims, one can see a similarity between the standard for assessing oversight liability and the standard for assessing a disinterested

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director's decision under the duty of care when the company has adopted an exculpatory provision pursuant to § 102(b)(7). In either case, a plaintiff can show that the director defendants will be liable if their acts or omissions constitute bad faith. A plaintiff can show bad faith conduct by, for example, properly alleging particularized facts that show that a director *consciously* disregarded an obligation to be reasonably informed about the business and its risks or *consciously* disregarded the duty to monitor and oversee the business.

The Delaware Supreme Court made clear in *Stone* that directors of Delaware corporations have certain responsibilities to implement and monitor a system of oversight; however, this obligation does not eviscerate the core protections of the business judgment rule--protections designed to allow corporate managers and directors to pursue risky transactions without the specter of being held personally liable if those decisions turn out poorly. Accordingly, the burden required for a plaintiff to rebut the presumption of the business judgment rule by showing gross negligence is a difficult one, and the burden to show bad faith is even higher. Additionally, as former-Chancellor Allen noted in *Caremark,* director liability based on the duty of oversight "is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." The presumption of the business judgment rule, the protection of an exculpatory § 102(b)(7) provision, and the difficulty of proving a *Caremark* claim together function to place an extremely high burden on a plaintiff to state a claim for personal director liability for a failure to see the extent of a company's business risk.

To the extent the Court allows shareholder plaintiffs to succeed on a theory that a director is liable for a failure to monitor business risk, the Court risks undermining the well settled policy of Delaware law by inviting Courts to perform a hindsight evaluation of the reasonableness or prudence of directors' business decisions. Risk has been defined as the chance that a return on an investment will be different that expected. The essence of the business judgment of managers and directors is deciding how the company will evaluate the trade-off between risk and return. Businesses--and particularly financial institutions--make returns by taking on risk; a company or investor that is willing to take on more risk can earn a higher return. Thus, in almost any business transaction, the parties go into the deal with the knowledge that, even if they have evaluated the situation correctly, the return could be different than they expected.

It is almost impossible for a court, in hindsight, to determine whether the directors of a company properly evaluated risk and thus made the "right" business decision.[58] In any investment there is a chance that returns will turn out lower than expected, and generally a smaller chance that they will be far lower than expected. When investments turn out poorly, it is possible that the decision-maker evaluated the deal correctly but got "unlucky" in that a huge loss--the probability of which was very small--actually happened. It is also possible that the decision-maker improperly evaluated the risk posed by an investment and that the company suffered large losses as a result.

Business decision-makers must operate in the real world, with imperfect information, limited resources, and an uncertain future. To impose liability on directors for making a

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"wrong" business decision would cripple their ability to earn returns for investors by taking business risks. Indeed, this kind of judicial second guessing is what the business judgment rule was designed to prevent, and even if a complaint is framed under a *Caremark* theory, this Court will not abandon such bedrock principles of Delaware fiduciary duty law. With these considerations and the difficult standard required to show director oversight liability in mind, I turn to an evaluation of the allegations in the Complaint.

The Complaint Does Not Properly Allege Demand Futility for Plaintiffs' Fiduciary Duty Claims

In this case, plaintiffs allege that the defendants are liable for failing to properly monitor the risk that Citigroup faced from subprime securities. While it may be possible for a plaintiff to meet the burden under some set of facts, plaintiffs in this case have failed to state a *Caremark* claim sufficient to excuse demand based on a theory that the directors did not fulfill their oversight obligations by failing to monitor the business risk of the company.

The allegations in the Complaint amount essentially to a claim that Citigroup suffered large losses and that there were certain warning signs that could or should have put defendants on notice of the business risks related to Citigroup's investments in subprime assets. Plaintiffs then conclude that because defendants failed to prevent the Company's losses associated with certain business risks, they must have consciously ignored these warning signs or knowingly failed to monitor the Company's risk in accordance with their fiduciary duties. Such conclusory allegations, however, are not sufficient to state a claim for failure of oversight that would give rise to a substantial likelihood of personal liability, which would require particularized factual allegations demonstrating bad faith by the director defendants.

Plaintiffs do not contest that Citigroup had procedures and controls in place that were designed to monitor risk. Plaintiffs admit that Citigroup established the ARM Committee and in 2004 amended the ARM Committee charter to include the fact that one of the purposes of the ARM Committee was to assist the board in fulfilling its oversight responsibility relating to policy standards and guidelines for risk assessment and risk management. The ARM Committee was also charged with, among other things, (1) discussing with management and independent auditors the annual audited financial statements, (2) reviewing with management an evaluation of Citigroup's internal control structure, and (3) discussing with management Citigroup's major credit, market, liquidity, and operational risk exposures and the steps taken by management to monitor and control such exposures, including Citigroup's risk assessment and risk management policies. According to plaintiffs' own allegations, the ARM Committee met eleven times in 2006 and twelve times in 2007.

Plaintiffs nevertheless argue that the director defendants breached their duty of oversight either because the oversight mechanisms were not adequate or because the director defendants did not make a good faith effort to comply with the established oversight

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procedures. To support this claim, the Complaint alleges numerous facts that plaintiffs argue should have put the director defendants on notice of the impending problems in the subprime mortgage market and Citigroup's exposure thereto. Plaintiffs summarized some of these "red flags" in their answering brief as follows:

- the steady decline of the housing market and the impact the collapsing bubble would have on mortgages and subprime backed securities since as early as 2005;

- December 2005 guidance from the FASB staff--"The FASB staff is aware of loan products whose contractual features may increase the exposure of the originator, holder, investor, guarantor, or servicer to risk of nonpayment or realization.";

- the drastic rise in foreclosure rates starting in 2006;

- several large subprime lenders reporting substantial losses and filing for bankruptcy starting in 2006;

- billions of dollars in losses reported by Citigroup's peers, such as Bear Stearns and Merrill Lynch.

Plaintiffs argue that demand is excused because a majority of the director defendants face a substantial likelihood of personal liability because they were charged with management of Citigroup's risk as members of the ARM Committee and as audit committee financial experts and failed to properly oversee and monitor such risk. As explained above, however, to establish director oversight liability plaintiffs would ultimately have to prove bad faith conduct by the director defendants. Plaintiffs fail to plead any particularized factual allegations that raise a reasonable doubt that the director defendants acted in good faith.

The warning signs alleged by plaintiffs are not evidence that the directors consciously disregarded their duties or otherwise acted in bad faith; at most they evidence that the directors made bad business decisions. The "red flags" in the Complaint amount to little more than portions of public documents that reflected the worsening conditions in the subprime mortgage market and in the economy generally. Plaintiffs fail to plead "particularized facts suggesting that the Board was presented with 'red flags' alerting it to potential misconduct" at the Company. That the director defendants knew of signs of a deterioration in the subprime mortgage market, or even signs suggesting that conditions could decline further, is not sufficient to show that the directors were or should have been aware of any wrongdoing at the Company or were consciously disregarding a duty somehow to prevent Citigroup from suffering losses. Nothing about plaintiffs' "red flags" supports plaintiffs' conclusory allegation that "defendants have not made a good faith attempt to assure that adequate and proper corporate information and reporting systems existed that would enable them to be fully informed regarding Citigroup's risk to the subprime mortgage market." Indeed, plaintiffs' allegations do not even specify how the board's oversight mechanisms were inadequate or how the director defendants knew of these inadequacies and consciously ignored them. Rather, plaintiffs seem to hope the

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Court will accept the conclusion that since the Company suffered large losses, and since a properly functioning risk management system would have avoided such losses, the directors must have breached their fiduciary duties in allowing such losses.

Moving from such general ipse dixit syllogisms to the more specific, plaintiffs argue that the director defendants, and especially those nine directors who were on the board at the time, "should have been especially sensitive to the red flags in the marketplace in light of the Company's prior involvement in the Enron Corporation debacle and other financial scandals earlier in the decade." Plaintiffs also allege that the director defendants should have been especially alert to the dangers of transactions involving SIVs because SIVs were involved in Citigroup's transactions with Enron that resulted in liability for the Company. Plaintiffs allege that Citigroup helped finance transactions that allowed Enron to hide its true financial condition and resulted in Citigroup paying approximately $ 120 million in penalties and disgorgement as well as agreeing to new risk management procedures designed to prevent similar conduct.

Plaintiffs fail in their attempt to impose some sort of higher standard of liability on the director defendants that were on Citigroup's board at the time of its involvement with Enron. They have utterly failed to show how Citigroup's involvement with the financial scandals at Enron has any relevance to Citigroup's investments in subprime securities. Plaintiffs cite *McCall v. Scott* to support the proposition that directors who were on the board during previous misconduct should be sensitive to similar circumstances which had previously prompted investigations. That case, however, actually shows how plaintiffs' attempt to impose a higher standard on the directors because of the Enron scandal is inadequate. Unlike here, the plaintiffs in *McCall* alleged numerous specific instances of widespread, prevalent wrongdoing throughout the company and the mechanisms by which the wrongdoing came to the board's attention. The Sixth Circuit in *McCall* did *not,* as plaintiffs assert, hold that alleged prior, *unrelated* wrongdoing would make directors "sensitive to similar circumstances." Unlike plaintiffs' allegations about Enron, the prior "experience" referenced in *McCall* was an investigation and settlement for the *same type* of questionable billing practices before the Sixth Circuit. Plaintiffs have not shown how involvement with the Enron related scandals should have in any way put the director defendants on a heightened alert to problems in the subprime mortgage market. Additionally, the use of SIVs in the Enron related conduct would not serve to put the director defendants on any type of heightened notice to the unrelated use of SIVs in structuring transactions involving subprime securities.

The Complaint and plaintiffs' answering brief repeatedly make the conclusory allegation that the defendants have breached their duty of oversight, but nowhere do plaintiffs adequately explain what the director defendants actually did or failed to do that would constitute such a violation. Even while admitting that Citigroup had a risk monitoring system in place, plaintiffs seem to conclude that, because the director defendants (and the ARM Committee members in particular) were charged with monitoring Citigroup's risk, then they must be found liable because Citigroup experienced losses as a result of exposure to the subprime mortgage market. The only factual support plaintiffs provide for this conclusion are "red flags" that actually amount to nothing more than signs of

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continuing deterioration in the subprime mortgage market. These types of conclusory allegations are exactly the kinds of allegations that do not state a claim for relief under *Caremark.*

To recognize such claims under a theory of director oversight liability would undermine the long established protections of the business judgment rule. It is well established that the mere fact that a company takes on business risk and suffers losses--even catastrophic losses--does not evidence misconduct, and without more, is not a basis for personal director liability.[47] That there were signs in the market that reflected worsening conditions and suggested that conditions may deteriorate even further is not an invitation for this Court to disregard the presumptions of the business judgment rule and conclude that the directors are liable because they did not properly evaluate business risk. What plaintiffs are asking the Court to conclude from the presence of these "red flags" is that the directors failed to see the extent of Citigroup's business risk and therefore made a "wrong" business decision by allowing Citigroup to be exposed to the subprime mortgage market.

This Court's recent decision in *American International Group, Inc. Consolidated Derivative Litigation* demonstrates the stark contrast between the allegations here and allegations that are sufficient to survive a motion to dismiss. In *AIG,* the Court faced a motion to dismiss a complaint that included "well-pled allegations of pervasive, diverse, and substantial financial fraud involving managers at the highest levels of AIG." In concluding that the complaint stated a claim for relief under Rule 12(b)(6), the Court held that the factual allegations in the complaint were sufficient to support an inference that AIG executives running those divisions knew of and approved much of the wrongdoing. The Court reasoned that huge fraudulent schemes were unlikely to be perpetrated without the knowledge of the executive in charge of that division of the company. Unlike the allegations in this case, the defendants in *AIG* allegedly failed to exercise reasonable oversight over pervasive *fraudulent* and *criminal* conduct. Indeed, the Court in *AIG* even stated that the complaint there supported the assertion that top AIG officials were leading a "criminal organization" and that "[t]he diversity, pervasiveness, and materiality of the alleged financial wrongdoing at AIG is extraordinary."

Contrast the *AIG* claims with the claims in this case. Here, plaintiffs argue that the Complaint supports the reasonable conclusion that the director defendants acted in bad faith by failing to see the warning signs of a deterioration in the subprime mortgage market and failing to cause Citigroup to change its investment policy to limit its exposure to the subprime market. Director oversight duties are designed to ensure reasonable reporting and information systems exist that would allow directors to know about and prevent wrongdoing that could cause losses for the Company. There are significant differences between failing to oversee employee fraudulent or criminal conduct and failing to recognize the extent of a Company's business risk. Directors should, indeed must under Delaware law, ensure that reasonable information and reporting systems exist

[47] *See Gagliardi v. TriFoods Int'l, Inc.,* 683 A.2d 1049, 1051 (Del. Ch. 1996) ("The business outcome of an investment project that is unaffected by director self-interest or bad faith, cannot itself be an occasion for director liability.") (footnote omitted).

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that would put them on notice of fraudulent or criminal conduct within the company. Such oversight programs allow directors to intervene and prevent frauds or other wrongdoing that could expose the company to risk of loss as a result of such conduct. While it may be tempting to say that directors have the same duties to monitor and oversee business risk, imposing *Caremark-type* duties on directors to monitor business risk is fundamentally different. Citigroup was in the business of taking on and managing investment and other business risks. To impose oversight liability on directors for failure to monitor "excessive" risk would involve courts in conducting hindsight evaluations of decisions at the heart of the business judgment of directors. Oversight duties under Delaware law are not designed to subject directors, even expert directors, to *personal liability* for failure to predict the future and to properly evaluate business risk.[48]

Instead of alleging facts that could demonstrate bad faith on the part of the directors, by presenting the Court with the so called "red flags," plaintiffs are inviting the Court to engage in the exact kind of judicial second guessing that is proscribed by the business judgment rule. In any business decision that turns out poorly there will likely be signs that one could point to and argue are evidence that the decision was wrong. Indeed, it is tempting in a case with such staggering losses for one to think that they could have made the "right" decision if they had been in the directors' position. This temptation, however, is one of the reasons for the presumption against an objective review of business decisions by judges, a presumption that is no less applicable when the losses to the Company are large.

Plaintiffs' Disclosure Allegations

Plaintiffs argue that demand is excused as futile because the director defendants face a substantial likelihood of personal liability for violating their duty of disclosure and would therefore be unable to exercise independent and disinterested business judgment in responding to a demand.[49] Plaintiffs allege that the director defendants violated their duty of disclosure by, among other things, failing to properly disclose the value of certain financial instruments, placing underperforming assets in SIVs without fully disclosing the risk that Citigroup might have to bring the assets back onto its balance sheet, and failing to properly account for guarantees, specifically the liquidity puts that allowed buyers of CDOs to sell the products back to Citigroup at face value. Plaintiffs argue that the "red

[48] If defendants had been able to predict the extent of the problems in the subprime mortgage market, then they would not only have been able to avoid losses, but presumably would have been able to make significant gains for Citigroup by taking positions that would have produced a return when the value of subprime securities dropped. Compl. P 78. Query: if the Court were to adopt plaintiffs' theory of the case--that the defendants are personally liable for their failure to see the problems in the subprime mortgage market and Citigroup's exposure to them--then could not a plaintiff succeed on a theory that a director was personally liable for failure to predict the extent of the subprime mortgage crisis and profit from it, even if the company was not exposed to losses from the subprime mortgage market? If directors are going to be held liable for losses for failing to accurately predict market events, then why not hold them liable for failing to profit by predicting market events that, in hindsight, the director should have seen because of certain red (or green?) flags? If one expects director prescience in one direction, why not the other?

[49] Plaintiffs argue that the disclosure claims relate to actions taken by the board and are therefore subject to the *Aronson* standard. Plaintiffs request, however, that the Court review demand futility under the substantial likelihood of liability standard and present their demand futility arguments under that standard.

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flags" alleged in the Complaint lead to a reasonable inference that the director defendants, and particularly the ARM Committee members, knew that certain disclosures regarding the Company's exposure to subprime assets were misleading.

"[E]ven in the absence of a request for shareholder action, shareholders are entitled to honest communication from directors, given with complete candor and in good faith." When there is no request for shareholder action, a shareholder plaintiff can demonstrate a breach of fiduciary duty by showing that the directors "*deliberately* misinform[ed] shareholders about the business of the corporation, either directly or by a public statement."[50] Citigroup's certificate of incorporation exculpates the director defendants from personal liability for violations of fiduciary duty except for, among other things, breaches of the duty of loyalty and acts or omissions not in good faith or that involve intentional misconduct or knowing violation of law. Thus, to show a substantial likelihood of liability that would excuse demand, plaintiffs must plead particularized factual allegations that "support the inference that the disclosure violation was made in bad faith, knowingly or intentionally."
Additionally, directors of Delaware corporations are fully protected in relying in good faith on the reports of officers and experts.[51]

The factual allegations in the Complaint are not sufficient to allow me to reasonably conclude that the director defendants face a substantial likelihood of liability that would prevent them from impartially considering a demand. This is so for at least three reasons. First, plaintiffs fail to allege with sufficient specificity the actual misstatements or omissions that constituted a violation of the board's duty of disclosure.[52] The Complaint merely alleges, in general and conclusory terms, that the director defendants did not adequately disclose certain risks faced by the Company--for example, the risks posed by Citigroup's SIVs and the liquidity puts that allowed purchasers of CDOs to sell the instruments back to Citigroup at face value.[53] The Complaint does not identify any actual

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[50] *Malone v. Brincat,* 722 A.2d 5, 14 (Del. 1998) (emphasis added); *see infoUSA,* 953 A.2d at 990 (finding that directors violate their fiduciary duties "where it can be shown that the directors involved issued their communication with the knowledge that it was deceptive or incomplete").
[51] 8 *Del. C.* § 141(e) ("A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member's duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation."); *see Brehm,* 746 A.2d at 261.
[52] *See Pfeffer v. Redstone,* No. 115, 2008, A.2d, 2009 Del. LEXIS 37, 2009 WL 188887, at *6 (Del. Jan. 23, 2009) ("Although there is 'no reason to depart from the general pleading rules when alleging duty of disclosure violations,' 'it is inherent in disclosure cases that the misstated or omitted facts be identified and that the pleading not be merely conclusory.'") (quoting *Loudon v. Archer-Daniels-Midland Co.,* 700 A.2d 135, 140 (Del. 1997)).
[53] Compl. PP 160-73. To be fair, plaintiffs point to some specific statements in the Complaint. For example, paragraph 82 of the Complaint alleges that the director defendants "caused or allowed" Citigroup to issue a press release that highlighted, among other things, "positive trends from Citigroup's strategic actions." Paragraphs 88 and 99 of the Complaint allege that the director defendants "caused" Citigroup to issue press releases that stated that the Company had "generated strong momentum this quarter" and that cited decreasing credit costs "reflecting a stable global credit environment." Even these allegations, however, fail

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disclosure that was misleading or any statement that was made misleading as a result of an omission of a material fact. Instead, plaintiffs allege, for instance, that the Citigroup board "abdicated its fiduciary duties by not disclosing information on the fair value of VIEs, CDOs and SIVs" and that "the ARM Committee abdicated its fiduciary duties . . . to ensure the integrity of Citigroup's financial statements and financial reporting process, including earnings press releases and financial information provided to analysts and rating agencies."

In other words, the disclosure allegations in the complaint do not meet the stringent standard of factual particularity required under Rule 23.1. They fail to allege with particularity which disclosures were misleading, when the Company was obligated to make disclosures, what specifically the Company was obligated to disclose, and how the Company failed to do so.[54] This information is critical because to establish a threat of director liability based on a disclosure violation, plaintiffs must plead facts that show that the violation was made knowingly or in bad faith, a showing that requires allegations regarding what the directors knew and when. Without knowing when and how the alleged disclosure violations occurred, it is impossible to determine if the directors made the misstatements or omissions knowingly or in bad faith. As a result, the disclosure allegations in the complaint do not meet the stringent requirements of factual particularity under Rule 23.1.

Second, the Complaint does not contain specific factual allegations that reasonably suggest sufficient board involvement in the preparation of the disclosures that would allow me to reasonably conclude that the director defendants face a substantial likelihood of personal liability. Plaintiffs do not allege facts suggesting that the director defendants prepared the financial statements or that they were directly responsible for the misstatements or omissions. The Complaint merely alleges that Citigroup's financial statements contained false statements and material omissions and that the director defendants reviewed the financial statements pursuant to their responsibilities under the ARM Committee charter. Thus, I am unable to reasonably conclude that the director

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to meet the strict pleading requirements under Rule 23.1. Pleading that the director defendants "caused" or "caused or allowed" the Company to issue certain statements is not sufficient particularized pleading to excuse demand under Rule 23.1. It is unclear from such allegations how the board was actually involved in creating or approving the statements, factual details that are crucial to determining whether demand on the board of directors would have been excused as futile. These allegations also fail for the other reasons described below, most notably because the Complaint fails to adequately plead facts reasonably suggesting that the director defendants made disclosures with knowledge that they were false or misleading or in bad faith.

[54] The closest plaintiffs come to alleging a specific disclosure violation are the allegations that the Company failed to disclosure the existence of the liquidity puts until November 2007 and failed to disclose that the Company may have to take certain assets held by SIVs back onto its balance sheet. Compl. PP 70, 165-69. Even these claims, however, are vague and relatively light on the details of what the Company was required to disclose, when it was required to disclose it, and how its failure to do so would constitute a violation of the duty of disclosure. In any event, as discussed below, these claims fail to plead demand futility because plaintiffs have (1) failed to sufficiently allege facts showing that the director defendants were involved in preparing (or were otherwise responsible for) the alleged misleading disclosures and (2) failed to allege facts that would lead to a reasonable inference that the director defendants made any false or misleading statements or omissions knowingly or in bad faith.

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defendants face a substantial likelihood of liability.

Third, and perhaps most importantly, the Complaint does not sufficiently allege that the director defendants had knowledge that any disclosures or omissions were false or misleading or that the director defendants acted in bad faith in not adequately informing themselves.[55] Plaintiffs have not alleged particular facts showing that the director defendants were even aware of any misstatements or omissions. Instead, plaintiffs conclusorily assert that the members of the ARM Committee, as financial experts, knew the relevant accounting standards, knew or should have known the extent of the Company's exposure to the subprime mortgage market, and are therefore responsible for alleged false statements or omissions in Citigroup's financial statements. Instead of providing factual allegations regarding the knowledge or bad faith of the individual director defendants, the Complaint makes broad group allegations about the director defendants or the members of the ARM Committee.[56] A determination of whether the alleged misleading statements or omissions were made with knowledge or in bad faith requires an analysis of the state of mind of the individual director defendants, and plaintiffs have not made specific factual allegations that would allow for such an inquiry. Plaintiffs' alleged "red flags," which amount to nothing more than indications of worsening economic conditions, do not support a reasonable inference that the director defendants approved or disseminated the financial disclosures knowingly or in bad faith. Merely alleging that there were signs of problems in the subprime mortgage market is not sufficient to show that the director defendants knew that Citigroup's disclosures were false or misleading. The allegations are not sufficiently specific to Citigroup or to the director defendants to meet the strict pleading requirements of Rule 23.1.
Although the members of the ARM Committee were charged with reviewing and ensuring the accuracy of Citigroup's financial statements under the ARM Committee charter, director liability is not measured by the aspirational standard established by the internal documents detailing a company's oversight system. Under our law, to establish liability for misstatements when the board is not seeking shareholder action, shareholder plaintiffs must show that the misstatement was made knowingly or in bad faith. Additionally, even board members who are experts are fully protected under § 141(e) in relying in good faith on the opinions and statements of the corporation's officers and employees who were responsible for preparing the company's financial statements. Plaintiffs' allegations that the members of the ARM Committee were financial experts and were aware of the "red flags" alleged in the Complaint do not support a reasonable inference that the director defendants' reliance on the officers and experts who prepared the financial statements was not in good faith.

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[55] *See Pfeffer,* A.2d , 2009 Del. LEXIS 37, 2009 WL 188887, at *6 ("When pleading a breach of fiduciary duty based on the . . . Directors' knowledge, [the plaintiff] must, at a minimum, offer 'well-pleaded facts from which it can be reasonably inferred that this 'something' was knowable and that the defendant was in a position to know it.'") (quoting *IOTEX Commc'ns, Inc. v. Defries,* C.A. No. 15817, 1998 Del. Ch. LEXIS 236, 1998 WL 914265, at *4 (Del. Ch. Dec. 21, 1998)).

[56] *See AIG,* 2009 Del. Ch. LEXIS 15, 2009 WL 366613 at *21 ("Although these allegations are varied and far reaching, . . . these allegations are supported by the pled facts. For starters, the Complaint is not laden with such accusations against the D & O Defendants as a group; these group accusations are used sparingly.").

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Even accepting plaintiffs' allegations as true, the Complaint fails to plead with particularity facts that would lead to the reasonable inference that the director defendants made or allowed to be made any false statements or material omissions with knowledge or in bad faith. Accordingly, plaintiffs have failed to plead with particularity facts creating a reasonable doubt that the director defendants face a threat of personal liability that would render them incapable of exercising independent and disinterested business judgment in responding to a demand. Plaintiffs' disclosure claims are therefore dismissed pursuant to Rule 23.1

DEMAND FUTILITY ALLEGATIONS REGARDING PLAINTIFFS' WASTE CLAIMS

Count III of the Complaint alleges that certain of the defendants are liable for waste for (1) approving the Letter Agreement dated November 4, 2007 between Citigroup and defendant Prince; (2) allowing the Company to purchase over $ 2.7 billion in subprime loans from Accredited Home Lenders at one of its "fire sales" in March 2007 and from Ameriquest Home Mortgage in September 2007; (3) approving the buyback of over $ 645 million worth of the Company's shares at artificially inflated prices pursuant to a repurchase program in early 2007; and (4) allowing the Company to invest in SIVs that were unable to pay off maturing debt.[57]

[57] Plaintiffs do not adequately plead that the asset purchases or the investments in SIVs were the result of board action rather than inaction. To establish demand futility in the absence of director action the Complaint would have to plead facts sufficient to create a reasonable doubt that the director defendants could exercise disinterested and independent business judgment in responding to a demand. It is not clear to the Court on exactly what theory plaintiffs believe that demand is excused for these allegations. Pls.' Answering Br. at 56 nn.45-46. In any event, the Complaint does not properly allege demand futility as to these claims because it does not create a reasonable doubt that the director defendants would be unable to exercise disinterested and independent business judgment in responding to a demand. First, because plaintiffs have failed to adequately plead that the challenged asset purchases or investments in SIVs were the result of board action, the director defendants cannot possibly face a substantial likelihood of personal liability for these transactions. *See Highland Legacy Ltd. v. Singer,* C.A. No. 1566-N, 2006 Del. Ch. LEXIS 55, 2006 WL 741939, at *7 (Del. Ch. Mar. 17, 2006) ("To excuse demand on the grounds of waste, the complaint must allege particularized facts sufficient to create a reasonable doubt that the *board authorized action on the corporation's behalf* on terms that no person of ordinary, sound business judgment could conclude represents a fair exchange.") (emphasis added).
Second, and in the alternative, the director defendants do not face a substantial likelihood of personal liability for these claims because the Complaint is devoid of any allegation that would lead to the conclusion that allowing the Company to purchase these assets or invest in the SIVs constituted bad faith conduct by the director defendants. For similar reasons as I explained with regard to the *Caremark* claims, the alleged "red flags" are not sufficient to support an inference that the director defendants did not act in good faith by not preventing those charged with making business decisions for the Company from purchasing subprime assets or investing in the SIVs. That these investments turned out poorly for the Company is not evidence of bad faith conduct. The decision to purchase certain investment assets, or to allow others in the Company to purchase certain investment assets, is the essence of the business judgment of directors and officers. Additionally, the Complaint makes no factual allegation that the decision to invest in the subprime assets or the SIVs was of no value to the Company. As I have said numerous times now, judges are in no position to second guess well-informed business decisions made in good faith, and the allegations in the Complaint are not sufficient to suggest that the directors knowingly or in bad faith disregarded their duty to monitor. Accordingly, the claims for waste for the asset purchases and the investments in SIVs fail to properly plead demand futility pursuant to Rule 23.1.

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Demand futility is analyzed under *Aronson* when plaintiffs have challenged board action or approval of a transaction. With regard to the claims based on the approval of the Letter Agreement and the repurchase of Citigroup stock, plaintiffs do not argue that a majority of the director defendants were not disinterested and independent. Rather, plaintiffs argue that demand is excused under the second prong of the *Aronson* analysis, which requires that the plaintiffs plead particularized factual allegations that raise a reasonable doubt at to whether "the challenged transaction was otherwise the product of a valid exercise of business judgment."

Delaware law provides stringent requirements for a plaintiff to state a claim for corporate waste, and to excuse demand on grounds of waste the Complaint must allege particularized facts that lead to a reasonable inference that the director defendants authorized "an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration." The test to show corporate waste is difficult for any plaintiff to meet; indeed, "[t]o prevail on a waste claim . . . the plaintiff must overcome the general presumption of good faith by showing that the board's decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation's best interests."

Approval of the Stock Repurchase Program

Plaintiffs' claim for waste for the board's approval of the stock repurchase program falls far short of satisfying the standard for demand futility. Plaintiffs allege that "in spite of its prior buybacks below $ 50 per share and in spite of the Company's expanding losses and declining stock price, Citigroup repurchased 12.1 million shares during the first quarter of 2007 at an average price of $ 53.37." Plaintiffs then claim that at the time the buyback of Citigroup stock was halted, the stock was trading at $ 46 per share. Plaintiffs conclude that the director defendants "authorized and did not suspend the Company's share repurchase program, which resulted in the Company's buying back over $ 645 million worth of the Company's shares at artificially inflated prices."

Specifically, plaintiffs argue the following:

> As set forth in the Complaint, the Director Defendants recklessly failed to consider and account for the subprime lending crisis, the Company's exposure to falling CDO values by virtue of its liquidity puts, and the collective impact on the Company's billions in warehoused subprime loans. Consequently, the Director Defendants are not entitled to the presumption of business judgment and are liable for waste for approving the buyback of over $ 645 million worth of the Company's shares at artificially inflated prices pursuant to the repurchase program. Under the circumstances, the repurchase program should have been suspended, and would have saved the Company hundreds of millions of dollars. The magnitude of the Director Defendants' utter failure to properly inform themselves of the Company's dire straits has only been highlighted by the Company's recent historically low share prices.

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To say the least, this argument demonstrates that the Complaint utterly fails to state a claim for waste for the board's approval of the stock repurchase. Plaintiffs seem to completely ignore the standard governing corporate waste under Delaware law--a standard that requires that plaintiffs plead facts overcoming the presumption of good faith by 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." Plaintiffs attempted to meet this standard by alleging that the director defendants approved a repurchase of Citigroup stock *at the market price.* Other than a conclusory allegation, plaintiffs have alleged nothing that would explain how buying stock at the market price--the price at which presumably ordinary and rational businesspeople were trading the stock--could possibly be so one sided that no reasonable and ordinary business person would consider it adequate consideration. Again, plaintiffs merely allege "red flags" and then conclude that the board is liable for waste because Citigroup repurchased its stock before the stock dropped in price as a result of Citigroup's losses from exposure to the subprime market. In short, the Complaint states no particularized facts that would lead to any inference that the board's approval of the stock repurchase constituted corporate waste. Accordingly, plaintiffs have not adequately alleged demand futility as to this claim pursuant to Rule 23.1.

Approval of the Letter Agreement

Plaintiffs allege that the board's approval of the November 4, 2007 letter agreement constituted corporate waste. Because approval of the letter was board action, demand is evaluated under the *Aronson* standard. Plaintiffs claim that demand is excused under the second prong of *Aronson* because the particularized factual allegations in the Complaint raise a reasonable doubt as to whether the approval was "the product of a valid exercise of business judgment."

The directors of a Delaware corporation have the authority and broad discretion to make executive compensation decisions. The standard under which the Court evaluates a waste claim is whether there was "an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade." It is also well settled in our law, however, that the discretion of directors in setting executive compensation is not unlimited. Indeed, the Delaware Supreme Court was clear when it stated that "there is an outer limit" to the board's discretion to set executive compensation, "at which point a decision of the directors on executive compensation is so disproportionately large as to be unconscionable and constitute waste."

According to plaintiffs' allegations, the November 4, 2007 letter agreement provides that Prince will receive $ 68 million upon his departure from Citigroup, including bonus, salary, and accumulated stockholdings. Additionally, the letter agreement provides that Prince will receive from Citigroup an office, an administrative assistant, and a car and driver for the lesser of five years or until he commences full time employment with another employer. Plaintiffs allege that this compensation package constituted waste and

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met the "so one sided" standard because, in part, the Company paid the multi-million dollar compensation package to a departing CEO whose failures as CEO were allegedly responsible, in part, for billions of dollars of losses at Citigroup. In exchange for the multi-million dollar benefits and perquisites package provided for in the letter agreement, the letter agreement contemplated that Prince would sign a non-compete agreement, a non-disparagement agreement, a non-solicitation agreement, and a release of claims against the Company. Even considering the text of the letter agreement, I am left with very little information regarding (1) how much additional compensation Prince actually received as a result of the letter agreement and (2) the real value, if any, of the various promises given by Prince. Without more information and taking, as I am required, plaintiffs' well pleaded allegations as true, there is a reasonable doubt as to whether the letter agreement meets the admittedly stringent "so one sided" standard or whether the letter agreement awarded compensation that is beyond the "outer limit" described by the Delaware Supreme Court. Accordingly, the Complaint has adequately alleged, pursuant to Rule 23.1, that demand is excused with regard to the waste claim based on the board's approval of Prince's compensation under the letter agreement.

The Motion to Dismiss under Rule 12(b)(6)

The only claim as to which plaintiffs adequately pleaded demand futility is the claim for corporate waste for the board's approval of the letter agreement granting a multi-million dollar compensation package to Prince upon his departure as Citigroup's CEO. When considering a motion to dismiss for failure to state a claim under Rule 12(b)(6), the Court is required to accept as true all well-pleaded factual allegations in the complaint and make all reasonable inferences that logically flow from the face of the complaint in the plaintiff's favor.[58] The Court can only dismiss the complaint if it "determines with 'reasonable certainty' that the plaintiff could prevail on no set of facts that may be inferred from the well-pleaded allegations in the complaint."

The standard for pleading demand futility under Rule 23.1 is more stringent than the standard under Rule 12(b)(6), and "a complaint that survives a motion to dismiss pursuant to Rule 23.1 will also survive a 12(b)(6) motion to dismiss, assuming that it otherwise contains sufficient facts to state a cognizable claim."[59] Accordingly, for the same reasons stated in the demand futility analysis, the Complaint contains well-pleaded factual allegations regarding the claim for waste for the approval of the Prince letter agreement that make it impossible for me to conclude with reasonable certainty that the plaintiff could prevail on no set of facts that could be reasonably inferred from the allegations in the Complaint.[60]

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[58] *See Malpiede v. Townson,* 780 A.2d 1075, 1082-83 (Del. 2001).
[59] *McPadden v. Sidhu,* C.A. No. 3310-CC, 2008 Del. Ch. LEXIS 123, 2008 WL 4017052, at *7 (Del. Ch. Aug. 29, 2008).
[60] I am also not convinced that defendants would be exculpated under Citigroup's certificate for committing waste. *See In re Walt Disney Co. Derivative Litig.,* 907 A.2d 693, 749 (Del. Ch. 2005) ("The Delaware Supreme Court has implicitly held that committing waste is an act of bad faith.") (citing *White v. Panic,* 783 A.2d 543, 553-55 (Del. 2001)).

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CONCLUSION

Citigroup has suffered staggering losses, in part, as a result of the recent problems in the United States economy, particularly those in the subprime mortgage market. It is understandable that investors, and others, want to find someone to hold responsible for these losses, and it is often difficult to distinguish between a desire to blame *someone* and a desire to force those responsible to account for their wrongdoing. Our law, fortunately, provides guidance for precisely these situations in the form of doctrines governing the duties owed by officers and directors of Delaware corporations. This law has been refined over hundreds of years, which no doubt included many crises, and we must not let our desire to blame someone for our losses make us lose sight of the purpose of our law. Ultimately, the discretion granted directors and managers allows them to maximize shareholder value in the long term by taking risks without the debilitating fear that they will be held personally liable if the company experiences losses. This doctrine also means, however, that when the company suffers losses, shareholders may not be able to hold the directors personally liable.

For the foregoing reasons, the motion to dismiss or stay in favor of the New York Action is denied. Defendants' motion to dismiss is denied as to the claim in Count III of the Complaint for waste for approval of the November 4, 2007 Prince letter agreement. All other claims in the complaint are dismissed for failure to adequately plead demand futility pursuant to Court of Chancery Rule 23.1.

An Order has been entered consistent with this Opinion.

C. Page 122, New Sec. 3.10.D.3 Rebuttal of Business Judgment Rule Presumption Where Target's Board Is Controlled by Representatives of Preferred Who Receive All of Merger Consideration—Trados

Page 122, New Sec. 3.10.D.3. Add before Sec. 3.10.F. the following:

New Sec. 3.10.D.3. **Rebuttal of Business Judgment Rule Presumption Where Target's Board Is Controlled by Representatives of Preferred Who Receive All of Merger Consideration—*Trados***

In Re Trados Incorporated Shareholder Litigation
Court of Chancery of Delaware, 2009
2009 Del. Ch. LEXIS 128

MEMORANDUM OPINION

CHANDLER, Chancellor

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This is a purported class action brought by a former stockholder of Trados Incorporated ("Trados," or the "Company") for breach of fiduciary duty arising out of a transaction whereby Trados became a wholly owned subsidiary of SDL, plc ("SDL"). Of the $ 60 million contributed by SDL, Trados' preferred stockholders received approximately $ 52 million. The remainder was distributed to the Company's executive officers pursuant to a previously approved bonus plan. Trados' common stockholders received nothing for their common shares.

Plaintiff contends that this transaction was undertaken at the behest of certain preferred stockholders that desired a transaction that would trigger their large liquidation preference and allow them to exit their investment in Trados. Plaintiff alleges that the Trados board favored the interests of the preferred stockholders, either at the expense of the common stockholders or without properly considering the effect of the merger on the common stockholders. Specifically, plaintiff alleges that the four directors designated by preferred stockholders had other relationships with preferred stockholders and were incapable of exercising disinterested and independent business judgment. Plaintiff further alleges that the two Trados directors who were also employees of the Company received material personal benefits as a result of the merger and were therefore also incapable of exercising disinterested and independent business judgment. Finally, plaintiff alleges that SDL and certain of its executive officers conspired with certain Trados directors to defer revenue until after the merger.

As explained below, plaintiff has alleged facts sufficient, at this preliminary stage, to demonstrate that at least a majority of the members of Trados' seven member board were unable to exercise independent and disinterested business judgment in deciding whether to approve the merger. Accordingly, I decline to dismiss the breach of fiduciary duty claims arising out of the board's approval of the merger. Plaintiff has failed, however, to state a claim based on the alleged revenue manipulation. Accordingly, I dismiss the breach of duty and aiding and abetting claims based on the alleged revenue manipulation.

BACKGROUND

The Parties

Before the merger, Trados developed software and services used by businesses to make the translation of text and material into other languages more efficient. Founded in 1984 as a German entity, Trados moved to the United States in the mid-1990s with the hope of going public, and became a Delaware corporation in March 2000. To better position itself for the possibility of going public, Trados accepted investments from venture capital firms and other entities. As a result, preferred stockholders had a total of four designees on Trados' seven member board. Each of the seven members of Trados' board at the time of the board's approval of the merger is named as a defendant in this action.

David Scanlan was the board designee of, and a partner in, Wachovia Capital Partners, LLC ("Wachovia"). At the time of the merger, Wachovia owned 3,640,000 shares of Trados' Series A preferred stock (100% of that series) and 1,007,151 shares of Trados'

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Series BB preferred stock (approximately 24% of that series).

Lisa Stone was the board designee of Rowan Entities Limited and Rowan Nominees Limited RR (together, the "Rowan Entities"), transferees of Trados' preferred stock held by Hg Investment Managers Limited (collectively, "Hg"). Stone was a director and employee of both Hg Investment Managers Limited and the Rowan Entities.[61]At the time of the merger, Hg owned 1,379,039 shares of Trados' common stock (approximately 4.3%), 2,014,302 shares of Trados' Series BB preferred stock (approximately 48.3% of that series), 5,333,330 shares of Trados' Series C preferred shares (all of that series), and 862,976 shares of Trados' Series D preferred stock (approximately 28.6% of that series).

Sameer Gandhi was a board designee of, and a partner in, several entities known as Sequoia. Sequoia owned 5,255,913 shares of Trados' Series E preferred stock (approximately 32% of that series).

Joseph Prang was also a board designee of Sequoia. Prang owned Mentor Capital Group LLC ("Mentor Capital"), which owned 263,810 shares of Trados' Series E preferred stock (approximately 1% of that series).

Wachovia, Hg, Sequoia, and Mentor combined owned approximately 51% of Trados' outstanding preferred stock. Plaintiff alleges that these preferred stockholders desired to exit their investment in Trados.[62]

Two of the three remaining director defendants were employees of Trados. Jochen Hummel was acting President of Trados from April 2004 until September or October 2004, and was also the Company's chief technology officer. Joseph Campbell was Trados' CEO from August 23, 2004 until the merger. The remaining Trados director was Klaus-Dieter Laidig.

The Negotiations

In April 2004, the Trados board began to discuss a potential sale of the Company, and later formed a mergers and acquisitions committee, consisting of Stone, Gandhi, and Scanlan, to explore a sale or merger of Trados. Around the same time, the Company's President and CEO was terminated due to, among other issues, a perception by the rest of the board that Trados was underperforming. The board appointed Hummel as an interim

[61] Plaintiff also alleges that Stone was a part owner of Hg, and that Stone had a personal financial interest in Hg's investment in Trados. Plaintiff further alleges that Hg Investment Managers Limited continued to be the beneficial owners of all shares owned by Hg, and that both Rowan Entities were affiliates of Hg Investment Managers Limited. First Am. Verified Compl. ("Compl.") P 8.

[62] Compl. PP 30, 35-37, 44, 51, 79, 84, 101-102. Plaintiff alleges, for example, that in January 2003 Gandhi wrote that Sequoia's "only real opportunity is to capture a fraction of our 13m investment," and that in June 2003 Gandhi acknowledged that Trados' long term prospects were improving, but wrote that Sequoia "d[id] not own enough of the company to make a meaningful return." Id. P 30. Plaintiff further alleges that by mid-2004 Wachovia wanted to exit its investment in Trados because Scanlan felt that the investment was underperforming and consuming too much of his time relative to the size of the investment. Id. P 35. Plaintiff also contends that Hg and Mentor wanted to exit their investments in Trados.

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President, but instructed him to consult with Gandhi and Scanlan before taking material action on behalf of the Company. In July 2004, Campbell was hired as the Company's CEO, effective August 23, 2004. Gandhi described Campbell as "a hard-nosed CEO whose task is to grow the company profitably or sell it."[63] At the time Campbell joined Trados, however, the Company was losing money and had little cash to fund continuing operations.[64]At a July 7, 2004 meeting, Trados' board determined that the fair market value of Trados' common stock was $ 0.10 per share.

In June 2004, Trados engaged JMP Securities, LLC, an investment bank, to assist in identifying potential alternatives for a merger or sale of the Company. By July 2004, JMP Securities had identified twenty seven potential buyers of Trados, and contacted seven of them, including SDL. By August 2004, JMP Securities had conducted discussions with SDL CEO Mark Lancaster, who made an acquisition proposal in the $ 40 million range. Trados informed Lancaster that it was not interested in a deal at that price, and Campbell formally terminated JMP Securities in September 2004.

In July 2004, Scanlan expressed concern that the executive officers of the Company might not have sufficient incentives to remain with the Company or pursue a potential acquisition of the Company, due to the high liquidation preference of the Company's preferred stock. The board instructed Scanlan to develop a bonus plan to address these concerns. This led to the December 2004 board approval of the Management Incentive Plan (the "MIP"), which set a graduated compensation scale for the Company's management based on the price obtained for the Company in an acquisition.[65]

Trados' financial condition improved markedly during the fourth quarter of 2004, in part due to Campbell's efforts to reduce spending and bring in additional cash through debt financing. By the time of the December 2004 board meeting, Trados had arranged to borrow $ 2.5 million from Western Technology Investment, with the right to borrow an additional $ 1.5 million.

Despite the Company's improved performance, the board continued to work toward a sale of the Company. In December 2004, Gandhi reported to Sequoia Capital that the Company's performance was improving, but that Campbell's "mission is to architect an M&A event as soon as practicable." At a February 2, 2005 board meeting, Campbell

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[63] Compl. P 40. In June 2004, Gandhi also reported to Sequoia that a "banker has also been retained to explore the M&A options for the business. I would expect that the company is sold within the next 18 months (perhaps sooner)." Id.

[64] Plaintiff alleges that Campbell believed that his "mission on joining TRADOS was to help the company understand its future path, which in the mind of the outside board members at that time was some type of either merger or acquisition event due to the company's performance that year and prior years." Compl. P 44.

[65] Under the MIP, management would receive 6% of the acquisition price for an acquisition between $ 30-40 million; 11% for an acquisition between $ 40-50 million; 13% for an acquisition between $ 50-90 million; 14% for an acquisition between $ 90-120 million; and 15% for an acquisition at or above $ 120 million. From that pool, Campbell would be entitled to 30%, Hummel to 12%, and James Budge to 10%. Plaintiff alleges that an investor described the MIP as "protection for the management team in case [some] shareholders want to sell [the company] at a price where the options/common shares are worthless." Compl. P 52.

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presented positive financial results from the fourth quarter of 2004, including record revenue and profit from operations. As a result of its improved performance and the lack of an immediate need for cash, the board extended by six months the period during which it could obtain additional cash from Western Technology Investment.

In January 2005, SDL initiated renewed merger discussions with Campbell. Upon learning of SDL's interest, the Trados board expressed that it was not interested in any transaction involving less than a "60-plus" million dollar purchase price. Lancaster first discussed a transaction at $ 50 million, but later offered $ 60 million. At the February 2, 2005 meeting, the board instructed Campbell to continue negotiating with Lancaster under the general terms SDL proposed, including the $ 60 million price. In mid-February 2005, Campbell made inquiries with two other potential acquirers of Trados, but neither expressed any substantive interest.

In a theme that runs throughout his allegations, plaintiff alleges that there was no need to sell Trados at the time because the Company was well financed and experiencing improved performance under Campbell's leadership. For example, plaintiff contends that by February 2005 Trados was beating its revenue budget for the year, a trend that continued as Trados beat its revenue projections for the first quarter of 2005 and through the end of May 2005.

By February 2005, Campbell and Lancaster agreed to the basic terms of a merger at $ 60 million. Trados then re-engaged JMP securities, which plaintiff alleges acted as little more than a "go-between." In April 2005, SDL and Trados signed the letter of intent for the merger at the $ 60 million price.

***The Alleged Revenue Manipulation* * * ***

Plaintiff alleges that SDL, Lancaster, and Alastair Gordon (the "SDL Defendants") conspired with Campbell, Budge, and Hummel to change Trados' normal business practices with respect to the receipt and recognition of revenue. These changes allegedly served no proper purpose for Trados, but would benefit SDL financially by increasing its post-merger revenues. Specifically, plaintiff alleges that Trados management and SDL agreed to (1) delay the recognition of at least $ 2,046,000 of Trados' revenues until after the merger closed; (2) delay the release of Desktop 7.0, Trados' newest version of its desktop translation software, until after the merger closed, and (3) allow deals representing approximately $ 1 million of Trados' revenues to "slip" until after the merger.

The Merger

The director defendants unanimously approved the merger, and on June 19, 2005 Trados and SDL entered into an Agreement and Plan of Merger. Of the $ 60 million merger price, approximately $ 7.8 million would go to management pursuant to the MIP, and the remainder would go to the preferred stockholders in partial satisfaction of their $ 57.9 million liquidation preference. Plaintiff alleges that the directors know both of these facts,

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and thus knew that the common shareholders would receive nothing in the merger.[66] The merger was consummated on July 7, 2005.

Plaintiff alleges that Campbell and Hummel received benefits as a result of the merger. Campbell became a director of SDL and received $ 775,000 through the MIP, $ 1,315,000 in exchange for a non-compete agreement, and a $ 250,000 bonus. Campbell took $ 702,000 of his MIP compensation in SDL stock, and $ 73,000 in cash. Hummel became "SDL's general manager of Europe, the Middle East, and Asia (technology division)," and received $ 1,092,000 under the MIP, of which he took $ 436,800 in SDL stock and $ 655,200 in cash.

On July 21, 2005, plaintiff filed a petition for appraisal, seeking payment of the fair value of his stock as of the date of the merger. Almost three years later, on July 3, 2008, plaintiff commenced a second action, both individually and purportedly on behalf of a class of former stockholders of Trados, against the director defendants. On December 12, 2008, plaintiff filed the First Amended Verified Complaint (the "Complaint"), which includes new facts allegedly discovered by plaintiff in discovery conducted as part of the appraisal action. Defendants have moved for dismissal of the Complaint for failure to state a claim upon which relief may be granted.

ANALYSIS

The Legal Standard

This Court may grant a motion to dismiss for failure to state a claim under Rule 12(b)(6) if the Court can determine with reasonable certainty that the plaintiff would not be entitled to relief under any set of facts that could be reasonably inferred from the well-pleaded allegations in the complaint. * * *

Fiduciary Duty Claims

Count I of the Complaint asserts a claim that the director defendants breached their fiduciary duty of loyalty to Trados' common stockholders by approving the merger. Plaintiff alleges that there was no need to sell Trados at the time because the Company was well-financed, profitable, and beating revenue projections. Further, plaintiff contends, "in approving the Merger, the Director Defendants never considered the interest of the common stockholders in continuing Trados as a going concern, even though they were obliged to give priority to that interest over the preferred stockholders' interest in exiting their investment."

Directors of Delaware corporations are protected in their decision-making by the business judgment rule, which "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the

[66] Plaintiff alleges that, based on advice from Kevin Passarello, Trados' vice president and general counsel, the board believed that the common stockholders did not have the right to seek appraisal of their shares. Id. P 85.

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action taken was in the best interests of the company." The rule reflects and promotes the role of the board of directors as the proper body to manage the business and affairs of the corporation.

The party challenging the directors' decision bears the burden of rebutting the presumption of the rule.[67] If the presumption of the rule is not rebutted, then the Court will not second-guess the business decisions of the board. If the presumption of the rule is rebutted, then the burden of proving entire fairness shifts to the director defendants. A plaintiff can survive a motion to dismiss under Rule 12(b)(6) by pleading facts from which a reasonable inference can be drawn that a majority of the board was interested or lacked independence with respect to the relevant decision.[68]

A director is interested in a transaction if "he or she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders" or if "a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders."[69] The receipt of any benefit is not sufficient to cause a director to be interested in a transaction. Rather, the benefit received by the director and not shared with stockholders must be "of a sufficiently material importance, in the context of the director's economic circumstances, as to have made it improbable that the director could perform her fiduciary duties . . . without being influenced by her overriding personal interest . . . ."[70]

"Independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences." [71]At this stage, a lack of independence can be shown by pleading facts that support a reasonable inference that the director is beholden to a controlling person or "so under their influence that their discretion would be sterilized."[72]

Plaintiff's theory of the case is based on the proposition that, for purposes of the merger, the preferred stockholders' interests diverged from the interests of the common stockholders. Plaintiff contends that the merger took place at the behest of certain preferred stockholders, who wanted to exit their investment. Defendants contend that plaintiff ignores the "obvious alignment" of the interest of the preferred and common stockholders in obtaining the highest price available for the company. Defendants assert that because the preferred stockholders would not receive their entire liquidation preference in the merger, they would benefit if a higher price were obtained for the Company.[73] Even accepting this proposition as true, however, it is not the case that the

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[67] Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).
[68] Orman v. Cullman, 794 A.2d 5, 22-23 (Del. Ch. 2002).
[69] Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993).
[70] In re Gen. Motors Class H S'holders Litig., 734 A.2d 611, 617 (Del. Ch. 1999); see Orman, 794 A.2d at 23.
[71] Aronson, 473 A.2d at 816.
[72] Rales, 634 A.2d at 936.
[73] Defendants also contend that the preferred stockholders would receive payment on an as converted basis with the common stockholders. Id. at 12-13 ("[T]he preferred would receive the first $ 57.9 million of any transaction, and would thereafter receive payment on an as converted basis with the common stockholders."); see Compl. P 37 ("[O]nce the Liquidation Preferences of Sequoia Capital and Mentor

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interests of the preferred and common stockholders were aligned with respect to the decision of whether to pursue a sale of the company or continue to operate the Company without pursuing a transaction at the time.

The merger triggered the $ 57.9 million liquidation preference of the preferred stockholders, and the preferred stockholders received approximately $ 52 million dollars as a result of the merger. In contrast, the common stockholders received nothing as a result of the merger, and lost the ability to ever receive anything of value in the future for their ownership interest in Trados. It would not stretch reason to say that this is the worst possible outcome for the common stockholders. The common stockholders would certainly be no worse off had the merger not occurred.

Taking, as I must, the well-pleaded facts in the Complaint in the light most favorable to plaintiff, it is reasonable to infer that the common stockholders would have been able to receive some consideration for their Trados shares at some point in the future had the merger not occurred.[74] This inference is supported by plaintiff's allegations that the Company's performance had significantly improved and that the Company had secured additional capital through debt financing. Thus, it is reasonable to infer from the factual allegations in the Complaint that the interests of the preferred and common stockholders were not aligned with respect to the decision to pursue a transaction that would trigger the liquidation preference of the preferred and result in no consideration for the common stockholders.[75]

Generally, the rights and preferences of preferred stock are contractual in nature.[76] This

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Capital's preferred stock were satisfied in a sale or acquisition of Trados, those entities would not share in any further consideration, which mostly would go to Trados' common stockholders.") (emphasis added); Pl.'s Answering Br. 22-23.

[74] On a motion to dismiss for failure to state a claim, I am required to draw all reasonable inferences in favor of the non-moving party. As a result, there are sometimes reasonable (even, potentially, more likely) inferences that must be passed over at this stage of the proceedings. For example, it would be reasonable to infer from the allegations in the Complaint that pursing the transaction with SDL was in the best interest of the Company because it secured the best value reasonably available for the Company's stakeholders and did not harm the common shareholders because, in fact, there was no reasonable chance that they would ever obtain any value for their stock even absent the transaction. Nothing in this Opinion is intended to suggest that it would necessarily be a breach of fiduciary duty for a board to approve a transaction that, as a result of liquidation preferences, does not provide any consideration to the common stockholders.

[75] Defendants do not argue that the board had an obligation to the preferred stockholders to pursue a transaction that would trigger the large liquidation preference of the preferred stock. Thus, it is reasonable to infer, at this stage, that one option would be for the Company to continue to operate without paying the large liquidation preference to the preferred, subject of course, to any other contractual rights the preferred stockholders may have had. Indeed, in a situation in which the liquidation preference of the preferred exceeded the consideration that could be achieved in a transaction, it would arguably be in the interest of the common stockholders not to pursue any transaction that would trigger the liquidation preference. It is also reasonable to infer that the preferred stockholders would benefit from a transaction that allowed them to exit the investment while also triggering their liquidation preference, something they did not have a contractual right to force the Company to do. Again, at this stage, I am required to make reasonable inferences in plaintiff's favor, even if there are other reasonable inferences that can be drawn from the alleged facts and that would result in dismissal of the Complaint.

[76] Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 594 (Del. Ch. 1986) ("[W]ith respect to matters relating to preferences or limitations that distinguish preferred stock from common, the duty of the

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Court has held that directors owe fiduciary duties to preferred stockholders as well as common stockholders where the right claimed by the preferred "is not to a preference as against the common stock but rather a right shared equally with the common."[77] Where this is not the case, however, "generally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of common stock--as the good faith judgment of the board sees them to be--to the interests created by the special rights, preferences, *etc.,* of preferred stock, where there is a conflict."[78] Thus, in circumstances where the interests of the common stockholders diverge from those of the preferred stockholders, it is *possible* that a director could breach her duty by improperly favoring the interests of the preferred stockholders over those of the common stockholders.[79] As explained above, the factual allegations in the Complaint support a

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corporation and its directors is essentially contractual and the scope of the duty is appropriately defined by reference to the specific words evidencing that contract . . . ."); see Matulich v. Aegis Commc'ns. Essar Invs., Ltd., 942 A.2d 596, 599-600 (Del. 2008).

[77] Jedwab, 509 A.2d at 594.

[78] Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1042 (Del. Ch. 1997) (citing Katz v. Oak Indus., Inc., 508 A.2d 873, 879 (Del. Ch. 1986)).

[79] See Blackmore Partners, L.P. v. Link Energy LLC, 864 A.2d 80, 85-86 (Del. Ch. 2004) ("[T]he allegation that the Defendant Directors approved a sale of substantially all of [the company's] assets and a resultant distribution of proceeds that went exclusively to the company's creditors raises a reasonable inference of disloyalty or intentional misconduct. Of course, it is also possible to infer (and the record at a later stage may well show) that the Director Defendants made a good faith judgment, after reasonable investigation, that there was no future for the business and no better alternative for the unit holders. Nevertheless, based only the facts alleged and the reasonable inferences that the court must draw from them, it would appear that no transaction could have been worse for the unit holders and reasonable to infer, as the plaintiff argues, that a properly motivated board of directors would not have agreed to a proposal that wiped out the value of the common equity and surrendered all of that value to the company's creditors."). Defendants contend that Blackmore Partners can be distinguished from this case because "the Court in Blackmore Partners found that defendants favored creditors to whom they did not owe fiduciary duties over unit holders to whom they did owe fiduciary duties" and that plaintiff "does not, and cannot, allege that the Director Defendants favored anyone to whom they did not owe a fiduciary duty." Reply Br. of Director Defendants in Further Support of their Mot. to Dismiss ("Defs.' Reply Br.") 23. As explained above, however, preferred stockholders are owed the same fiduciary duties as common stockholders when the right claimed by the preferred is "a right shared equally with the common." Jedwab, 509 A.2d at 594. If and when the interests of the preferred stockholders diverge from those of the common stockholders, the directors generally must "prefer the interests of common stock--as the good faith judgment of the board sees them to be--to the interests created by the special rights, preferences, etc., of preferred stock." Equity-Linked Investors, 705 A.2d at 1042. Based on the allegations in the Complaint, it does not appear that the preferred stockholders had any contractual right to force a transaction that would trigger their liquidation preference. Moreover, the transaction with SDL was, under at least one reasonable inference that can be drawn from the Complaint, not in the best interest of Trados' common stockholders.

Defendants may be correct that the facts in Blackmore Partners are somewhat more "extreme" than those alleged in the complaint because the Court in Blackmore Partners found "a basis in the complaint to infer that the value of [the company's] assets exceeded its liabilities by least $ 25 million." Blackmore Partners, 864 A.2d at 85. The Court in Blackmore Partners, however, concluded, even in the absence of factual allegations that supported an inference of interest or lack of independence by the directors, that "the allegation that the Defendant Directors approved a sale of substantially all of [the company's] assets and a resultant distribution of proceeds that went exclusively to the company's creditors raises a reasonable inference of disloyalty or intentional misconduct." Id. at 86. Here, in contrast, there is an allegation that a majority of the board was interested in the decision to pursue the transaction; accordingly, the Court need

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reasonable inference that the interests of the preferred and common stockholders diverged with respect to the decision of whether to pursue the merger. Given this reasonable inference, plaintiff can avoid dismissal if the Complaint contains well-pleaded facts that demonstrate that the director defendants were interested or lacked independence with respect to this decision.

The Director Defendants' Approval of the Merger

Plaintiff has alleged facts that support a reasonable inference that Scanlan, Stone, Gandhi, and Prang, the four board designees of preferred stockholders, were interested in the decision to pursue the merger with SDL, which had the effect of triggering the large liquidation preference of the preferred stockholders and resulted in no consideration to the common stockholders for their common shares. Each of these four directors was designated to the Trados board by a holder of a significant number of preferred shares. While this, alone, may not be enough to rebut the presumption of the business judgment rule,[80] plaintiff has alleged more. Plaintiff has alleged that Scanlan, Stone, Gandhi, and Prang each had an ownership or employment relationship with an entity that owned Trados preferred stock. Scanlan was a partner in Wachovia; Stone was a director, employee and part owner of Hg; Gandhi was a partner in several entities referred to as Sequoia; and Prang owned Mentor Capital. Plaintiff further alleges that each of these directors was dependent on the preferred stockholders for their livelihood. As detailed above, each of these entities owned a significant number of Trados' preferred shares, and together these entities owned approximately 51% of Trados' outstanding preferred stock. The allegations of the ownership and other relationships of each of Scanlan, Stone, Gandhi, and Prang to preferred stockholders, combined with the fact that each was a board designee of one of these entities, is sufficient, under the plaintiff-friendly pleading standard on a motion to dismiss, to rebut the business judgment presumption with respect to the decision to approve the merger with SDL[81]

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not conclude that the decision to approve the transaction, of itself, raises "a reasonable inference of disloyalty or intentional misconduct."

[80] See Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 65 (Del. 1989) (stating that a director's representation of one of the corporations largest shareholders "alone did not make him an interested director."). But see Goldman v. Pogo.com, Inc., 2002 Del. Ch. LEXIS 71, 2002 WL 1358760, at *3 (Del. Ch. June 14, 2002) ("Because Khosla and Wu were the representatives of shareholders which, in their institutional capacities, are both alleged to have had a direct financial interest in this transaction, a reasonable doubt is raised as to Khosla and Wu's disinterestedness in having voted to approve the First Bridge Loan."). Defendants contend that Goldman is distinguishable because "the 'interest' in Goldman was far greater and obviously distinct in nature from simply being corporate designees as Christen attempts to posit." Defs.' Reply Br. 13-14. Given the inferences the Court must draw at this stage, it is my inclination that Goldman would have some persuasive value in this case. I need not rely on such inclination, however, because plaintiff does not rely merely on the allegation that Scanlan, Stone, Gandhi, and Prang were designees of the preferred. Rather, plaintiff alleges that each of these directors had additional significant relationships to preferred stockholders.

[81] See Orman, 794 A.2d at 30-31 ("Because director Solomon's principal occupation is that of 'Chairman of Peter J. Solomon Company Limited and Peter J. Solomon Securities Company Limited,' it is reasonable to assume that director Solomon would personally benefit from the $ 3.3 million his company would receive if the challenged transaction closed. I think it would be naive to say, as a matter of law, that $ 3.3 million is immaterial. In my opinion, therefore, it is reasonable to infer that director Solomon suffered a disabling interest when considering how to cast his vote in connection with the challenged merger when the

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At oral argument, defendants relied on *Dubroff v. Wren Holdings, LLC*[82] for support of the argument that plaintiff had failed to state a claim because he had not alleged that the preferred stockholders were acting in concert or had otherwise formed a controlling group. The discussion of a "control group" in *Wren Holdings* was in connection with the general rule that "equity dilution" claims are derivative, rather than direct. As explained in *Wren Holdings,* there is an exception to this general rule "where a controlling shareholder causes the corporate entity to issue more equity to the controlling shareholder at the expense of the minority shareholders." The emphasis on a control group in *Wren Holdings* arose from the plaintiffs' attempt to establish that certain of the defendants had collectively formed a controlling shareholder group so that plaintiffs would be able to bring a direct claim for the alleged equity dilution. Here, in contrast, there is no need for plaintiff to allege that there was a controlling shareholder or control group in order to establish that individual director defendants were interested.[83]

Defendants also rely on *Orban v. Field,*[84] but that decision does not counsel in favor of dismissal at this stage of the litigation. In *Orban,* the Court was evaluating whether a board breached its duties where it "deploy[ed] corporate power against its own shareholders" by "eliminating the leverage of the common stockholders by diluting their ownership interest below 10%" in order to prevent the common stockholder from using his ability to block a transaction to extract value for his shares. The Court, in deciding to grant summary judgment in favor of defendants, asked whether defendants had met their burden "to show that their conduct was taken in good faith pursuit of valid ends and was reasonable in the circumstances." Although this inquiry was "inevitably one that must be applied in the rich particularity of context," the Court was still able to conclude, based on the evidence in the record, that the plaintiff's "threat to impede the realization of th[e] transaction by the corporation was thwarted by legally permissible action that was

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Board's decision on that matter could determine whether or not his firm would receive $ 3.3 million.") (footnote omitted). Defendants attempt to distinguish Orman by arguing that, unlike the fees earned by the director's company in Orman, the only consideration received by the preferred stockholders was consideration for their shares. Defendants cite In re Ply Gem Indus., Inc. S'holders Litig., 2001 Del. Ch. LEXIS 84, 2001 WL 755133, at *9 (Del. Ch. June 26, 2001) for the proposition that directors were not interested where there was no allegation that they "obtained any improper benefit whatsoever from the merger other than from their entitlement, as shareholders, to receive the merger consideration." As explained above, however, the preferred stockholders were not "entitled" to a transaction that would trigger their liquidation preference. Under at least one reasonable inference that can be drawn from the Complaint, the interests of the common and preferred stockholders diverged on that very issue. Indeed, those divergent interests are what led to the present dispute. Accordingly, In re Anderson, Clayton S'holders Litig., 519 A.2d 680 (Del. Ch. 1986), also does not counsel in favor of dismissal here. In Anderson, Clayton the Court held that directors "affiliated" with certain trusts would not be considered interested for purposes of the motion for preliminary injunction because the trusts only had an interest as shareholders in the Company and thus were not interested "in a transaction that will treat all shareholders equally." Id. at 687. Unlike in Anderson, Clayton, the Complaint in this case raises a reasonable inference that the interest of the common and preferred stockholders diverged with respect to the decision to enter into a transaction that triggered the liquidation preference of the preferred and resulted in no consideration to the common stockholders. It is this decision that the four designees of preferred stockholders were allegedly interested in.

[82] 2009 Del. Ch. LEXIS 89, 2009 WL 1478697 (Del. Ch. May 22, 2009).

[83] While it is true that an individual stockholder that is not a controlling stockholder can generally vote in its individual interest, the same cannot be said of directors designated to the board by such a stockholder.

[84] 1997 Del. Ch. LEXIS 48, 1997 WL 153831 (Del. Ch. Apr. 1, 1997).

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measured and appropriate in the circumstances." In making this determination, the Court assumed that the business judgment rule did not apply to the challenged actions.
Here, in contrast, the issue on the motion to dismiss is whether plaintiff has rebutted the presumption of the business judgment rule. Unlike on a motion for summary judgment, I must accept the well-pleaded factual allegations in the Complaint as true. As explained above, those allegations, with the benefit of reasonable inferences, are sufficient, at this stage, to rebut the presumption of the business judgment rule. Unlike in *Orban,* I am unable, at this stage, to make determinations based on the record, such as that the board acted "both in good faith and reasonably." Those determinations must wait for another day.[85]

Plaintiff has alleged facts that support a reasonable inference that a majority of the board was interested or lacked independence with respect to the decision to approve the merger. Accordingly, plaintiff has alleged sufficient facts to survive defendants' motion to dismiss the fiduciary duty claims based on the board's decision to approve the merger.[86]

The Alleged Revenue Shifting * * *

Aiding and Abetting * * *

CONCLUSION

For the reasons set forth above, defendants' motion to dismiss is granted in part and denied in part. The motion to dismiss is denied with respect to the claim in Count I for breach of fiduciary duty arising out of the board's approval of the merger. The motion to dismiss is granted with respect to the claims based on the alleged revenue shifting. Accordingly, the claim in Count I for breach of fiduciary duty based on the alleged revenue shifting is dismissed. Count II's claim for aiding and abetting is dismissed in its entirety.

IT IS SO ORDERED.

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[85] Plaintiff is not entitled to relief merely by rebutting the presumption of the business judgment rule; rather, even if the plaintiff ultimately rebuts the presumption of the rule, the burden shifts to the director defendants to demonstrate the entire fairness of the transaction. Cede, 634 A.2d at 361.
[86] Because, at this stage, plaintiff has rebutted the business judgment presumption for a majority of the board, I need not reach plaintiff's allegations as to the remaining director defendants.

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D. Page 128, New Sec. 3.10.F.3. Allegation that Acquiror's Directors Entered Merger Agreement without a Financing Condition and Failed to Properly Supervise—Dow

Page 128, New Sec. 3.10.F.3.	Add before Sec. 3.11. the following:
New Sec. 3.10.F.3.	**Allegation that Acquiror's Directors Entered Merger Agreement without a Financing Condition and Failed to Properly Supervise—*Dow***

In Re The Dow Chemical Company Derivative Litigation
COURT OF CHANCERY OF DELAWARE, 2010
2010 Del. Ch. LEXIS 2

MEMORANDUM OPINION

CHANDLER, Chancellor

This is a shareholder derivative action brought on behalf of the Dow Chemical Company ("Dow" or the "Company"), seeking to recover for the Company its losses arising from the difficulties with the Rohm & Haas Company ("R&H") transaction. Plaintiffs, stockholders of Dow, brought this action against current directors and officers of the Company, alleging that the defendants breached their fiduciary duties to the company by (1) approving the R&H transaction, (2) misrepresenting the relationship between the R&H transaction and a joint venture with a Kuwaiti company, and (3) failing to detect and prevent a variety of alleged wrongs, including bribery, misrepresentation, insider trading, and wasteful compensation.

Pending before the Court is defendants' motion to dismiss the complaint for failure to properly plead demand futility under Chancery Court Rule 23.1.[87] For the reasons set forth below, the motion to dismiss is granted as to all claims. Pursuant to Chancery Court Rule 15(aaa), the primary breach of fiduciary duties claims are dismissed with prejudice

[87] Plaintiffs argue that the broader pleading requirements of Rule 12(b)(6) should govern the majority of the claims, but all claims are derivative; there are no direct claims. See Compl. P 119. Defendants correctly note, however, that HN1 demand futility under Rule 23.1 is "logically the first issue [for all derivative claims] and if plaintiffs cannot succeed under the heightened pleading requirements of Rule 23.1 . . . there is no need to proceed to an analysis of the merits of the claim" under Rule 12(b)(6). Defs.' Reply Br. at 3, n.4; In re Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 139 (Del. Ch. 2009) (citing McPadden v. Sidhu, 964 A.2d 1262, 2008 WL 4017052, at *7 (Del. Ch. 2008) (HN2 "The standard for pleading demand futility under Rule 23.1 is more stringent than the standard under Rule 12(b)(6), and 'a complaint that survives a motion to dismiss pursuant to Rule 23.1 will also survive a 12(b)(6) motion to dismiss, assuming that it otherwise contains sufficient facts to state a cognizable claim.'")). Therefore, the Court begins its analysis of the derivative claims under Rule 23.1, and does not continue to Rule 12(b)(6) for the individual defendants because plaintiffs fail to adequately plead demand futility as to the entire derivative complaint.

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as to the named plaintiffs, and all remaining claims--insider trading, waste, and contribution and indemnification--are dismissed without prejudice. [88]

BACKGROUND

The Parties

Dow is a large, historically lucrative American chemical company. For years, Dow focused on the commodities side of the chemical business. More recently the Company decided to embark on a "transformative strategy" by diversifying into the specialty chemicals business. Dow is a corporation organized and existing under the laws of Delaware; its principal place of business is Midland, Michigan.

Defendants in this action are current directors and officers of Dow. The complaint names twelve directors as of February 9, 2009, the date the first of the now-consolidated actions was filed. Dow's board of directors consists of Andrew N. Liveris, Geoffry E. Merszei, Arnold A. Allemang, Jacqueline K. Barton, James A. Bell, Jeff M. Fettig, Barbara Hackman Franklin, John B. Hess, Dennis H. Reilley, James M. Ringler, Ruth G. Shaw, and Paul G. Stern (collectively, the "director defendants"). Liveris and Merszei are also current officers of the Company. Liveris serves many roles as the President, Chief Executive Officer, Chairman of the Board, and de facto Chief Operating Officer; Merszei is Dow's Chief Financial Officer.

The complaint also names three officers, alleged to have committed insider trading under Count I. The three officers are: Michael Gambrell, William Banholzer, and David E. Kepler.

Plaintiffs Michael D. Blum and Norman R. Meier are owners of shares of Dow stock.

K-Dow Joint Venture with Kuwait

In December 2007, Dow's board of directors caused the Company to enter a Memorandum of Understanding ("MOU") with Kuwait's Petrochemicals Industries Company ("PIC"). The MOU, which was subject to the execution of a definitive agreement, customary conditions, and regulatory approvals, provided for $ 9 billion in cash payments to Dow upon the transfer of a 50% interest in five global Dow commodities chemical businesses into a joint venture with Kuwait. The joint venture was known as "K-Dow," and each company was to take a 50% equity interest in the new

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[88] Ch. Ct. R. 15(aaa). With regard to plaintiffs' primary breach of fiduciary duty claims, I find no good cause to depart from *HN3*the default pleading rule of Rule 15(aaa) which dictates dismissal with prejudice when a defendant succeeds on a motion to dismiss for failure to plead demand futility. I do find good cause, however, to dismiss all insider trading and waste claims without prejudice because plaintiffs voluntarily abandoned these claims. See discussion infra Part II.B.I. Good cause also exists to dismiss the contribution and indemnification claims without prejudice because those claims are unripe. See discussion infra Part II.C. Additionally, plaintiffs' request to replead in the event I grant defendants' motion to dismiss--in clear contravention of Rule 15(aaa)--is also denied. *HN4* A plaintiff must amend his complaint before standing on it in opposition to a motion to dismiss.

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company. At the time, Dow expected the K-Dow transaction to close in late 2008.

The R&H Merger Agreement

In July 2008, following an intense auction and six months after the K-Dow MOU, the Dow board unanimously approved and caused Dow to enter into a strategic merger agreement with R&H (the "R&H Transaction" or the "Merger Agreement"), pursuant to which Dow agreed to acquire all of R&H's stock for $ 78 per share, or roughly $ 18.8 billion. Recognizing that uncertainty was a deal-breaker for R&H--and that there were many competitors standing ready to provide the certainty R&H sought--Dow did not condition the transaction's close on financing. The transaction was slated to close within two business days of receiving all the required regulatory approvals.

The Merger Agreement provided no traditional "outs" from completing the transaction with R&H but provided traditional penalties for any delay or failure to close, including specific performance. Section 5.1(b)(i) of the Merger Agreement required Dow to "take all action necessary to ensure that as of the Closing Date, [Dow] will obtain the Financing." Moreover, under Section 4.6 Dow expressly represented that it would have the funds necessary to close by the closing date. Dow also agreed to assume all risk regarding negative developments affecting the chemical industry or financial markets, in the form of a "Material Adverse Effect" clause. Pursuant to this provision Dow assumed the risk that the chemical industry or the financial markets would be negatively affected between signing and closing. The Merger Agreement also included a "force majeure" clause which only would provide Dow an out if R&H performed worse than all its peers.

Furthermore, the Merger Agreement provided for additional consideration--but not liquidated damages--to R&H in the event that the Transaction was delayed or did not close. In particular, Section 2.1(a) provided for "ticking fees" for a period up to six months. The per-day ticking fee amounted to approximately $ 3.3 million, minus any dividend that R&H paid to its shareholders during that period. These payments were clearly not liquidated damages because the Merger Agreement contained a specific performance provision in Section 8.5(a).

Though the markets may have been tightening during the summer of 2008, funding remained available and Dow had a variety of potential sources of financing. In addition to its available cash balances, Dow anticipated $ 9 billion in pre-tax cash proceeds from the K-Dow joint venture, $ 4 billion from investments by Berkshire Hathaway Inc. and the Kuwait Investment Authority, and a syndicated bridge loan for $ 13 billion of debt financing led by Citibank, N.A. if the R&H transaction closed before the K-Dow venture.

Although proceeds from K-Dow were one source of financing, the R&H deal was not conditioned nor did it depend on the K-Dow deal closing. Accordingly, the Dow board informed stockholders that the financing for the Merger did not depend on Dow entering into a binding contract with Kuwait. Specifically, Liveris and Merszei disclaimed any temporal connection at a July 10, 2008 press conference. Liveris told an analyst: "we are not counting on [the K-Dow deal]. We can do [the R&H] deal without the Kuwait

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money, and we will stay at investment grade." Merszei expanded, stating: "[t]his deal is certainly not contingent on the closing of our Kuwait joint venture." Throughout the fall of 2008 defendants remained confident that the R&H Transaction would close "early next year."

At the time Dow entered the Merger Agreement with R&H, its earnings and stock price were strong. Two weeks after signing the Agreement, Liveris announced favorable second quarter results on behalf of Dow. Although oil prices surged from the first to second quarter of 2008, Dow "reacted quickly…enabl[ing Dow] to weather unparalleled increases in hydrocarbons, supply chain and other costs." All signs still indicated Dow would be able to arrange the financing necessary to close the R&H Transaction.

Tightening of Credit Markets & K-Dow's Disintegration

Unfortunately, a series of unforeseeable economic events unfolded over the next six months, which led to a drastic change in circumstances. As with other companies and the commodities and specialty chemicals industries, Dow's earnings and share price declined precipitously. Concurrently, Dow's cash reserves plummeted, and when coupled with the Company's general financial health decline, Dow's ability to tap alternative lines of credit, including the $ 13 billion bridge loan, quickly changed. Dow, along with many other companies, experienced multiple credit rating agency downgrades. In the span of five days, from December 29, 2008 to January 2, 2009, all three of the rating agencies--S&P, Moody's, and Fitch--lowered Dow's credit ratings to just a few notches above junk. Plaintiffs allege that the Dow board was faced with two problems in late 2008: (1) Dow did not have sufficient cash reserves to complete the R&H Transaction, and (2) if Dow closed the R&H Transaction without K-Dow's proceeds, a series of credit defaults would be triggered, causing insolvency.

Despite these challenges the Dow board remained committed to its transformative strategy and worked diligently to keep the R&H Transaction and K-Dow deals on track. For the R&H Transaction, the board worked to secure the required regulatory approvals, and remained on schedule by late December 2008. At that point the only remaining conditions on Dow's obligation to close were antitrust approvals by the FTC and the European Commission, which were anticipated to be obtained within the first two weeks of January.

Regarding the K-Dow deal, Dow received approval on November 24, 2008 from the Supreme Petroleum Council ("SPC") of Kuwait. Within days Dow executed the K-Dow Petrochemicals joint venture agreement with Kuwait, setting a closing date of January 2, 2009. Dow announced the execution of the K-Dow joint venture agreement on December 8, 2008. Unfortunately, yet another set back occurred on December 28, 2008. The Kuwaiti Petrochemicals Corporation and Petrochemicals Industries Company informed Dow that the Kuwait Supreme Petroleum Council had rescinded its approval of the joint venture. No reason was given for the rescission. Dow received written notice of the rescission on December 31, 2008, and promptly issued a press release restating that the R&H Transaction was not contingent on K-Dow and reiterating its intent to keep the

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R&H Transaction on track.

It took nearly a month after Kuwait's withdrawal of its regulatory approval, before it publicly announced the bribery allegations through a report published by the *Kuwait Times.* Up until that report, vague allegations of the SPC's justifications trickled from the media stream. For instance, on December 29, 2008, the *Kuwait Times* reported that SPC's reversal was a reaction to believing that many senior oil sector officials had complained of "external interference" and "politicizing" of the country's vital oil industry. These vague terms were left undefined in the December 29th article. That same article stated that:

> The [K-Dow] deal came under the spotlight early this month when the Popular Action Bloc threatened it would grill the prime minister if the government *did not cancel the deal before the start of the New Year.* The Bloc described the deal as a sellout and that its value was highly exaggerated, citing the fact that Dow Chemical's value had fallen from $ 51 billion last year to $ 17 billion now because of the global financial crisis. The call was supported by many other MPs who also *questioned the benefits of the deal in the wake of the global financial crisis.*

The same article disclosed that had Kuwait waited until the New Year to cancel its agreement it would be "liable to pay a penalty of up to $ 2.5 billion."

It was not until January 28, 2009, in another report published by the *Kuwait Times,* that the alleged reason for Kuwait's backing out of the deal came to light. According to the article, the National Assembly had voted overwhelmingly to investigate "suspicions of profiteering and accepting all forms of commissions by oil executives" involved in several deals, including K-Dow. Not only does this report still not mention "bribery"--though that allegation flows more reasonably than from the "external interference" and "politicizing" allegations--the same article stated that MP Mohammad Al-Mutair "said the government should tell Dow Chemical that if it initiated legal action against Kuwait on the deal, it risks losing its strategic projects in the country."

Dow's Attempt to Extend R&H Closing

Contemporaneously, the Dow board proceeded ahead with the R&H Transaction, but allegedly attempted to delay the closing. By January 9, 2009, only one hurdle remained before the Transaction could close: FTC regulatory approval. Plaintiffs allege that the Dow board lobbied the FTC to delay its approval and asked R&H to consider extending the deadline, but both routes were unsuccessful. The FTC granted final antitrust clearance for the R&H Transaction on January 23, 2009, which triggered a closing date of no later than January 27, 2009.

Dow thereafter refused to close the Merger and informed R&H on January 25, 2009, citing economic concerns and viability of the combined entities. On January 26, 2009, R&H filed suit against Dow in this Court seeking specific performance of the Merger Agreement.

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Plaintiffs' Claims

Plaintiffs primarily allege that director defendants breached their fiduciary duties by entering a merger agreement with the specialty chemical maker Rohm & Haas for $ 18.8 billion that unconditionally obligated Dow to consummate the merger. Plaintiffs challenge the wisdom of the board's July 2008 decision, focusing on the substantive provisions of the deal, rather than the procedure employed to make an informed business judgment by a majority of the disinterested and independent board members. In particular, plaintiffs take issue with the board's decision to enter a merger agreement without a financing condition. Repeatedly plaintiffs assert that the director defendants have placed Dow in a precarious position, facing potential financial ruin if this Court forced specific performance of the R&H Transaction.[89] Since plaintiffs in this action challenge a board decision, they must show that demand was futile under the two-pronged *Aronson* test.

Plaintiffs also seek to hold the directors liable under a *Caremark* theory for a variety of alleged monitoring failures. Under this theory, plaintiffs must demonstrate that the defendant directors acted in bad faith and consciously disregarded their fiduciary duties and thus face a "substantial likelihood" of liability for the alleged bribery, misrepresentations, insider trading, and wasteful and excessive compensation.

Plaintiffs attempt to show that the K-Dow deal fell apart because Dow officers bribed certain senior Kuwaiti officials. Plaintiffs argue that the press releases and newspaper articles from Kuwait, described above, support an allegation of bribery. They also assert that the Dow board was aware of or should have been aware of the bribery and failed to do anything. Therefore, plaintiffs conclude that the director defendants breached their fiduciary oversight duties under *Caremark.*

Plaintiffs allege that Liveris' and Merszei's press statements on behalf of Dow, among others, were false and misleading, and made with the direct intent to cover up the conditional nature of the R&H Transaction on K-Dow. Plaintiffs further allege that the director defendants knew the negotiations with Kuwait and PIC were not on track, yet continued to tell the press they were throughout the fall of 2008. Liveris continued to reassure stockholders and the public that Dow was "on track to close the [R&H] acquisition," that Dow "remain[ed] committed to the deal," and that Dow has "plenty of financing resources available" to do so.[90]

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[89] This assertion is moot as the R&H Transaction was consummated on April 1, 2009 and the combined entity has survived. Additionally, the potential liabilities of billions of dollars in damages to R&H is not only moot, but also unripe at the time the complaint was filed and as this motion is pending before the Court.

[90] Compl. P 63. Plaintiffs assert a corollary argument that the director defendants admitted in the R&H litigation that the R&H Transaction depended on K-Dow all along. Compl. P 88. That a component of the financing for the R&H Transaction was anticipated to come from K-Dow does not mean that statements making clear the R&H Transaction was not dependent on the closing of K-Dow were misleading or false. To the contrary, the statements, as described below, were not misstatements at all; they merely relayed the temporal connection between the two deals. See discussion infra Part II.B.2.b.

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To add to their litany of allegations, plaintiffs also allege unlawful insider trading by three directors and three officers: Allemang, Liveris, and Merszei (directors); Banholzer, Gambrell, and Kepler (officers). Here, plaintiffs make attenuated insider trading arguments, insisting that these defendants had "non-public information about the business of Dow, as well as its finances, major contracts, merger plans, and present and future business prospects" through access to internal corporate matters. All but two of the twelve stock sales at issue here were made before the R&H Merger Agreement was executed; the vast majority was sold in April 2008, months before the R&H Transaction. Plaintiffs further assert that at the time of these sales the insiders knew that the R&H Transaction was dependent on the K-Dow deal but failed to disclose that material information to the public. As made clear throughout this Opinion, the statements were not misstatements; they were accurate as to the temporal significance of the two deals.

As for plaintiffs' final substantive allegation, wasteful and excessive compensation, there are no particularized allegations in the complaint. Even in plaintiffs' brief in opposition to defendants' motion, plaintiffs do not allege particularized facts. Rather, plaintiffs merely make broad assertions that the Dow board caused excessive and wasteful compensation to be made to unidentified directors and officers.

The Procedural History

On January 26, 2009, R&H filed suit in this Court seeking specific performance of the Merger Agreement. On the eve of trial, the lawsuit settled and the merger closed on April 1, 2009, on substantially altered financial terms.

Shortly after R&H filed suit, on February 9 and 12, 2009, two individual stockholders filed two virtually identical derivate actions that have been consolidated into this action. The actions were consolidated on March 5, 2009. Defendants filed a motion to dismiss on April 15, 2009. Oral argument on this motion to dismiss was held on December 31, 2009.

ANALYSIS

Legal Standard for Demand Excusal

In recognition of the "fundamental precept that directors manage the business and affairs of corporations," Chancery Court Rule 23.1 imposes a demand requirement for derivative actions.[91] The shareholder-plaintiff must either make pre-suit demand on the corporation's board of directors or allege demand futility. Demand is deemed futile, and therefore excused, only if a majority of the directors have such a personal stake in the matter at issue or the proposed litigation that they would not be able to make a proper

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[91] HN6 The purpose of this requirement "is not to insulate defendants from liability; rather, the demand requirement and the strict requirements of factual particularity under Rule 23.1 'exist[] to preserve the primacy of board decisionmaking regarding legal claims belonging to the corporation.'" Citigroup, 964 A.2d at 120 (citing Am. Int'l Group, Inc., Consol. Derivative Litig., 965 A.2d 763, 807-09, 2009 WL 366613, at *29 (Del. Ch. 2009)).

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business judgment in response to a demand. Rule 23.1 places "stringent requirements of factual particularity [on allegations of demand futility] that differ substantially from the permissive notice pleading[]" requirements of Rule 8. The purpose of this heightened standard is to ensure only derivative actions supported by a reasonable factual basis proceed. Plaintiffs need not demonstrate, however, a reasonable probability of success on the merits. Rather, plaintiffs need only make a "threshold showing through the allegation of particular facts, that their claims have some merit."[92]

Upon reviewing a motion to dismiss for failure to demonstrate demand futility pursuant to Rule 23.1, the Court must accept the well-pled factual allegations of the derivative complaint as true and draw all reasonable inferences in favor of plaintiffs.[93] "Conclusory allegations, however, are not accepted as true." Different standards apply to the various decisions or non-decisions a board may make. For conscious board decisions--whether to act or not--the two-pronged *Aronson* test applies.[94] A board's failure to act absent a conscious decision to refrain from acting, such as a failure to supervise,[95] is analyzed under *Rales*.[96]

The *Aronson* standard clearly applies to plaintiffs' claims arising from the board's approval of the R&H merger. The remaining claims are based on a failure to supervise, and thus are governed by the *Rales* standard.[97]

Demand Futility Regarding Plaintiffs' Breach of Fiduciary Duty Claims

Plaintiffs' complaint pleads three derivative claims. Count I pleads a breach of the fiduciary duty of loyalty claim for insider trading by certain director and officer defendants. Count II pleads breaches of fiduciary duty by the director defendants by: (a) approving the R&H Transaction, (b) misrepresenting the relationship between the R&H and K-Dow transactions, (c) failing to detect and prevent alleged bribery in connection with the K-Dow transaction, (d) failing to detect and prevent the alleged misrepresentations, (e) failing to detect and prevent insider trading, and (f) failing to prevent the payment of allegedly excessive and wasteful compensation. Count III asserts claims for contribution and indemnification against the director defendants for unidentified future claims.

Insider Trading Claim -- Count I

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[92] Rales v. Blasband, 634 A.2d 927, 934 (citing Aronson, 473 A.2d at 811-12).
[93] Rales, 634 A.2d at 931 (footnotes omitted).
[94] See Aronson, 473 A.2d at 813. See also Citigroup, 964 A.2d at 121.
[95] In re Caremark Int'l Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996).
[96] Rales, 634 A.2d at 930.
[97] Plaintiffs argue that the breach of fiduciary duty claims arising from the R&H Transaction should be analyzed under Rales as well as Aronson. But defendants correctly note that plaintiffs are not entitled to "two bites at the demand futility apple." Defs. Supp. Br. at 17. As Citigroup made clear, Aronson applies to board action and Rales applies to board inaction. Citigroup at 121. The R&H Merger was a transaction and any allegations relating to that decision are analyzed under Aronson. Plaintiffs' other claims as to failure to supervise (enabling bribery and insider trading) are not board decisions and, thus, are appropriately analyzed under Rales.

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As an initial matter, I deem plaintiffs' insider trading claims in Count I as waived. Plaintiffs quietly abandoned this claim in their brief in opposition to defendants' motion to dismiss, by failing to address or respond to defendants' arguments in their motion to dismiss. * * *

Approval of R&H Transaction -- Count II

To satisfy *Aronson* plaintiffs must plead particularized facts that raise a reasonable doubt either (i) that a majority of the directors who approved the transaction in question were disinterested and independent, or (ii) that the transaction was the product of the board's good faith, informed business judgment.

First Prong of *Aronson*

Plaintiffs argue that demand is excused because it would be futile. According to plaintiffs, at least half of the board members, or six of the board's twelve directors, fail the test of being disinterested and independent.[98] Disinterested "means that directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally."[99] "Independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences." One such influence occurs when a director is "dominated and controlled" by someone who is interested; an entrenchment motive can provide another such influence. But where there is no director who is interested in the transaction, there is no need to consider the independence of the remaining directors.[100] Here, none of the outside directors[101] stood on both sides of the transaction; nor are they alleged to have received a personal financial benefit from it other than one devolved on all Dow stockholders alike. Moreover, *no* directors are alleged to have been interested in the deal.[102] Thus, there is no issue regarding any directors' interest. Rather, the thrust of plaintiffs' allegations is that the Dow directors were not independent because of various

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[98] HN10 Plaintiffs must show that at least half of the board is not disinterested and independent. Beam v. Stewart, 845 A.2d 1040, 1046 (Del. 2004) ("[D]emand is excused where a board is evenly divided between interested and disinterested directors.").

[99] Aronson, 473 A.2d at 812.

[100] Brehm, 746 A.2d at 258. The situation may be different where a majority or control stockholder exists. There the majority or control stockholder may influence board members even if the controller is not on the board. In that case, independence may be dispositive without any director being interested. That individual will satisfy the interest hook of the Aronson test. Here, no control or majority stockholder exists, so the relevant persons to examine for purposes of interest are the directors, and absent an interest hook, the Court need not consider the remaining directors' independence.

[101] Of the twelve directors on Dow's board, nine are outside directors. See Compl. P 125(c).

[102] Defendants directly challenged plaintiffs' apparent misunderstanding of the relationship between interestedness and independence. Defs. Supp. Br. at 15. In response, plaintiffs consciously chose: (i) to stand on their complaint that contained no interest allegation, and (ii) to answer defendants' brief still without addressing the interest issue and instead focusing solely on the independence analysis. See Pls. Opp'n Br. at 14-19. Plaintiffs have clearly misunderstood the Aronson test and its progeny; under Brehm, the independence of directors is only relevant when there exists an interested person.

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business or personal relationships with Liveris, which allegedly left at least seven directors beholden to Liveris, and thus unable to act independently of his influence. But plaintiffs do not allege any interest on the part of Liveris.[103] At best plaintiffs point to Liveris' role as a director at Citigroup--the named bank in a consortium of nineteen to provide bridge financing for the R&H Transaction, should Dow need it. That the potential for a conflict of interest may have existed does not reasonably lead to the conclusion that a conflict existed. Defendants correctly note that Liveris may have had a conflict if R&H had succeeded in forcing Dow to draw on its bridge financing to close the deal, and Dow had gone into bankruptcy as a result.[104] Nonetheless, under *JP Morgan,* even directors with "substantial personal wealth invested in their related companies [e.g., Citi], each of which conducts business with [Dow]" were found independent.[105] Without a conflict there is no interest hook for plaintiffs to assert.

Under *Brehm,* without an interested director the independence of the remaining directors need not be examined. Plainly put, the beholdenness or dominance of any director is irrelevant because there is no fear that the dominating director, without a personal or adverse interest, will do anything contrary to the best interest of the company and its stockholders. Thus, plaintiffs' allegations of Liveris' domination over seven directors is irrelevant.[106] Liveris is not interested in the R&H deal and, therefore, his influence is not in question.

Before moving on to the second prong of *Aronson,* I pause to address two of plaintiffs' arguments. First, plaintiffs allege that the three inside directors--Liveris, Merszei, and Allemang--depend for their livelihood on Dow.[107] Under *Rales,* depending on a director office for one's livelihood is evidence of beholdenness.[108] But where a director is beholden to the *company* there is no reason to doubt her loyalty to that company. Her interests are aligned with the company and presumably she is able to make decisions in the best interests of the company. Thus, plaintiffs' allegations of "beholdenness to Dow"

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[103] See Compl. P 125 (although plaintiffs allege the directors "are not disinterested and independent," the list of specific allegations (PP (a) - (k)) focuses solely on independence and does not mention interestedness).

[104] But even that conflict is not clear. First, the decisions challenged under the alleged conflict are decisions made after the K-Dow deal--not R&H--did not close. Plaintiffs are solely challenging the R&H deal, not K-Dow. Second, Citigroup was one of nineteen banks that agreed to provide bridge financing. The potential conflict here is too attenuated, especially in light of plaintiffs' own argument that Liveris depends on his continued employment with Dow for his livelihood, suggesting he would not place Citigroup's interest above Dow's. Pls.' Opp'n Br. at 14.

[105] In re J.P. Morgan Chase & Co. S'Holder Litig., 906 A.2d 808, 821-22 (Del. Ch. 2005) ("JPMC is a national commercial and investment bank. That it provided financing to large American companies should come as no shock to anyone. Yet this is all that plaintiffs allege.").

[106] The seven directors are Bell, Hess, Merszei, Reilley, Shaw, Stern, and Franklin. Pls.' Opp'n Br. at 16.

[107] The board is dominated by outsiders. Of the twelve directors, only three are insiders. Liveris, Merszei, and Allemang are employed by Dow in various executive capacities. Compl. P 125(c). The remaining nine directors are not employees and, therefore, not insiders. Neither party disputes these three directors' dependence. Both the New York Stock Exchange and Dow's own director independence standards support their dependence. Id.; Defs.' Reply Br. at 9.

[108] Rales, 634 A.2d at 936. Yet, beholdenness is only relevant where there is an interested person, as there was in Rales. See id. at 936 (Rales brothers found "interested" because subject to a substantial likelihood of liability); see also, Brehm, 746 A.2d at 258.

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are misplaced and inaccurate.

Second, assuming that plaintiffs adequately pleaded interest as to one director--which they have not--a domination and control inquiry still would not establish a lack of independence. Plaintiffs have alleged no more than "mere outside business relationship[s which], standing alone, are insufficient to raise a reasonable doubt about a director's independence."[109] Plaintiffs assert that the defendant directors are beholden to Liveris for numerous reasons, but they fail to demonstrate why that is so.[110]

Problems also exist with all other allegations of influence. That directors of one company are also colleagues at another institution does not mean that they will not or cannot exercise their own business judgment with regard to the disputed transaction.[111] Furthermore, the mere fact that a director played a role in nominating new directors does not mean that the new director is beholden to the nominating director.[112] It is a business reality that current directors often nominate new directors, and some former relationship usually factors in to the nomination.[113] Finally, allegations of interlocking positions forming a tight "inner circle" between the Audit Committee and Governance Committee and Liveris on the board are, without more, also insufficient. Committees may, and often do, have overlapping members. That sole fact, without some allegation of improper influence, is not enough to establish lack of independence. [114]

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[109] Beam, 845 A.2d at 1050. See also J.P. Morgan, 906 A.2d at 821 (citing Beam at 1051 ("Allegations that Stewart and the other directors moved in the same social circles, attended the same weddings, developed business relationships before joining the board, and described each other as 'friends,' even when coupled with Stewart's 94% voting power, is insufficient, without more, to rebut the presumption of independence.")).
[110] For example, plaintiffs' argument that Liveris allegedly exercised influence by "order[ing] the Board, overnight, to summarily terminate two dissident officers"--their best argument--falls short. Upon further investigation it is clear that valid business reasons existed to terminate those two officers; they held clandestine meetings and set up a proposed leveraged buyout--all behind the board's back. Not surprisingly, the board may not have wanted them at the company. On the contrary, plaintiffs paint a different picture, suggesting that the two officers were whistleblowers on the bribery charges brought by the SEC against Dow in early 2007. Pls.' Opp'n Br. at 16. The complaint, however, states that the officers were engaged in clandestine meetings without the full board or the CEO's knowledge. See Compl. P 125. Thus, it is far from clear that the board acted as Liveris' puppets in deciding to fire them.
[111] For instance, in addition to co-directorship at Dow, Hess and Franklin also are colleagues at J.P. Morgan Chase. Plaintiffs suggest, as a result of this perceived "structural bias," that "neither would take action to investigate or sue the other with respect to the R&H Merger for fear of jeopardizing his own financial dependence on J.P. Morgan." Pls.' Opp'n Br. at 18. But without more, such as a financial connection between Dow and the other company, this allegation is merely conclusory and insufficient. See Beam, supra note 45; see also J.P. Morgan at 821-24 (finding that outside directors' ties to organizations that JPMorgan donated to still was not enough to find an improper influence).
[112] Plaintiffs allege that Liveris "hand picked or played a heavy role" in the selection and retention of six of Dow's board members who joined in 2005 or later: Bell, Hess, Merszei, Reilley, Shaw, and Stern. Pls.' Opp'n Br. at 16.
[113] See A. Gilchrist Sparks, III, Corporate Democracy -- What It Is, What It Isn't, and What It Should Be 6 (February 2006), available at www.mnat.com/attachment/39/Sparks+New+Article.pdf ("the corporation's slate is nominated by a committee of the incumbent board").
[114] As the Supreme Court observed in Brehm, demand futility allegations cannot be based on deviations from "aspirational goals of ideal corporate governance practices." 746 A.2d at 256. Moreover, plaintiffs concede that they did not employ a books and records demand as a tool to flesh out their unparticularized

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Upon review of the plaintiffs' allegations, I find that plaintiffs fail to meet their burden under Rule 23.1 with respect to any of the outside directors. The majority of the Dow board was disinterested and independent.

Second Prong of *Aronson*

Plaintiffs argue that demand is also excused under the second prong of the *Aronson* test. In order to succeed, "plaintiffs must allege particularized facts that raise doubt about whether the challenged transaction is entitled to protection of the business judgment rule."[115] Specifically, the "plaintiffs must plead particularized facts sufficient to raise (1) a reason to doubt that the action was taken honestly and in good faith or (2) a reason to doubt that the board was adequately informed in making the decision."

Nothing in the complaint indicates the Dow board was not adequately informed about the transaction with R&H. The complaint is devoid of any allegations that the board failed to put in the time and effort necessary to properly evaluate the risks and benefits of that transaction, or allegations that the board was unaware of any material terms of the transaction or failed to obtain the advice of experts before approving it. On the contrary, plaintiffs unintentionally concede--on more than one occasion--that defendant directors did perform some due diligence.[116] Even accepting all the well-pled allegations as true, plaintiffs do not rebut or address the accepted facts that the board was negotiating in a seller's market and R&H demanded certain deal protections.[117] Fearing that R&H would walk away, Dow made a clear business decision to approve the R&H deal and sign the Merger Agreement without a financing contingency. Plaintiffs' failure to address these facts is highly suggestive that they do not focus on the process but rather on the substantive content of the directors' decision.

Simply put, plaintiffs take issue with the substantive decisions of the R&H Transaction, instead of the process the board followed. This Court made clear in *Citigroup* that substantive second-guessing of the merits of a business decision, like what plaintiffs ask the Court to do here, is precisely the kind of inquiry that the business judgment rule prohibits.[118]

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allegations of a "clubby" inner circle on the Dow board. Had they done so (as plaintiffs were admonished in Beam, supra note 45) their allegations might have met the requirements of Rule 23.1.

[115] J.P. Morgan, 906 A.2d at 824 (citing In re Walt Disney Co. Derivative Litig., 825 A.2d 275, 286 (Del. Ch. 2003)).

[116] "Plaintiffs do, indeed, attack the board of directors for the woefully inadequate process, and lack of acting properly on what they must have learned through due diligence, in connection with the K-Dow and R&H transactions." Pls. Opp'n Br. at 20 (emphasis added). See also Compl. P 58 (quoting Liveris stating: "[A] lot of work we've done already on due diligence tells us that we'll make sure that synergies are bankable.").

[117] Both parties acknowledge that R&H was unwilling to enter an agreement without the certainty that an agreement without a financing condition provides. Compl. P 56; Defs.' Supp. Br. at 17.

[118] Citigroup, 964 A.2d at 122 ("[S]o long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests" the court will not second-guess a board's business decisions.).

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Both of plaintiffs' attempts to distinguish *Citigroup* fail. First, plaintiffs draw a line between a simple exercise of business judgment relating to a transaction or series of transactions, and a "bet the company" transformational transaction. Delaware law simply does not support this distinction. A business decision made by a majority of disinterested, independent board members is entitled to the deferential business judgment rule regardless of whether it is an isolated transaction or part of a larger transformative strategy. The interplay among transactions is a decision vested in the board, not the judiciary.

Second, plaintiffs again attempt to distinguish *Citigroup* on the ground that the Citigroup directors were accused of failing to recognize business risk, rather than failing to uncover fraud or criminal conduct. As described below, I am not persuaded that the directors made any misrepresentations, and plaintiffs' bribery allegations with respect to the board's involvement are wholly unsupported. Nonetheless, as in *Citigroup* I examine plaintiffs' primary claim in evaluating whether plaintiffs properly pleaded demand futility.[119] Here, plaintiffs have failed to adequately plead that the directors are not entitled to business judgment review for decisions made by a disinterested and independent board.

Turning to plaintiffs' allegations of bad faith, I am unconvinced that the directors acted in any way other than honestly and in good faith. To show that a disinterested and independent board acted outside the bounds of business judgment, plaintiffs must show that directors acted in bad faith.[120] Recently, the Supreme Court clarified the concept of bad faith in *Lyondell Chemical Co. v. Ryan,* noting that "[i]n the transactional context, [an] extreme set of facts [is] required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties."[121] Plaintiffs must show that defendants completely and "utterly failed" to even attempt to meet their duties.[122]

Though the complaint does identify specific disclosures alleged to be misleading, plaintiffs do not allege specific facts "that reasonably suggest sufficient board involvement in the preparation of the disclosures," nor does the complaint sufficiently allege that "the director defendants had knowledge that any disclosures or omissions were false or misleading or that the director defendants acted in bad faith in not adequately informing themselves." To determine "whether the alleged misleading statements were made with knowledge or bad faith requires an analysis of the state of mind of the individual director defendants." Plaintiffs have not made specific factual allegations that allow for such an inquiry.

The gist of plaintiffs' claim is that Liveris and Merszei, with the board's approval,

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[119] The primary claim in Citigroup was that the directors failed to recognize the coming subprime business risk. The Court examined this claim under the business judgment rule, even though the plaintiffs also accused management of making misrepresentations and engaging in other misconduct. See Citigroup, 964 A.2d at 124.
[120] Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 2009 WL 1024764 at *7 (Del. 2009).
[121] Id. (quoting In re Lear Corp. S'holder Litig., 967 A.2d 640, 2008 WL 4053221 at *11 (Del. Ch. 2008)).
[122] Lyondell, 970 A.2d 235, [WL]at *7.

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misrepresented the connection between the R&H and K-Dow deals. According to plaintiffs the K-Dow deal was an integral part of the R&H financing, known to the board upon entering the merger agreement in July 2008. The board, therefore, must have concealed and misrepresented this fact when Liveris stated that the R&H deal was not contingent on the closing of the K-Dow deal.

This claim fails for two reasons. First, plaintiffs' own allegations show that Liveris never stated anything that misrepresented the relationship between the R&H and K-Dow transactions; he merely stated that the *order in which the transactions were completed* did not matter.[123] At that time the board believed that the $ 13 billion bridge loan would enable Dow to maintain its investment grade rating and close the R&H deal in the event that R&H closed *before* K-Dow. Liveris never stated, and there is no allegation to suggest that the board believed, that the R&H deal was contingent on K-Dow. Even in light of the unanticipated financial turmoil, which made it impossible for Dow to take advantage of its back-up financing arrangement when K-Dow did not close, Liveris' earlier statement still was not a misrepresentation because the board only intended to draw on the bridge loan if Dow would remain at investment grade.

Second, plaintiffs accusation as to state of mind is, as defendants correctly note, "utterly circular." For Liveris and Merszei to "feel a need to conceal" they must first have made a misrepresentation, which they did not. The complaint offers no factual basis for plaintiffs' misrepresentation claim and, furthermore, the disputed statements, on their face, do not appear to be misrepresentations. Thus, plaintiffs' allegations are insufficient to support demand futility under the second prong of *Aronson.*

Finally, plaintiffs have alleged no particularized facts to connect the board to Liveris or Merszei's statements. Without a connection, there is reason to doubt that the board knew that the statements were false or misleading or acted in bad faith by not adequately informing themselves about the statements.

Plaintiffs thus are unable to meet either prong of *Aronson.* They have failed to show that a majority of the board is either interested or lacks independence. They also have failed to establish a reasonable doubt that the board's decision was anything other than a valid business judgment. Plaintiffs' derivative claim for breach of fiduciary duties regarding the R&H Transaction must be dismissed because demand is not excused. Pursuant to Rule 15(aaa), this claim is dismissed with prejudice.

Caremark Failure to Supervise Claims -- Count II

Plaintiffs allege that demand is futile as to their failure to supervise claims because the director defendants are not able to exercise disinterested business judgment in responding to a demand because their failure of oversight subjects them to a substantial likelihood of personal liability. According to plaintiffs, the directors face a substantial threat of liability

[123] "[W]e are not counting on [the K-Dow deal]. We can do [the R&H] deal without the Kuwait money, and we will stay at investment grade." Compl. P 57. Furthermore, Merszei stated "[t]his deal is certainly not contingent on the closing of our Kuwait joint venture." Id.

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because their conscious disregard of their duties and lack of proper supervision and oversight caused the Company to be exposed to (1) bribery allegations in relation to the K-Dow transaction, (2) misrepresentation allegations regarding the relationship between the K-Dow and R&H transactions, and (3) insider trading allegations.

A board's unconscious failure to act is governed by *Rales.*[124] Under *Rales,* the only demand futility issue is whether "the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations." Again, plaintiffs must plead particularized factual allegations that create a reasonable doubt that the board could have, at the time the complaint is filed, validly exercised its independent and disinterested business judgment when responding to a demand. Under *Rales,* defendant directors who face a "substantial likelihood of personal liability" are deemed interested in the transaction and thus cannot make an impartial decision. But "[d]emand is not excused solely because the directors would be deciding to sue themselves."[125] Rather, "demand will be excused based on a possibility of personal director liability only in the rare case when a plaintiff is able to show director conduct that is 'so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists.'"

Substantial Likelihood of Personal Directorial Liability

As in *Citigroup,* plaintiffs' arguments are "based on a theory of director liability famously articulated by former-Chancellor Allen in *In re Caremark.*"[126] That theory is oversight liability. Under *Citigroup,* "to establish oversight liability a plaintiff must show that the directors *knew* they were not discharging their fiduciary obligations or that the directors demonstrated a *conscious* disregard for their responsibilities such as by failing to act in the face of a known duty to act."[127] Furthermore, the test is "rooted in concepts of bad faith; indeed, a showing of bad faith is a *necessary condition* to director oversight liability." Only an "utter failure" will satisfy a showing of bad faith.[128] Moreover, because Dow has adopted a Section 102(b)(7) provision in its charter, plaintiffs must plead particularized facts showing bad faith in order to establish a substantial likelihood of personal directorial liability.[129]

Bribery Allegations Relating to K-Dow Transaction

Plaintiffs allege that Dow's board failed to detect and prevent bribery in connection with the K-Dow transaction, and though plaintiffs allege that bribery may have occurred, they do not allege that the board knew about, or had reason to suspect, bribery. Plaintiffs do

[124] See Rales, 634 A.2d at 930.
[125] Citigroup, 964 A.2d at 121 (citing Jacobs v. Yang, 2004 Del. Ch. LEXIS 117, 2004 WL 1728521, at *6 n.31 (Del. Ch. Aug. 2, 2004)).
[126] Citigroup, 964 A.2d at 121 (citing In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996)).
[127] Citigroup, 964 A.2d at 123 (emphasis supplied) (footnotes omitted).
[128] Lyondell, 970 A.2d 235, 2009 WL 1024764 at *7 (quoting In re Lear Corp. S'holder Litig., 967 A.2d 640, 2008 WL 4053221 at *11).
[129] See Stone v. Ritter, 911 A.2d 362, 369-70 (Del. 2006); Citigroup, 964 A.2d at 125.

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not dispute that no formal charge of bribery has been made. The only proffered support for the bribery allegation is an unsubstantiated charge made by a member of the Kuwaiti Parliament. But even plaintiffs concede that Kuwait is an "unpredictable regime whose adherence to the rule of law [is] doubtful." Moreover, as the complaint admits, Kuwaiti politics have been riddled with "[e]ndemic infighting" for more than a decade. Further, the Kuwait government took nearly a month to formulate its bribery allegations against Dow. Initially, Kuwait cited vague concerns of "external interference" and "politicizing." During the next month these allegations evolved into "suspicions of profiteering and accepting all forms of commissions by oil executives" involved in K-Dow. Concurrently, the *Kuwait Times* reported that the political group, Popular Action Bloc, "threatened it would grill the prime minister if the government *did not cancel the deal before the start of the New Year.*" Presumably this was because after the New Year Kuwait would be liable to pay up to a $ 2.5 billion penalty. Moreover, the political group makes clear its hesitation to enter a deal "in the wake of the global financial crisis." Other politicians did not hesitate to use strong-arm techniques. For instance, MP Mohammad Al-Muair suggested the government threaten to block Dow out of any Kuwait ventures if Dow brought legal action against the country.

Though plaintiffs' bribery allegations are sketchy (at best), plaintiffs have adequately alleged particularized facts that allow a reasonable inference that bribery may have occurred in relation to the joint venture between Dow and the Kuwaiti government. At a motion to dismiss stage, the key inquiry is "do[es the nonmoving party] get . . . access to evidence to go further." Though the particularized factual allegations also support a theory that Kuwait got cold feet in the wake of the global financial meltdown, and used allegations of bribery as the vehicle to back out of the deal, it is not irrational to infer that bribery could have occurred. Accordingly, based on plaintiffs' factual allegations and the low motion to dismiss threshold, I accept for purposes of this motion the inference that Dow officers may have engaged in bribery.

Nonetheless, plaintiffs fail to plead with particularity allegations that, if true, would give the Dow board cause for suspicion. The alleged "red flag" to alert the board that Dow management had engaged in bribery in connection with K-Dow simply is not a "red flag." As a preliminary matter, the only "red flag" plaintiffs mention is not even contained in the complaint. Accordingly, I need not address it. Even had such an allegation been in the complaint, it is still insufficient. Plaintiffs argue that because bribery may have occurred in the past (Dow paid a fine to the SEC in January 2007), by different members of management, in a different country (India), and for a different transaction (pesticide registrations), the board should have suspected similar conduct by different members of management, in a different country, in an unrelated transaction. This argument is simply too attenuated to support a *Caremark* claim.

With neither knowledge of bribery, nor any reason to suspect such conduct, the defendant directors could not "conscious[ly] disregard" their duty to supervise against bribery. Plaintiffs have also failed to allege facts suggesting that the Dow board "utterly fail[ed]" to supervise insiders, or that any director acted with anything other than good faith. Therefore, plaintiffs have failed to allege facts that establish a substantial likelihood of

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director liability due to oversight liability under *Citigroup,* and their *Caremark* claims as to bribery in Count II are dismissed with prejudice pursuant to Rule 15(aaa).

Misrepresentation of Relationship between K-Dow and R&H Transactions

Plaintiffs repeat their allegations that the board is responsible--and thus a substantial likelihood of liability must exist--for violations of the duty of disclosure made by Liveris and Merszei regarding the relationship between the K-Dow and R&H transactions. For the same reasons stated above, and based on the complaint's conclusory allegations, I cannot conclude that the director defendants face a substantial likelihood of liability that would prevent them from impartially considering a demand. Accordingly, these *Caremark* claims are dismissed with prejudice.

Insider Trading and Waste Claims

The complaint also alleges that the board failed to (i) detect and prevent insider trading and (ii) prevent the payment of allegedly excessive and wasteful compensation to unidentified officers and directors. Plaintiffs quietly abandoned these arguments when they failed to respond to defendants' arguments regarding the *Caremark,* claims beyond mere reassertions of broad allegations. I, therefore, deem these claims waived or abandoned, and grant defendants' motion to dismiss without prejudice as to the *Caremark* insider trading and waste claims of Count II.

Director(s) Domination or Control of Board

Plaintiffs further argue that even if none of the outside directors face a substantial likelihood of liability for failing to supervise Dow's management, they have shown that Liveris does and that he dominates and controls a majority of the directors. For all the reasons presented above, I likewise conclude that plaintiffs have not alleged facts sufficient to show that Liveris is subject to a substantial likelihood of liability; therefore, whether he dominates and controls at least five other members of the Dow board is irrelevant because he suffers from no disabling or conflicting interest. * * *

Demand Futility Allegations Regarding Plaintiffs' Indemnification and Contribution Claims

Count III of the complaint seeks to assert claims for contribution or indemnity against the director defendants for unidentified claims that might be asserted in the future against Dow. The complaint is devoid of any currently pending claims, let alone actual claims, against Dow. To establish demand futility, plaintiffs must show that the board cannot exercise valid business judgment in deciding whether to pursue the derivative action because it is not disinterested and independent. Delaware courts only hear disputes that are ripe for judicial determination. "[A] ripe dispute is one where litigation 'sooner rather than later appears to be unavoidable,' and one in which the 'material facts are static.'"

Plaintiffs' claims for contribution and indemnification are clearly not ripe because no

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dispute or litigation currently exists or is pending. Therefore, plaintiffs' allegations are insufficient to establish demand futility, and Count III is dismissed without prejudice under Rule 23.1.

CONCLUSION

For the foregoing reasons, defendants' motion to dismiss is GRANTED. All claims in the complaint are dismissed for failure to adequately plead demand futility pursuant to Chancery Court Rule 23.1. Pursuant to Chancery Court Rule 15(aaa), the primary breach of fiduciary duties claims--the *Aronson* and *Caremark* claims--are dismissed with prejudice as to the named plaintiffs; all remaining claims--insider trading, waste, and contribution and indemnification--are dismissed without prejudice.

Counsel shall confer and agree upon a form of implementing Order.

E. Page 148, New Sec. 3.12.E. Lynch Not Applicable Where Offer Made by Third Party Acquiror for a Target with a Controlling Shareholder—Hammons

Page 148, New Sec. 3.12.E. Add before Sec. 3.13. the following:
New Sec. 3.12.E. **Lynch Not Applicable Where Offer Made by Third Party Acquiror for a Target with a Controlling Shareholder—*Hammons***

In Re John Q. Hammons Hotels Inc. Shareholder Litigation
Court of Chancery of Delaware, 2009
2009 Del. Ch. LEXIS 174

MEMORANDUM OPINION

CHANDLER, Chancellor

This case arises out of the merger in September of 2005 of John Q. Hammons Hotels, Inc. ("JQH" or the "Company") with and into an acquisition vehicle owned by Jonathan Eilian, pursuant to which the holders of JQH Class A common stock received $ 24 per share in cash (the "Merger"). Plaintiffs in this purported class action seek damages for the allegedly inadequate price paid for the publicly held Class A shares. Plaintiffs contend that John Q. Hammons, JQH's controlling stockholder, used his control position to negotiate an array of private benefits for himself that were not shared with the minority stockholders. Eilian, a third party with no prior relationship with Hammons or JQH, negotiated with Hammons and the special committee, which was formed to represent and negotiate on behalf of the minority stockholders. The result of these negotiations was that the Class A stockholders received cash for their shares, and Hammons, in exchange for his Class B stock and interest in a limited partnership controlled by JQH, received a small

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equity interest in the surviving limited partnership, a preferred interest with a large liquidation preference, and various other contractual rights and obligations.

Plaintiffs contend that Hammons breached his fiduciary duties as a controlling stockholder by negotiating benefits for himself that were not shared with the minority stockholders. Plaintiffs also contend that the JQH directors breached their fiduciary duties by allowing the Merger to be negotiated through an allegedly deficient process, and by voting to approve the Merger. Plaintiffs also assert claims against the Merger acquisition vehicles for aiding and abetting the breaches of fiduciary duty. Finally, plaintiffs assert four disclosure claims based on alleged misstatements and omissions in the Company's proxy statement.

Before the Court are cross-motions for summary judgment, and the threshold issue is whether the Court should apply the entire fairness or business judgment standard of review. Defendants argue that business judgment is the appropriate standard of review because (1) Hammons was not involved in the process of negotiation for the purchase of the minority shares, (2) the minority stockholders were adequately represented by the disinterested and independent special committee, and (3) a majority of the minority stockholders approved the Merger in a fully informed vote. Plaintiffs, of course, disagree, and contend that entire fairness is the appropriate standard of review because (1) the special committee was ineffective, (2) the majority of the minority vote was "illusory," and (3) Hammons was subject to a conflict of interest because he negotiated benefits for himself that were not shared with the minority stockholders. Plaintiffs assert that the minority stockholders were "coerced" into accepting the Merger because the price of the Class A stock did not reflect the Company's true value. Moreover, according to plaintiffs, Hammons's ability to block any transaction limited the special committee's ability to negotiate at arm's length and relegated it to the subservient role of negotiating only with bidders acceptable to Hammons.

As explained below, I conclude that *Kahn v. Lynch Communication Systems, Inc.*[130] does not mandate application of the entire fairness standard of review in this case, notwithstanding any procedural protections that may have been used. Rather, the use of sufficient procedural protections for the minority stockholders *could* have resulted in application of the business judgment standard of review in this case. The procedures used here, however, were not sufficient to invoke business judgment review. Accordingly, the appropriate standard of review is entire fairness. As explained below, defendants' motions for summary judgment are granted in part and denied in part, and plaintiffs' motion for summary judgment is granted in part and denied in part.

BACKGROUND

At a February 3, 2005 Board meeting, Hammons informed the Board that he would like to negotiate a transaction with Eilian. At the same meeting, the Board was informed that the Company had received an expression of interest from Eagle and from Corporex Companies. The Board concluded that because Eagle and Corporex did not come forward

[130] 638 A.2d 1110 (Del. 1994).

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sooner after the expiration of the exclusivity period with Barcelo and because of many other factors discussed at the meeting, the Board would not pursue a transaction with that group and would instead proceed expeditiously to negotiate a transaction with Eilian. Based upon a recommendation from the special committee, the Board granted Eilian exclusivity until February 28, 2005.

Over the next several months, representatives of Eilian, Hammons, and the special committee continued to negotiate the terms of a potential deal, during which time the exclusivity agreement with Elian was renewed several times. On June 3, 2005, Hammons and Acquisition (Eilian's acquisition vehicle) informed the special committee that they had reached certain agreements and requested the special committee's approval of them. Acquisition also reaffirmed its offer to purchase all the outstanding shares of Class A common stock held by unaffiliated stockholders for $ 24 per share.

On June 14, 2005, the special committee met with its advisors. Katten Muchin reviewed the process the special committee used over the previous nine months and provided an overview of the various agreements between Hammons and Acquisition. Lehman provided a presentation of its analysis and methodology in issuing its fairness opinion that the $ 24 per share price was fair to the minority stockholders from a financial point of view. Lehman also advised the special committee of its opinion that the allocation of the consideration between Hammons and the unaffiliated stockholders was reasonable. Lehman calculated that the value received by Hammons and his affiliates was between $ 11.95 and $ 14.74 per share. The special committee then approved the merger agreement (the "Merger Agreement") and the related agreements between Hammons and Eilian (collectively with the Merger Agreement, the "Transaction Agreements").

The Board met immediately following the June 14 special committee meeting. Hammons advised the Board that he supported the proposed transactions and then recused himself from the meeting. After presentations from Katten Muchin on the Transaction Agreements and the Board's fiduciary duties, and from Lehman on its fairness opinion, the Board voted to approve the Merger and the Transaction Agreements.

The Merger and the Transaction Agreements

The Merger Agreement provided that each share of Class A common stock would be converted into the right to receive $ 24 per share in cash upon consummation of the Merger. The Merger was contingent on approval by a majority of the unaffiliated Class A stockholders, unless that requirement was waived by the special committee.[131] The Merger Agreement included a termination fee of up to $ 20 million and a "no shop" provision that placed limitations on the Company's ability to solicit offers from other parties. Moreover, Hammons agreed to vote his interests in favor of the Merger and against any competing proposal or other action that would prevent or hinder the completion of the Merger.

[131] As explained below, plaintiffs discount the majority of the minority vote because it only required approval of a majority of the minority shares voting, as opposed to a majority of all the minority shares.

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In addition to the Merger Agreement, Hammons and Acquisition entered into a series of other agreements, which provided for a complex, multi-step transaction designed to provide Hammons financing to continue his hotel development activities without triggering the tax liability associated with an equity or asset sale. Although each Class B share initially remained a share of common stock of the surviving corporation, those shares were eventually converted into a preferred interest in the surviving limited partnership (the "surviving LP"). In order to achieve his tax goals, Hammons had to have an ownership interest in the surviving LP and continue to have capital at risk. Accordingly, Hammons was allocated a 2% interest in the cash flow distributions and preferred equity of the surviving LP. Atrium GP, LLC, an Eilian company, became general partner of the surviving LP and received a 98% ownership interest. Hammons's preexisting limited partner interest in JQHLP was converted into a capital account associated with his preferred interest in the surviving LP, which had a liquidation preference of $ 328 million. When combined with the preferred interest from the conversion of his Class B shares, Hammons's capital account totaled a liquidation preference of $ 335 million. The partnership agreement provided for events in which the capital account could be distributed during Hammons's lifetime, but because of certain tax consequences, it was anticipated that distribution of the capital account was to occur at Hammons's death.

The terms of the Transaction Agreements also provided Hammons other rights and obligations. Importantly, Hammons received a $ 25 million short-term line of credit and a $ 275 million long-term line of credit. Hammons also received (1) the Company's Chateau Lake property in exchange for transferring certain assets and related liabilities to an Acquisition affiliate, (2) a right of first refusal to acquire hotels sold post-merger, and (3) an indemnification agreement for any tax liability from the surviving LP's sale of any of its hotels during Hammons's lifetime. Hammons and Eilian entered into a reciprocal agreement that imposed restrictions on the development of new hotels that would compete with existing hotels owned by either party. Hammons also obtained an agreement whereby his management entity would continue to manage the hotels in exchange for payments of actual operating costs and expenses incurred (estimated to be approximately $ 6.5 million based on the budget for 2005) and a $ 200,000 annual salary to Hammons, plus benefits.

On August 24, 2005, the Company sent a proxy statement to its stockholders in connection with the vote on the Merger at a special meeting of stockholders on September 15, 2005. Of the 5,253,262 issued and outstanding shares of Class A stock, 3,821,005 shares, or over 72%, were voted to approve the Merger. In total, more than 89% of the Class A shares that voted on the Merger voted to approve it. The Merger closed on September 16, 2005.

Plaintiffs' Contentions Regarding the Negotiation Process

Plaintiffs paint a picture of the negotiation process that is dominated by Hammons's ability to walk away and block any transaction, which would have left plaintiffs holding illiquid stock that would likely trade in the $ 4 to $ 7 range. According to plaintiffs, this

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threat relegated the special committee to a passive, tag-along role and forced them to be "friends of the deal" in an effort to prevent Hammons from backing out of the deal.

Plaintiffs also contend that both Katten Muchin and Lehman developed conflicts of interest that biased them in favor of completing a transaction with Eilian. In March 2005, Katten Muchin informed the special committee that it would be representing the entity providing Eilian's financing, iStar Financial Inc. ("iStar"), in connection with the Merger. Plaintiffs contend that this representation gave Katten Muchin an incentive to ensure the Merger proceeded with Eilian, and that iStar played a substantial role in negotiation of the transactions between Hammons and Eilian. Defendants point out that a separate team of lawyers represented iStar and was prohibited from discussing the transaction with the team representing the special committee. The special committee discussed the matter and waived the conflict. The conflict, however, was not disclosed in the proxy statement.

Plaintiffs also assert that Lehman faced a conflict of interest because it sought a role in Eilian's planned refinancing of the Company's debt. Although Lehman did not get the business, plaintiffs contend that Lehman had multiple contacts with Eilian and that "Lehman's efforts to secure business that would have dwarfed the value of its advisory services to the Special Committee" presented a "clear conflict" that was not disclosed in the Company's proxy statement. Defendants contend that the group at Lehman that contacted Eilian about the debt refinancing was separate from the group advising the special committee. Defendants further contend that the alleged conflict was not material and that there is no evidence that Lehman's opinion was affected because the contacts regarding the debt refinancing occurred after Lehman had opined to the special committee in December 2004 that a bid of $ 21 per share was fair to the minority stockholders.

The Litigation

This action was filed on October 20, 2004. The now-operative Second Amended and Consolidated Supplemental Class Action Complaint was filed on October 3, 2006. On October 24, 2008, after discovery and an unsuccessful attempt at mediation, the defendants other than Hammons filed their motion for summary judgment. The director defendants seek summary judgment on the grounds that (1) plaintiffs cannot satisfy their burden to rebut the presumption of the business judgment rule, (2) the special committee members and the director defendants are shielded from monetary liability pursuant to the Company's 8 *Del. C.* § 102(b)(7) exculpatory provision, and (3) there is no evidence to support the aiding and abetting claim. On February 20, 2009, after additional discovery, Hammons filed his motion for summary judgment. Hammons contends that he took no part in the negotiations for the purchase of the minority's shares and argues that he is entitled to summary judgment because plaintiffs cannot rebut the presumption of the business judgment rule and because even if entire fairness applies, Hammons acted fairly. On April 17, 2009, plaintiffs filed their motion for partial summary judgment. Plaintiffs seek summary judgment holding that (1) entire fairness is the applicable standard of review, (2) the special committee process and stockholder vote were ineffective and the burden of persuasion at trial remains with defendants, (3) the challenged transactions

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were the result of unfair dealing, (4) certain defendants are liable for aiding and abetting Hammons's breach, and (5) the only issue for trial is therefore fair price. Plaintiffs now concede that *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* does not govern the duties of the Board, that the special committee was disinterested and independent (although not free from coercion by Hammons), and that a number of the disclosure violations previously alleged should be withdrawn.

ANALYSIS

The Summary Judgment Standard

Summary judgment is appropriate if the moving party demonstrates that there is "no genuine issue as to any material fact" and that it is "entitled to a judgment as a matter of law." The court views the evidence in the light most favorable to the nonmoving party and assumes the truth of uncontroverted facts set forth in the record. When the moving party shows that no genuine issue of material fact exists, "the burden shifts to the nonmoving party to substantiate its adverse claim by showing that there are material issues of fact in dispute." If the nonmoving party bears the burden of proof, summary judgment is appropriate where that party fails to make a sufficient showing on any essential element of its case.

The Standard of Review: Entire Fairness or Business Judgment?

The threshold issue is whether the Court should apply the entire fairness standard or the business judgment standard in reviewing the Merger. Plaintiffs label the Merger a "minority squeeze-out transaction" and contend that *Kahn v. Lynch Communication Systems, Inc.* mandates that the Court apply the entire fairness standard of review, while defendants urge the Court to apply the business judgment standard of review.

In *Lynch* the Delaware Supreme Court held "that the exclusive standard of judicial review in examining the propriety of an interested cash-out merger transaction by a controlling or dominating shareholder is entire fairness" and that "[t]he initial burden of establishing entire fairness rests upon the party who stands on both sides of the transaction." Additionally, "approval of the transaction by an independent committee of directors or an informed majority of minority shareholders" would shift the burden of proof on the issue of fairness to the plaintiff, but would not change that entire fairness was the standard of review.[132]

Plaintiffs contend that *Lynch* controls this case and mandates application of the entire fairness standard, regardless of any procedural protections that were used that may have protected the minority stockholders. Plaintiffs argue that Hammons stood on both sides of

[132] Id. A different standard applies to transactions that effectively cash out minority shareholders through a tender offer followed by a short-form merger. See In re Aquila Inc., 805 A.2d 184, 190-91 (Del. Ch. 2002); In re Siliconix Inc. S'holders Litig., 2001 Del. Ch. LEXIS 83, 2001 WL 716787, at *6-9 (Del. Ch. June 21, 2001); see generally In re Pure Res., Inc. S'holders Litig., 808 A.2d 421, 434-39 (Del. Ch. 2002).

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the transaction because he did not in fact sell his interest in the companies to Eilian, but rather restructured them in a way that accomplished his tax and financing goals while maintaining a significant interest in the surviving company, in addition to other rights. Plaintiffs point not only to Hammons's numerous contractual arrangements and continuing preferred interest in the surviving LP, but also to statements from various witnesses that the transaction was not actually a "sale" by Hammons but rather a "joint venture of some sort" or a "recapitalization" designed to accomplish Hammons's tax and liquidity needs. Thus, plaintiffs contend:

> as viewed from a legal and tax standpoint, as communicated to employees and the public, and as understood by the transaction participants themselves, the Related Transactions effected a restructuring in which Mr. Hammons brought in a business partner and obtained access to financing while retaining most of his equity (in modified form), together with substantial upside from future growth of JQH, significant veto rights over future operations of the Company, and continued direct management of the Company's hotel properties. Under these circumstances, the rule of *Lynch*--that "the exclusive standard of judicial review in examining the propriety of an interested cash-out merger transaction by a controlling or dominating shareholder is entire fairness,"--applies directly.

Although plaintiffs' argument has some appeal, ultimately, I disagree. Unlike in *Lynch,* the controlling stockholder in this case did not make the offer to the minority stockholders; an unrelated third party did. Eilian had no prior relationship with the Company or with Hammons. Eilian negotiated separately with Hammons, who had a right to sell (or refuse to sell) his shares, and with the minority stockholders, through the disinterested and independent special committee. The rights Hammons retained after the Merger--the 2% interest in the surviving LP, the preferred interest with a $ 335 million liquidation preference, and various other contractual rights and obligations--do not change that *Eilian* made an offer to the minority stockholders, who were represented by the disinterested and independent special committee. Put simply, this case is not one in which Hammons stood "on both sides of the transaction." Accordingly, *Lynch* does not mandate that the entire fairness standard of review apply notwithstanding any procedural protections that were used.[133]

Plaintiffs further contend that, even if Hammons did not stand on both sides of the transaction as contemplated in *Lynch,* the policy rationales underlying the *Lynch* decision warrant extending its holding to this case. In support of this position, plaintiffs cite several Court of Chancery decisions in which the Court applied or extended *Lynch.* Although I do not fully address all the cases plaintiffs cite in support of this argument, I generally reach two conclusions with respect to them: first, the cases plaintiffs cite can be factually distinguished from this case, and second, to the extent those cases extended the application of *Lynch* based on certain policy rationales, I decline to do so here.

For example, in *In re Tele-Communications, Inc. Shareholders Litigation*[134]*,* the evidence

[133] Importantly, and as explained below, this result does not provide a final answer to the standard of review that will be applied.
[134] 2005 Del. Ch. LEXIS 206, 2005 WL 3642727 (Del. Ch. Dec. 21, 2005).

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suggested that a majority of the board of directors was interested because they received material personal benefits from the transaction they approved. Specifically, the transaction materially benefited a majority of the directors because it allocated a disproportionate amount of the merger consideration to the directors' class of stock. Moreover, only one of those directors was a controlling stockholder entitled to a control premium. Thus, the interestedness of a majority of the directors led the Court to apply the entire fairness standard and to conclude that, as in *Lynch,* the approval of the transaction by the stockholders and a special committee could at most shift the burden of demonstrating entire fairness to plaintiffs.[135] Here, in contrast, Hammons negotiated with Eilian and did not participate in the negotiations between Eilian and the special committee. Nothing in *In re Tele-Communications* mandates the extension of *Lynch* to this case.[136]

In *In re LNR Property Corp. Shareholders Litigation*[137]*,* the complaint alleged that the board breached its fiduciary duties by allowing a conflicted controlling shareholder, who was acting as both buyer and seller in the transaction, to "personally negotiate[] a one-sided deal that allowed him and select members of management to continue to reap the benefits of [the company's] future growth while cutting out plaintiff and the class." The complaint also alleged that the controlling shareholder dominated and controlled the board and the "sham" special committee, which did not have the authority to engage in independent negotiations. Taking the allegations in the complaint in the light most favorable to plaintiffs, the Court could not, on a motion to dismiss, rule out the possibility that the entire fairness standard would apply because the controlling stockholder negotiated the transaction, including the allocation of a 20.4% stake in the resulting company for himself. The Court noted, however, that "[t]here is authority for the proposition that the mere fact that a controller has or may be acquiring some interest in the buyer does not automatically trigger entire fairness review." The Court noted that the business judgment standard of review may ultimately apply if, at a later stage, the

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[135] 2005 Del. Ch. LEXIS 206. [WL] at *8. Because of the conflict of interest of a majority of the board in that case, the Court in In re Telecommunications determined that entire fairness review should apply to the transaction. The Court also determined that, as in Lynch, approval by shareholders and a special committee could shift the burden of entire fairness to plaintiffs. Nothing in that case, however, suggests that such a rule must apply in every case in which the Court is determining whether to apply entire fairness review. In other words, the result in Lynch--that shareholder and special committee approval merely shifts the burden of entire fairness--does not preclude the possibility that shareholder and special committee review could be relevant in determining whether to apply business judgment or entire fairness in a case that is not governed by Lynch.

[136] Plaintiffs also cite In re Cysive, Inc. S'holders Litig., 836 A.2d 531 (Del. Ch. 2003) and In re W. Nat'l Corp. S'holders Litig., 2000 Del. Ch. LEXIS 82, 2000 WL 710192 (Del. Ch. May 22, 2000). In Cysive, however, the Court addressed the question of whether the stockholder, who made the buy-out proposal to the minority stockholders, was a "controlling stockholder" for purposes of Lynch, and concluded that the large stockholder "possess[ed] the attributes of control that motivate the Lynch doctrine." Cysive, 836 A.2d at 551-552. In W. Nat'l, the plaintiff challenged the merger between Western National Corporation and its 46% stockholder. The Court concluded that the record did not support a finding of control. W. Nat'l 2000 Del. Ch. LEXIS 82, [WL] at *5-10. Here, in contrast, there is no dispute that Hammons was the controlling stockholder of JQH. Hammons, however, did not make the offer to the minority stockholders or agree to a merger with JQH. Rather, an unaffiliated third-party negotiated separately with Hammons and the special committee.

[137] 896 A.2d 169 (Del. Ch. 2005).

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defendants are able to show that the interests of the minority stockholders were adequately protected. As the *LNR Property* Court stated:

> Of course, the defendants may be able to show at the summary judgment stage that Miller, as they argue, negotiated this transaction as a seller, not a buyer, and that the board and the Special Committee were entitled to repose confidence in his unconflicted motivation to obtain the maximum price for all LNR stockholders. In that case, the court may well be able to conclude that the measures taken by the board and the Special Committee to protect the interests of the minority were adequate in the circumstances to invoke the business judgment standard of review. Nonetheless, those facts and circumstances do not appear in the well pleaded allegations of the complaint.

Although I have determined that the measures taken in this case were not “adequate in the circumstances to invoke the business judgment standard of review,” this result is not mandated by *Lynch.* Rather, it results from deficiencies in the specific procedures used in this case. In other words, I accept defendants’ argument that *Lynch* does not mandate the application of entire fairness review in this case, notwithstanding any procedural protections for the minority stockholders.[138] In this case--which, again, I have determined is not governed by *Lynch*--business judgment would be the applicable standard of review if the transaction were (1) recommended by a disinterested and independent special committee, *and* (2) approved by stockholders in a non-waivable vote of the majority of all the minority stockholders.[139]

I reject, however, defendants’ argument that the procedures used in this case warrant application of the business judgment standard of review. Although I have determined that Hammons did not stand “on both sides” of this transaction, it is nonetheless true that Hammons and the minority stockholders were in a sense “competing” for portions of the consideration Eilian was willing to pay to acquire JQH and that Hammons, as a result of his controlling position, could effectively veto any transaction. In such a case it is paramount--indeed, necessary in order to invoke business judgment review--that there be robust procedural protections in place to ensure that the minority stockholders have

[138] Although I have determined that the facts of this case fall outside the ambit of Lynch, I am also cognizant of recent suggestions of ways to “harmonize” the standards applied to transactions that differ in form but have the effect of cashing out minority stockholders. See In re Cox Commc’ns, Inc. S’holders Litig., 879 A.2d 604, 606-07, 642-48 (Del. Ch. 2005); In re Cysive, Inc. S’holders Litig., 836 A.2d 531, 549 n.23 (Del. Ch. 2003); In re Pure Res., 808 A.2d at 443-46.

[139] Of course, it is not sufficient for the special committee to merely be disinterested and independent. Rather, the committee must be given sufficient authority and opportunity to bargain on behalf of the minority stockholders, including the ability to hire independent legal and financial advisors. Moreover, neither special committee approval nor a stockholder vote would be effective if the controlling stockholder engaged in threats, coercion, or fraud. As explained below, plaintiffs contend that the price of the minority shares was depressed as a result of Hammons’s improper self-dealing conduct and that as a result the special committee and the minority stockholders were coerced into accepting the Merger. If a plaintiff were able to make such a showing, even special committee approval and a majority of the minority vote would not invoke the business judgment standard of review. Similarly, a stockholder vote would not be effective for purposes of invoking the business judgment standard of review if it were based on disclosure that contained material misstatements or omissions.

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sufficient bargaining power and the ability to make an informed choice of whether to accept the third-party's offer for their shares.

Here, the vote of the minority stockholders was not sufficient both because the vote could have been waived by the special committee and because the vote only required approval of a majority of the minority stockholders voting on the matter, rather than a majority of all the minority stockholders. Defendants would no doubt argue that the special committee merely had the ability to waive the vote but chose not to waive it in this case and that the Merger was in fact approved by a majority of all the minority stockholders. Importantly, however, the majority of the minority vote serves as a complement to, and a check on, the special committee. An effective special committee, unlike disaggregate stockholders who face a collective action problem, has bargaining power to extract the highest price available for the minority stockholders. The majority of the minority vote, however, provides the stockholders an important opportunity to approve or disapprove of the work of the special committee and to stop a transaction they believe is not in their best interests. Thus, to provide sufficient protection to the minority stockholders, the majority of the minority vote must be nonwaivable, even by the special committee.[140] Moreover, requiring approval of a majority of all the minority stockholders assures that a majority of the minority stockholders truly support the transaction, and that there is not actually "passive dissent" of a majority of the minority stockholders.[141]

To give maximum effect to these procedural protections, they must be pre-conditions to the transaction. In other words, the lack of such requirements cannot be "cured" by the fact that they would have been satisfied if they were in place. This increases the likelihood that those seeking the approval of the minority stockholders will propose a transaction that they believe will generate the support of an actual majority of the minority stockholders. Moreover, a clear explanation of the pre-conditions to the Merger is necessary to ensure that the minority stockholders are aware of the importance of their votes and their ability to block a transaction they do not believe is fair. Accordingly, entire fairness is the appropriate standard of review in this case.

The Entire Fairness of the Merger

The concept of entire fairness has two components: fair dealing and fair price. These prongs are not independent, and the Court does not focus on each of them individually. Rather, the Court "determines entire fairness based on all aspects of the entire transaction." Fair dealing involves "questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained."[142] Fair price involves questions of "the economic and financial considerations of the proposed merger, including all relevant

[140] See In re JCC Holding Co., 843 A.2d 713, 724-25 n.33 (Del. Ch. 2003); see also Gesoff v. IIC Indus., Inc., 902 A.2d 1130, 1150 n.121 (Del. Ch. 2006); In re Pure Res., 808 A.2d at 445.
[141] See In re PNB Holding Co. S'holders Litig., 2006 Del. Ch. LEXIS 158, 2006 WL 2403999, at *15 (Del. Ch. Aug. 18, 2006).
[142] Emerald Partners v. Berlin, 787 A.2d 85, 97 (Del. 2001) (quoting Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983)).

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factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock." That the special committee approval and the majority of the minority vote were not sufficient to invoke the business judgment standard of review does not necessarily mean that defendants will be unable to prevail on the issue of fair dealing.

Hammons contends that he is entitled to summary judgment even if entire fairness is the applicable standard of review. Hammons asserts that he received less than $ 24 per share for his Class B shares and did not receive any consideration at the expense of the minority stockholders. In support of this assertion Hammons relies on Lehman's opinion that Hammons received less than $ 24 per share in actual value for his Class B shares and therefore received less per share than the minority stockholders. Plaintiffs, however, attack Lehman's opinion. For example, plaintiffs criticize Lehman's decision to value the $ 275 million line of credit at only $ 20 to $ 30 million dollars based on the cost to Hammons of a theoretical line of credit obtained in the market, notwithstanding that such a line of credit would not, in fact, have been available to Hammons in the open market. Plaintiffs also contend that Lehman erred by failing to account for the significant tax benefits Hammons received and the other benefits Hammons received that Lehman determined "do not have a quantifiable valuation from a financial point of view." Finally, plaintiffs contend that Lehman's analysis is not determinative on the issue of fair price because it does not account for the impact of Hammons's tax and other specialized requirements on the price obtained for the minority stockholders. These factual and legal disputes regarding the persuasive value of Lehman's opinion on the issue of fair price preclude entry of summary judgment in defendants' favor on that issue.

Because entire fairness is the appropriate standard of review and because there are material factual issues as to the fairness of the price, Hammons's motion for summary judgment on that issue is denied. Similarly, the director defendants' motion for summary judgment on that issue is also denied.[143]

Plaintiffs contend that they have established that the Merger process involved unfair dealing, thus leaving for trial only the issue of fair price. Plaintiffs also argue that the special committee was not effective because the special committee was "coerced" to accept Hammons's offer to avoid the "worse fate" of a continuing presence of minority stockholders. I am not convinced that the special committee was ineffective merely based on the fact that Hammons was able to veto any transaction. In the first instance, there is no requirement that Hammons sell his shares. Nor is there a requirement that Hammons sell his shares to any particular buyer or for any particular consideration, should he decide in the first instance to sell them. There is no requirement that Hammons agree to a transaction that would have adverse tax implications for him. If Hammons chose not to

[143] See Emerald Partners, 787 A.2d at 93-94 ("[W]hen entire fairness is the applicable standard of judicial review, a determination that the director defendants are exculpated from paying monetary damages can be made only after the basis for their liability has been decided."); LNR Property, 896 A.2d at 178 & n.54 (declining to dismiss claims on the basis of 8 Del. C. § 102(b)(7) exculpatory provision because "the entire fairness standard of review may be applicable, and, thus, 'the inherently interested nature of those transactions [may be] inextricably intertwined with issues of loyalty.'") (quoting Emerald Partners, 787 A.2d at 93).

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sell his shares, the minority stockholders would have remained as minority stockholders. The mere possibility that the situation would return to the status quo, something Hammons could have chosen to do by never considering selling his shares, is not, standing alone, sufficient "coercion" to render a special committee ineffective for purposes of evaluating fair dealing.

Plaintiffs also contend, however, that the price of the minority shares before the Merger was depressed as a result of Hammons's improper self-dealing transactions. Defendants contend that any "undervaluing" of the shares merely represents the lack of control premium attributable to a minority position in the Company. I am unable, on the current record, to resolve this factual dispute, and neither plaintiffs nor defendants are entitled to summary judgment on the issue of fair dealing. Plaintiffs could prevail at trial on the issue of fair dealing if they were able to establish that the price of the minority shares was depressed as a result of Hammons's improper self-dealing conduct. If the price were depressed as a result of such conduct, then the special committee and the stockholders could have been subject to improper coercion, meaning they would have been coerced into accepting any deal, whether fair or not, to avoid remaining as stockholders. This result addresses the concern that majority stockholders may have an incentive to depress the price of minority shares through improper self-dealing so they could then buy out the minority at a low price. As explained above, however, the issues of whether the price of the minority shares was depressed as a result of such conduct, and whether, as a result, the special committee or the minority stockholders were improperly coerced into accepting the Merger, must remain for trial. Accordingly, neither plaintiffs nor defendants are entitled to summary judgment on the issue of fair dealing.[144]

The Disclosure Claims

As noted above, plaintiffs agree that a number of disclosure violations previously alleged should be withdrawn, but continue to assert that the proxy statement contained four misstatements and omissions. Plaintiffs maintain that the proxy statement mischaracterized the special committee process, omitted information regarding the alleged conflicts of interest of Lehman and Katten Muchin, and omitted information regarding a presentation Eilian made to the special committee. Defendants seek summary judgment on the disclosure claims.[145]

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[144] Although the procedural protections used in this case were not sufficient to invoke business judgment protection, they could have been sufficient to shift the burden of demonstrating entire fairness to plaintiffs. As explained below, some of plaintiffs' disclosure claims have survived summary judgment. Accordingly, at this stage, I cannot conclude that the majority of the minority vote shifts the burden of demonstrating entire fairness to plaintiffs. Because of the material issues of fact that remain, I also leave open the question whether the special committee's process and approval were sufficient to shift the burden of entire fairness to plaintiffs.

[145] Defendants cite In re Transkaryotic Therapies, Inc., 954 A.2d 346 (Del. Ch. 2008) and argue that they are entitled to summary judgment because there is no longer a remedy available for any of the alleged disclosure violations. Entire fairness, however, is the appropriate standard of review in this case, and because of the issues of loyalty "intertwined" with transactions subject to such a standard, this is not a case in which the Court will refrain from granting relief for disclosure violations because the transaction has been completed. See LNR Property, 896 A.2d at 178 & n.54. In other words, this is not a case "where there is no evidence of a breach of the duty of loyalty or good faith by the directors who authorized the

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The fiduciary duty of disclosure, which is a specific formulation of the duties of care and loyalty, requires the Board to "disclose fully and fairly all material information within the board's control . . . ."[146] To succeed on their disclosure claims, plaintiffs must identify the facts allegedly omitted from the proxy statement and "state why they meet the materiality standard and how the omission caused injury."[147] "An omitted fact is material if there is a substantial likelihood that a reasonable stockholder would consider it important in deciding how to vote."[148] In other words, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable stockholder as having significantly altered the 'total mix' of information made available."[149] Of course, "[u]nsupported conclusions and speculation are not a substitute for facts."

First, plaintiffs contend that the proxy statement "mischaracterized the Special Committee process as effective and independent of Mr. Hammons" and that "[b]y failing to convey the subservient, deferential approach adopted by the Special Committee, JQH's minority shareholders were led to believe that the price achieved resulted from an effective, arm's length process and not from the constrained, coerced posture occupied by the Special Committee."

Even interpreting the facts in plaintiffs' favor, I am not convinced that they have stated a claim based on the failure to disclose the "subservient, deferential approach adopted by the Special Committee." Plaintiffs point to no specific factual misrepresentation or misleading disclosure in the proxy statement. Rather, plaintiffs seek to have defendants disclose their characterization of the special committee process. This Court has clearly held that directors are not required to disclose the plaintiffs' characterization of the facts or engage in "self-flaggelation." Here, I cannot conclude that defendants violated the duty of disclosure by failing to describe the special committee as "subservient" or "deferential." The proxy statement describes the special committee process and even includes disclosure of the special committee's recognition that it lacked the authority and ability to broadly market the Company in light of Hammons's ability to block any transaction and that Hammons's interest in any transaction would be influenced by, among other things, tax implications personal to Hammons and different from those of the minority stockholders. Given this disclosure and the thorough description of the other aspects of the special committee process, Delaware law does not require that the proxy statement include plaintiffs' characterization of the special committee process. Accordingly, summary judgment is granted in favor of defendants on this claim.

Plaintiffs also bring a claim based on the failure to disclose that Lehman faced a potential conflict of interest because it had contacts with Eilian about the possibility of

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disclosures." Transkaryotic, 954 A.2d at 362; see Emerald Partners, 787 A.2d at 93-94. Similarly, the Board is not entitled to summary judgment at this stage under the Company's 8 Del. C. § 102(b)(7) exculpatory provision. See LNR Property, 896 A.2d at 178 & n.54; Emerald Partners, 787 A.2d at 93-94.

[146] Skeen v. Jo-Ann Stores, Inc., 750 A.2d 1170, 1172 (Del. 2000) (quoting Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992)).

[147] Id. at 1173 (Loudon v. Archer-Daniels-Midland Co., 700 A.2d 135, 141 (Del. 1997)).

[148] Loudon, 700 A.2d at 143.

[149] Skeen, 750 A.2d at 1172 (quoting Loudon, 700 A.2d at 143) (internal quotation marks omitted).

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underwriting the nearly $ 700 million commercial mortgage-backed security offering planned by Eilian after completion of the Merger. Plaintiffs contend that the possibility of getting this business gave Lehman a powerful incentive to approve the transaction.

Defendants contend that the group at Lehman that had contact with Eilian about the debt refinancing was different from the group advising the special committee and that Lehman did not ultimately get the business. This Court, however, has stressed the importance of disclosure of potential conflicts of interest of financial advisors. Such disclosure is particularly important where there was no public auction of the Company and "shareholders may be forced to place heavy weight upon the opinion of such an expert." It is imperative that stockholders be able to decide for themselves what weight to place on a conflict faced by the financial advisor.

Defendants further contend that "there is no evidence that Lehman's opinion was affected by the purported pitch." There is no rule, however, that conflicts of interest must be disclosed only where there is evidence that the financial advisor's opinion was actually affected by the conflict. Thus, defendants cannot defend the alleged omission as immaterial by arguing that any contacts between Lehman and Eilian regarding the refinancing occurred after Lehman opined in December 2004 that the then-high bid of $ 21 per share was fair to the minority stockholders. By an extension of the logic underlying this argument (that a conflict is not material because the current bid is higher than a bid that was previously found fair by the financial advisor), Lehman's continued engagement after the $ 21 bid was wholly unnecessary so long as any subsequent bid was not below $ 21. If this is not the case--if Lehman's judgment was still valuable and necessary even after the opinion on the $ 21 bid--then the financial advisor's conflict of interest would need to be disclosed in the proxy statement. There remain important factual issues about the timing and content of any contact between Lehman and Eilian regarding the refinancing, as well as whether the Board knew or should have known of the alleged conflict. Defendants, therefore, are not entitled to summary judgment on this claim.

Plaintiffs also assert a claim based on the failure to disclose Katten Muchin's representation of iStar. iStar is the firm that provided Eilian the financing to complete the Merger, and plaintiffs contend that iStar played a substantial role in negotiations between Hammons and Eilian. Plaintiffs argue that this conflict gave Katten Muchin an incentive to see the Merger proceed with Eilian. The special committee was informed of the conflict and that iStar would be represented by a separate team of attorneys at Katten Muchin that was prohibited from discussing the matter with the team of attorneys advising the special committee. The special committee discussed the matter and unanimously approved the representation and agreed that the matter would not compromise Katten Muchin's independence. The conflict, however, was not disclosed to stockholders in the proxy statement.

Again, the compensation and potential conflicts of interest of the special committee's advisors are important facts that generally must be disclosed to stockholders before a vote. This is particularly true, where, as here, the minority stockholders are relying on the

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special committee to negotiate on their behalf in a transaction where they will receive cash for their minority shares. Although the waiver of the conflict by the special committee may have resolved any ethical violation, the special committee's waiver of the conflict would likely be important to stockholders in evaluating the Merger and in assessing the efforts of the special committee and its advisors. For these reasons, defendants are not entitled to summary judgment on this claim.

Finally, plaintiffs bring a claim based on the failure to disclose in the proxy statement a presentation Eilian made to the special committee. The presentation, which was made to the special committee in November 2004, included a valuation of JQH shares from $ 35.37 to $ 43.01 based on the average of "peer multiples." Defendants contend that the valuation was based on a hypothetical scenario in which the Company remained public but was transformed into a new entity under Eilian's management. Plaintiffs assert that although the presentation lists several factors that result in JQH's share price being below peer multiples, the presentation does not describe the valuation as contingent on any of these hypothetical factors. Plaintiffs also contend that none of the factors listed are proper grounds for a discount from fair value under Delaware law.

After reviewing the presentation and the minutes of the November 18, 2004 special committee meeting, it is not clear to the Court whether or not the valuation in the presentation was based on a "hypothetical" scenario in which the company remained public with Eilian taking control. If the valuation was not contingent on such a hypothetical scenario, then it appears to be information that a reasonable stockholder would find relevant in determining whether to vote to approve Eilian's $ 24 per share offer. If, on the other hand, the valuation in the presentation was based on such a hypothetical transaction--a transaction the Board likely could have determined in good faith was highly unlikely given Hammons's objectives--then the Board would likely not have violated their duty of disclosure by failing to disclose the presentation in the proxy statement. Accordingly, defendants are not entitled to summary judgment on this claim.

The Aiding and Abetting Claims

Plaintiffs assert a claim against Acquisition and Merger Sub for aiding and abetting a breach of fiduciary duty. To prevail on an aiding and abetting claim, a plaintiff must establish "'(1) the existence of a fiduciary relationship, (2) a breach of the fiduciary's duty, . . . (3) knowing participation in that breach by the defendants,' and (4) damages proximately caused by the breach." As a controlling stockholder, Hammons owed fiduciary duties to the minority stockholders, and the issue of fair dealing and fair price cannot be decided on summary judgment and therefore must remain for trial. Defendants assert that they are entitled to summary judgment on this issue because there is no evidence that Eilian's entities knowingly participated in a breach of fiduciary duty.

"Knowing participation in a board's fiduciary breach requires that the third party act with the knowledge that the conduct advocated or assisted constitutes such a breach." Eilian was intimately involved in the negotiations and structuring of the transaction and understood that Hammons and the minority stockholders were in a sense "competing" for

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the consideration he would pay to acquire JQH. An offeror, however, may bargain at arm's-length for the lowest possible price, and Eilian was permitted to negotiate both with Hammons and the special committee, so long as he did not have knowledge that those negotiations and the resulting transaction would cause a breach of duty to the minority stockholders. As noted above, plaintiffs contend that Hammons's improper self-dealing conduct depressed the price of the minority shares, and plaintiffs could prevail at trial on the issue of fair dealing if they were able to make such a demonstration. Plaintiffs cite evidence that Eilian was aware of those conflicts and that they may have had an effect on the price of the minority shares. For example, plaintiffs point to Eilian's October 28, 2004 letter to the special committee, which cited "[p]erceived conflicts of interest with the controlling Class B shareholder" as an explanation for the underperformance of JQH shares, and Eilian's November 17, 2004 presentation that cited "unique issues of controlling shareholder" as a source of the Company's trading discount. Accordingly, there remains a material issue of fact as to whether Eilian was aware that JQH's stock price was depressed as a result of Hammons's improper self-dealing conduct. Accordingly, defendants are not entitled to summary judgment on this claim.

CONCLUSION

For the foregoing reasons, defendants' motions for summary judgment are granted in part and denied in part, and plaintiffs' motion for partial summary judgment is granted in part and denied in part. Counsel shall confer and submit a form of order that implements the rulings described above.

IT IS SO ORDERED.

F. Page 170, New Sec. 3.13.E. Delaware Chancery Court Deals with First Triggering of a Flip-In Pill, Selectica

Page 170, New Sec. 3.13.E.	Add before Sec. 3.14. the following:
New Sec. 3.13.E.	**Delaware Chancery Court Deals with First Triggering of a Flip-In Pill, *Selectica***

Selectica, Inc. Versata Enterprises, Inc.
Court of Chancery of Delaware, 2010
2010 Del. Ch. LEXIS 39

MEMORANDUM OPINION

NOBLE, Vice Chancellor

INTRODUCTION

This is an action for declaratory judgment with respect to the validity of (1) the implementation of a rights agreement adopted by the plaintiff company in attempt to

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preserve certain net operating loss carryforwards perceived to be at risk as a result of share purchases by the defendants; (2) certain subsequent actions taken by plaintiff's board of directors in response to defendants' purposeful trigger of the rights agreement; and (3) the amended and restated rights agreement established in the wake of the rights agreement's triggering. The defendants who triggered the rights agreement have countersued seeking to have the rights agreement and other actions by plaintiff's board of directors declared invalid, void, and unenforceable, as well as the entry of an order enjoining or rescinding them. The defendants also seek damages for alleged breaches of fiduciary duty by the plaintiff's board.

BACKGROUND

A Brief Explanation of NOLs

At its core, this case is about the value of net operating loss carryforwards ("NOLs") to a currently profitless corporation, and the extent to which such a corporation may fight to preserve them. For convenience, the Court provides a brief overview--although perhaps a simplistic and certainly incomplete one--of the concepts surrounding NOLs, their calculation, and possible impairment.

NOLs are tax losses realized and accumulated by a corporation that can be used to shelter future (or immediate past income from taxation.[150] If taxable profit has been realized, the NOLs operate to provide a refund of prior taxes paid or to reduce the amount of future income tax owed. Thus, NOLs can be a valuable asset, as a means of lowering tax payments and producing positive cash flow. However, NOLs are considered a contingent asset; their value is contingent upon the firm's reporting a future profit (or having an immediate past profit). Should the firm fail to realize a profit during the lifetime of the NOL (20 years), the NOL expires worthless. The precise value of a given NOL is impossible to determine since its ultimate use is subject to the timing and amount of recognized profit at the firm. If the firm never realizes taxable income, at dissolution, its NOLs, regardless of their size, would have zero value.

In order to prevent corporate taxpayers from benefiting from NOLs generated by other entities, Internal Revenue Code Section 382 establishes limitations on the use of NOLs in periods following an "ownership change." If Section 382 is triggered, the law places a restriction on the amount of prior NOLs that can be used in subsequent years to reduce the firm's tax obligations.[151] Of course, once NOLs are so impaired, a substantial portion of their value is lost.

The precise definition of an "ownership change" under Section 382 is rather complex. At its most basic, an ownership change occurs when more than 50% of a firm's stock ownership changes over a three-year period. Specific provisions in Section 382 define the

[150] NOLs may be carried backward two years and carried forward twenty years.
[151] The annual limitation on the use of past period NOLs following a change in control is calculated as the value of the firm's equity at the time of the ownership change, multiplied by a published rate of return, the federal long term exemption rate.

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precise manner by which this determination is made. Most importantly for the Court's purposes, the only shareholders considered in the context of calculating an ownership change under Section 382 are those who hold, or have obtained during the testing period, a 5% or greater block of the corporation's shares outstanding. Calculating the likelihood of a Section 382 ownership change at a given company at a particular time is extraordinarily difficult and requires making a number of factual assumptions, subject to varied interpretations of the correct application of Section 382, upon which reasonable experts may disagree.

With this general background in place, the Court now turns to the facts of this case.[152]

The Parties

Plaintiff and Counterclaim-Defendant Selectica, Inc. ("Selectica" or the "Company") is a Delaware corporation, headquartered in California and listed on the NASDAQ Global Market. It provides enterprise software solutions for contract management and sales configuration systems. Selectica is a micro-cap company with a concentrated shareholder base: the Company's seven largest investors own a majority of the stock, while fewer than twenty-five investors hold nearly two-thirds of the stock.[153]

Defendant and Counterclaim-Plaintiff Trilogy, Inc. ("Trilogy") is a Delaware corporation also specializing in enterprise software solutions. Trilogy stock is not publicly traded, and its founder, Joseph Liemandt, holds over 85% of the stock. Defendant and Counterclaim-Plaintiff Versata Enterprises, Inc. ("Versata") is a Delaware corporation and subsidiary of Trilogy; it provides technology powered business services to clients. Before the events giving rise to this action, Versata and Trilogy beneficially owned 6.1% of Selectica's common stock.[154]

Following their intentional triggering of Selectica's shareholder rights agreement through the purchase of additional shares, the joint beneficial ownership of Versata and Trilogy was diluted from 6.7% to approximately 3.3%.

Counterclaim-Defendants James Arnold, Alan B. Howe, Lloyd Sems, Jim Thanos, and Brenda Zawatski are members of the Selectica Board of Directors (the "Board").[155] Zawatski and Thanos also served as Co-Chairs of the Board during the events at issue in

[152] The facts evidencing "what happened" are largely uncontested. The inferences to be drawn from those facts and the motivations of those involved are, however, fertile sources of debate.
[153] PX 121. However, because of the shareholder rights plan first instituted in 2003, no stockholder holds more than 15% of the outstanding shares.
[154] PX 103.
[155] Alan Howe was elected to the Board on January 12, 2009, after the events at issue in this case. He has not been charged with any breach of fiduciary duty and has not been served with process. Selectica asserts that Howe is not subject to personal jurisdiction in this Court and seeks to have him dismissed as a Counterclaim-Defendant. Trilogy purports to name Howe as a Counterclaim-Defendant solely "in order to afford [Trilogy] complete relief." Answer and Counterclaims of Defs. Trilogy, Inc. and Versata Enterprises, Inc. P 62.

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the case.[156] In this role, they handled the day-to-day operations of the Company, as Selectica has been without a Chief Executive Officer since June 30, 2008.

Selectica's Historical Operating Difficulties and Relationship with Trilogy

Selectica, since it became a public company in March 2000, has lost a substantial amount of money and failed to turn an annual profit, despite routinely projecting near-term profitability. Its IPO price of $ 30 per share has steadily fallen and now languishes below one dollar per share, placing Selectica's market capitalization at roughly $ 23 million at the end of March 2009. By its own admission, its value today "consists primarily in its cash reserves, its intellectual property portfolio, its customer and revenue base, and its accumulated NOLs." By consistently failing to achieve positive net income, Selectica has generated an estimated $ 160 million in NOLs for federal tax purposes over the past several years.

Selectica has had a complicated and often adversarial relationship with Trilogy, stretching back at least five years. Both compete in the relatively narrow market space of contract management and sales configuration. In April 2004, a Trilogy affiliate sued Selectica for patent infringement and secured a judgment that required Selectica, among other things, to pay Trilogy $ 7.5 million. While the suit was pending, in January 2005, Trilogy made an offer to buy Selectica for $ 4 per share in cash--a 20% premium from the then-trading price--which the Board rejected. Nevertheless, during March and April of that year, a Trilogy affiliate acquired nearly 7% of Selectica's common stock through open market trades. In early fall 2005, Trilogy made than another offer for Selectica's shares at a 16%-23% premium, which was also rejected. In September 2006, a Trilogy-affiliated holder of Selectica stock sent a letter to the Board questioning whether certain stock option grants had been backdated.[157] The following month, Trilogy filed another patent lawsuit against Selectica, which was settled in October 2007, when Selectica agreed to a one-time payment of $ 10 million, plus an additional amount of not more than $ 7.5 million in subsequent payments to be made quarterly. In late fall 2006, Trilogy sold down its holdings in Selectica.[158]

The Role of Steel Partners

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[156] On August 19, 2009, Thanos stepped down as Co-Chair and Zawatski became sole Chair of the Board and continued to handle the Company's daily operations. Defs./Counterclaim Pls.' Second Mot. for Judicial Notice under Del. R. of Evidence 201 ("RJN2"), Ex. A at 4.

[157] A special committee empanelled by the Board ultimately concluded that certain options had, in fact, been backdated. Consequently, Selectica was required to restate its financial statements to record additional stock-based compensation and related tax effects for past option grants and incurred fees associated with the investigation in excess of $ 6.2 million. DX 214 at 21; DX 260 at 14. This episode also led to the resignation of Selectica's then-Chairman and Chief Executive Officer Stephen Bannion (who had been the Company's Chief Financial Officer at the time of the grants of question) and the appointment of then-Director Robert Jurkowski to the Chief Executive and Chair position.

[158] From late fall 2006 until October 2008, neither Trilogy nor its affiliates owned any Selectica stock.

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Steel Partners is a private equity fund that has been a Selectica shareholder since at least October 2006 and is its largest shareholder. One of the apparent investment strategies of Steel Partners is to invest in small companies with large NOLs with the intent to help pair the failing company with a profitable business in order to reap the tax benefits of the NOLs. Steel Partners has actively worked with Selectica to calculate and monitor the Company's NOLs since the time of its original investment.

By early 2008, Steel Partners was advocating a quick sale of Selectica's assets, leaving an NOL shell that could be merged with a profitable operating company in order to shelter the profits of the operating company.

In October 2008, Steel Partners informed members of the Board that it planned to increase its ownership position to 14.9%, just below the 15% trigger of the 2003 Pill, which it later did. Jack Howard, President of Steel Partners, lobbied for a Board seat twice in 2008, citing his experience dealing with NOLs, but was rebuffed.

Selectica Investigates its NOL

In 2006, at the urging of Steel Partners, the Company directed Alan Chinn, its outside tax adviser, to perform a high-level analysis into whether the Company's NOLs were subject to any limitations under Section 382 of the Internal Revenue Code. Chinn concluded that five prior changes in ownership had caused the forfeiture of approximately $ 24.6 million of NOLs. Selectica provided the results of this study to Steel Partners, though not to any other Selectica shareholder. In March 2007, again at Steel Partners' recommendation, Selectica retained a second accountant who specialized in NOL calculations, John Brogan of Burr Pilger & Mayer LLP, to analyze the Company's NOLs more carefully and report on Chinn's Section 382 analysis.[159] Brogan had previously analyzed the NOLs at other Steel Partners ventures. Brogan ultimately determined that Chinn's conclusions were erroneous. The Company engaged Brogan in additional work on the topic of NOLs in June 2007. One of Steel Partners' employees, Avi Goodman, worked closely with Brogan on the matter, although Brogan was working for and being paid by Selectica and received no compensation from Steel Partners. Brogan's draft letter opinion, concluding that the Company had not undergone an "ownership change" for Section 382 purposes since 1999, was shared with Steel Partners, although again not with any other outside investors.

In the fall of 2007, Brogan proposed a third, more detailed, Section 382 study, which Selectica's then-CEO Robert Jurkowski opposed. In February 2008, the Board voted against spending $ 40,000-$ 50,000 to fund this Section 382 study. By July, however, the Board asked Brogan to update his study, and he delivered the draft opinion that, as of March 31, 2008, the Company had approximately $ 165 million in NOLs.[160] Brogan was

[159] Selectica concedes that it valued Steel Partners' recommendation in these matters as it found its principals to be knowledgeable on the topic of NOLs. Pl.'s Pre-Trial Br. at 6.
[160] During this time, Brogan included Howard in nearly all correspondence relating to his analysis of Selectica's NOLs, even when Company directors were not. See, e.g., DX 427; DX 456. This was brought to the attention of the Board in September, which then asked Brogan to desist. Tr. 102-03, 230-32, 251-57, 997; Zawatski Dep. at 194-95. The Board did not investigate what Howard had learned or whether Steel Partners had traded on the information provided

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later asked to advise the Board in the fall of 2008 on the updated status of its NOLs when the Board moved to amend its rights plan.

Lloyd Sems Joins the Board

In April 2008, the Board began interviewing candidates for an open board seat, giving preference to the Company's large shareholders. Selectica investor Lloyd Sems had previously expressed interest in joining the Board and had sought support from certain shareholders, including Steel Partners, through Howard, and Lloyd Miller, another large Selectica shareholder not affiliated with Steel Partners. Both Miller and Howard wrote to the Board in support of Sems's appointment, although he was already favored by the Board by that time.[161] In June 2008, Sems was appointed to the Board.
As large shareholders, Sems, Howard, and Miller had periodically discussed Selectica as early as October 2007. At that time, Sems had emailed Howard, stating, "I wanted to get your opinion of how or if you would like me to proceed with [Selectica]." Howard replied, "Lloyd [Miller] said he would call you about [Selectica]."[162] Both before and after his appointment to the Board, Sems discussed with Howard and Miller a number of the proposals that Sems ultimately advocated for as a director, including that Selectica should buy back its stock,[163] that Selectica should consider selling its businesses, that the NOLs were important and should be preserved through the adoption of a 5% pill, and that Jurkowski should be removed as CEO. As a Board member, Sems also reached out to Howard and Miller from time to time on other issues, including seeking recommendations for chief financial officer candidates, [164] investment bankers to conduct the sale process, and attorneys in the run up to this litigation, although the Board apparently adopted none of Howard's recommendations.

Selectica Decides to Restructure and to Explore Strategic Alternatives

In early July 2008, after determining that the Company needed to change course, the Board terminated Jurkowski as CEO and eliminated a number of management positions in the sales configuration business.[165] Later that month, prompted by the receipt of five unsolicited acquisition offers over the space of a few weeks, the Board announced that it

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[161] Tr. 938-41. Jurkowski testified that, at the time the Board was considering Sems as a potential director, Jurkowski viewed Sems as an investor who "was interested in what we were going to do to grow the business, and perhaps as an investor, anything that he could do to actually help us grow the business, as opposed to somebody who just focused on some of the financial elements of the company." Jurkowski Dep. at 77-78.
[162] DX 227. Sems explained that this email was a follow-up seeking their opinion on his efforts to join the Board, which he had previously discussed with both, and was sent in an attempt to gain support. Sems Dep. 192-94. In the context of the entire email, this is a plausible explanation, certainly more plausible than as a unilateral offer to be controlled by Steel Partners.
[163] DX 609; DX 610; DX 419 at 4; DX 455 at 2-3. The Board had previously concluded that this was not in the Company's best interest. DX 238; DX 281.
[164] DX 402. In reply, Howard queried, "Should we push to sell the company before [bringing] in a new cfo?" Id.
[165] The day that the Company released its 8-K announcing the resignations of those officers, Howard wrote an email to Sems, stating, "[Call] me about the news--great job." DX 416.

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was in the process of selecting an investment banker (ultimately, Jim Reilly of Needham & Company) to evaluate strategic alternatives for the Company and to assist with a process that ultimately might result in the Company's sale. In view of the potential sale, the Board decided to forgo the expense of replacing Jurkowski and, instead, asked Zawatski and Thanos jointly to assume the title of Co-Chair and to perform operational oversight roles on an interim basis.

The Needham Process

Needham has actively carried out its task of evaluating Selectica's strategic options since its selection by the Board. Needham first discussed with the Board the various strategic choices that the Company could take, including a merger of equals with a public company, a reverse IPO or other going-private transaction, the sale of certain assets, and the use of cash to acquire another company, as well as stock repurchases or the issuance of dividends, should Selectica decide to continue as an independent public company in the absence of sufficient market interest for an acquisition.

In October 2008, Needham prepared an Executive Summary of the assets and operations of Selectica and subsequently reached out to potential buyers, remaining in communication with various interested parties throughout the remainder of the year and into the first part of 2009.[166] By February 2009, at least a half-dozen parties had come forward with letters of intent and were in the process of meeting with Selectica management and conducting due diligence in the Company, while Needham evaluated their various proposals for the purchase of all or part of Selectica's operations. As of April 2009, Selectica, through Needham, had signed a letter of intent and entered into exclusive negotiations with a potential buyer.

Trilogy Begins Buying

On July 15, 2008, Liemandt called Zawatski to inquire generally about the possibility of an acquisition of Selectica by Trilogy. On July 29, Trilogy Chief Financial Officer Sean Fallon, Trilogy Director of Finance Andrew Price, and Versata Chief Executive Officer Randy Jacops participated in a conference call with Selectica Co-Chairs Zawatski and Thanos on the same topic. During the call, Thanos inquired as to how Trilogy would calculate a value for the Company's NOLs. Fallon replied that Trilogy, "really [did not] pursue them with as much vigor as other[s] might since that is not our core strategy."[167] The following evening, Fallon contacted Zawatski and outlined two proposals for Trilogy to acquire Selectica's business: (1) Trilogy's purchase of all of the assets of Selectica's sales configuration business in exchange for the cancellation of the $ 7.1 million in debt

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[166] Reilly Dep. at 137-54. None of the potential buyers expressed specific interest in Selectica's NOLs. Reilly Dep. at 14.

[167] Id. However, as part of its 2005 effort to acquire Selectica, Trilogy had performed "a pretty detailed analysis" of Selectica's NOLs. Johnston Dep. at 21 (Sherie Johnston, Trilogy's tax director, performed the analysis). Johnston testified that this analysis was occasionally updated and that similar analyses had been performed on a dozen or so other acquisition targets. Id. at 22-26. On or around November 18, 2008, Price and Fallon asked about obtaining an updated change in control calculation for Selectica but, due to other more pressing matters, Johnston never performed it. Id. at 27-35.

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Selectica still owed under the October 2007 settlement with Trilogy; or (2) Trilogy's purchase of the entire operations of Selectica for the cancellation of the debt plus an additional $ 6 million in cash. Fallon subsequently followed up with an email reiterating both proposals and suggesting that either proposal would allow Selectica to still make use of its NOLs through the later sale of its corporate entity.[168]

Shortly thereafter, the Board rejected both proposals. The Board made no counterproposal and there were no follow-up discussions. On October 9, 2008, Trilogy made a second bid to acquire all of the Selectica's assets for $ 10 million in cash plus the cancellation of the debt, which the Board also rejected. Trilogy was invited to participate in the sale process being overseen by Needham, but Trilogy was apparently unwilling to sign a non-disclosure agreement, which was a prerequisite for participation.[169] Around this same time, Trilogy had begun making open-market purchases for Selectica stock, although the Board was apparently not aware of this fact at the time.

On the evening of November 10, Fallon contacted Zawatski and informed her that Trilogy had purchased more than 5% of Selectica's outstanding stock and would be filing a Schedule 13D shortly, which it did on November 13.[170] On a subsequent call with Zawatski and Reilly, Fallon explained that Trilogy had begun buying because it believed that "the company should work quickly to preserve whatever shareholder value remained and that we were interested in seeing this process that they announced with Needham, that we were interested in seeing that accelerate. . . ." Within four days of its 13D filing, Trilogy had acquired more than 320,000 additional shares, representing an additional 1% of the Company.

The November 16 Board Meeting & Decision to Adopt the NOL Pill

In the wake of Trilogy's decision to begin acquiring Selectica shares, the Board took actions to gauge the impact of these acquisitions, if any, on the Company's NOLs, and to determine whether anything needed to be done to mitigate their effects. Sems immediately asked Brogan to revise his Section 382 analysis--which had not been formally updated since July--to take into account the recent purchases. This was delivered to Sems and the Company's new CFO, Richard Heaps, on November 15, showing that the cumulative acquisition of stock by shareholders over the past three years stood at 40%, which was roughly unchanged from the previous calculation, due to some double counting that occurred in the July analysis.[171]

The Board met on November 16 to discuss the situation and to consider amending Selectica's shareholder rights plan, which it had had in place since February 2003. As

[168] PX 78. That this was his suggestion was confirmed by Fallon in his deposition. Fallon Dep. at 98-99.
[169] Reilly Dep. at 46. Fallon also told John Reilly from Needham that "if he were to make another proposal . . . that it would be lower than the last proposal that they had made. . . ." Id.
[170] The November 13, 2008, Schedule 13D reported that Versata and affiliates had purchased 1,437,891 shares of Selectica stock, increasing its ownership to 5.1%. PX 102.
[171] PX 72. A more formal analysis was provided on November 26, finding a 38.8% change in ownership over the relevant period. DX 688.

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with many poison pills employed as protection devices against hostile takeovers, Selectica's initial pill had a 15% trigger. The Board considered an amendment that would reduce that threshold trigger to 4.99% in order to prevent additional 5% owners from emerging and potentially causing a change in control event, thereby devaluing Selectica's NOLs.[172] Also present at the meeting were Heaps, Brogan, and Reilly, along with Delaware counsel.

Heaps gave an overview of the Company's existing shareholder rights plan and reviewed the stock price activity since Trilogy had filed its Schedule 13D, noting that shares totaling approximately 2.3% of the Company had changed hands in the two days following the filing. Brogan reviewed the Section 382 ownership analysis that his firm had undertaken on behalf of the Company, noting that additional acquisitions of roughly 10% of the float by new or existing 5% holders would "result in a permanent limitation on use of the Company's net operating loss carryforwards and that, once an ownership change occurred, there would be no way to cure the use limitation on the net operating loss carryforwards." He further advised the Board that "net operating loss carryforwards were a significant asset" and that he generally advises companies to consider steps to protect their NOLs when they experience a 30% or greater change in beneficial ownership. Lastly, Brogan noted that, while he believed that the cumulative ownership change calculations would decline significantly over the next twelve months, "it would decline only modestly, if at all, over the next three to four months," meaning that "the Company would continue to be at risk of an ownership change over the near term."

Reilly discussed the Company's strategic alternatives and noted that Steel Partners and other parties had expressed interest in pursuing a transaction that would realize the value of Selectica's NOLs, while also reviewing potential transaction structures in which the Company might be able to utilize its NOLs. Reilly responded to questions from the Board, and noted that "it is difficult to value the Company's net operating loss carryforwards with greater precision, because their value depends, among other things, on the ability of the Company to generate profits," and confirmed that "existing stockholders may realize significant potential value" from the utilization of the Company's NOLs, which would be "significantly impaired" if a Section 382 ownership change occurred.

At the request of the Board, Delaware counsel reviewed the legal standards that apply under Delaware law for adopting and implementing measures that have an anti-takeover effect.

The Board then discussed amending the existing shareholder rights plan, and what the terms of such an amendment might be, including the pros and cons of providing a cushion for preexisting 5% holders, the appropriate effective date of the new shareholder rights plan, whether the Board should have authority to exclude purchases by specific

[172] Sems had previously recommended reducing the poison pill threshold trigger to 5% at the Board's July 23, 2008, meeting. The Board decided to defer consideration of the recommendation until it received additional information on the potential legal consequences of such an action. DX 455 at 2-3. See also Sems Dep. 165-66; Tr. 740-42 (contesting the stated rationale in the Board minutes of protecting against hostile takeovers and testifying that his then-stated rationale was the protection of the NOLs).

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stockholders from triggering the rights plan, and whether a review process should be implemented to determine periodically whether the rights plan should remain in effect.

The Board then unanimously passed a resolution amending Selectica's shareholder rights plan, decreasing the beneficial ownership trigger from 15% to 4.99%, while grandfathering in existing 5% shareholders and permitting them to acquire up to an additional 0.5% (subject to the original 15% cap) without triggering the NOL Pill.

The resolution also established the Independent Director Evaluation Committee (the "Committee") as a standing committee of the Board to review periodically the rights agreement at the behest of the Board and to "determine whether the Rights Agreement continues to be in the best interest of the Corporation and its stockholders," as well as to review "the appropriate trigger percentage" of the pill, based on corporate and shareholder developments, any broader developments relating to rights plans generally--including academic studies of rights plans and contests for corporate control, and any other factors it deems relevant. The Board set April 30, 2009, as the first date that the Committee should report back its findings.

Trilogy Buys through the Pill

The Board announced the amendment of Selectica's rights agreement on Monday, November 17. Early the following morning, Fallon emailed Trilogy's broker, saying, "[W]e need to stop buying SLTC. They announced a new pill and we need to understand it." Fallon also sent Liemandt a copy of Selectica's 8-K containing the amended language of the NOL Pill. Trilogy immediately sought legal advice about the NOL Pill. The following morning, Liemandt emailed Price, with a copy to Fallon, asking, "What percentage of [Selectica] would we need to buy to ruin the tax attributes that [S]teel [P]artners is looking for?"[173] They concluded that they would need to acquire 23% to trigger a change in control event.

Later that week, Trilogy sent Selectica a letter asserting that a Selectica contract with Sun Microsystems constituted a breach of the October 2007 settlement and seeking an immediate meeting with Selectica purportedly to discuss the breach, despite the fact that members of its management had been put on notice as to the contract as early as July. Fallon, Liemandt, and Jacops from Trilogy, along with Zawatski, Thanos, and Heaps from Selectica met on December 17. The parties' discussions at this meeting are protected by a confidentiality agreement circulated in advance. However, Selectica contends that "based solely on statements and conduct outside that meeting, it is evident that Trilogy threatened to trigger the NOL Pill deliberately unless Selectica agreed to Trilogy's renewed efforts to extract money from the Company."

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[173] DX 649. Liemandt testified that his question meant, "what is the amount that we can buy without hurting it, which is the other way of asking, what's the amount you can buy to ruin it." Liemandt Dep. at 101. Price testified, however, that he understood the question as being more straightforward, specifically, "what percentage would we have to buy to trigger a change of control as per section 382." Price Dep. at 151.

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On December 18, Trilogy purchased an additional 30,000 Selectica shares, and Trilogy management verified with Liemandt his intention to proceed with buying through the NOL Pill. The following morning, Trilogy purchased an additional 124,061 shares of Selectica, bringing its ownership share to 6.7% and thereby becoming an Acquiring Person under the NOL Pill. Liemandt testified that the rationale behind triggering the pill was to "bring accountability" to the Board and "expose" what Liemandt characterized as "illegal behavior" by the Board in adopting a pill with such a low trigger. Fallon asserted that the reason for triggering the NOL Pill was to "bring some clarity and urgency" to their discussions with Selectica about the two parties' somewhat complicated relationship by "setting a time frame that might help accelerate discussions" on the direction of the business.

Fallon placed a brief telephone call to Zawatski on December 19 to advise her that Trilogy had bought through the NOL Pill. During a return call by Zawatski later that evening, Fallon indicated that Trilogy felt, based on the conversations from December 17, that Selectica no longer wanted Trilogy as a shareholder or creditor. He then proposed that Selectica agree to purchase Trilogy's shares back, accelerate the payment of its debt, terminate its license with Sun, and make a payment to Trilogy of five million dollars "for settlement of basically all outstanding issues between our companies." Zawatski recalled that Fallon indicated to her that Trilogy had triggered the pill "to get our attention and create a sense of urgency"; that, since the Board would have ten days to determine how to react to the pill trigger, "it would force the board to make a decision."

The Board Considers its Options and Repeatedly Requests a Standstill

The Selectica Board had a telephonic meeting on Saturday, December 20, to discuss Trilogy's demands and an appropriate response. The Board discussed "the desirability of taking steps to ensure the validity of the shareholder rights plan," and ultimately passed a resolution authorizing the filing of this lawsuit, which occurred the following day. On December 22, Trilogy filed an amended Schedule 13D disclosing its ownership percentage and the Selectica Board met telephonically yet again to discuss the litigation, eventually agreeing to have a representative contact Trilogy to seek a standstill on any additional open market purchases while the Board used the ten-day clock under the NOL Pill to determine whether to consider Trilogy's purchases "exempt" under the rights plan, or else how Selectica would go about implementing the pill.

The amended rights plan allowed the Board to declare Trilogy an "Exempt Person" during the ten-day period following the trigger, upon its determination that Trilogy would not "jeopardize or endanger the availability to the Company of the NOLs. . . ." The Board could also decide during this window to exchange the rights (other than those held by Trilogy) for shares of common stock. If the Board did nothing, after ten days, the rights would "flip in" automatically, becoming exercisable for $ 36 worth of newly-issued common stock at a price of $ 18 per right.

The Board met again by telephone the following day, December 23, to discuss the

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progress of the litigation and to consider the potential impact of the various options under the NOL Pill. The Board agreed to meet in person the following Monday, December 29, along with the Company's financial, legal, and accounting advisors, to evaluate further the available options. The Board also voted to reduce the number of authorized directors from seven to five.

On Wednesday, December 24, the Board met once again by telephone upon learning that the Company's counsel had not succeeded in convincing Trilogy to agree to a standstill. The Board resolved to have Zawatski call Fallon to determine whether Trilogy was willing "to negotiate a standstill agreement that might make triggering the remedies available under the Shareholder Rights Plan, as amended, unnecessary at this time." Zawatski spoke with Fallon on the morning of December 26. Fallon stated that Trilogy did not want to agree to a standstill, that relief from the NOL Pill was not Trilogy's goal, and that Trilogy expected that the NOL Pill would apply to it. Fallon reiterated that the ten-day window would help "speed [the] course" towards a resolution of their claims.

The Board and its advisors met again on December 29. Thanos provided an update on recent developments at the Company, including financial results, management changes, and the Needham process and provided an overview of the make-up of the Company's shareholder base. Reilly then provided a more detailed report on the status of the Needham process to the Board. Thereafter, Brogan gave a presentation on his firm's updated analysis of Selectica's NOLs, finding that the Company had at least $ 160 million of NOLs and that there had been a roughly 40% ownership change by 5% holders over the three-year testing period, which would not be expected to "roll off" in the near term, and that "there was therefore a significant risk of a Section 382 ownership change." Brogan subsequently discussed the possible consequences of the two principal mechanisms for implementing the triggered NOL Pill to the change in control analysis, finding that employing a share exchange would not likely have a materially negative impact on the Section 382 analysis, while expressing more concern over the uncertain effect of a flip-in pill on subsequent ownership levels (specifically, the possibility that a flip-in pill would, itself, trigger a Section 382 ownership change), as well as what steps could be taken to reduce this uncertainty. Reilly once again addressed the Board to explain the ways he believed the NOLs would be valuable to the Company in its ongoing exploration of strategic alternatives, and to reiterate his opinion that an ownership change would "reduce the value of the Company."

The Board also discussed Trilogy's settlement demands and found them "highly unreasonable" and "lack[ing] any reasonable basis in fact," and that "it [was] not in the best interests of the Company and its stockholders to accept Trilogy/Versata's settlement demands relating to entirely separate intellectual property disputes as a precondition to negotiating a standstill agreement to resolve this dispute." The Board discussed Trilogy's actions at some length, ultimately concluding that they "were very harmful to the Company in a number of respects," and that "implementing the exchange was reasonable in relation to the threat imposed by Trilogy," in particular, because the NOLs were seen as "an important corporate asset that could significantly enhance stockholder value," and because Trilogy had intentionally triggered the NOL Pill, publicly suggested it might

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purchase additional stock, and had refused to negotiate a standstill agreement, despite the fact that an additional 10% acquisition by a 5% shareholder would likely trigger an ownership change under Section 382.

The Board then authorized Delaware counsel to contact Trilogy in writing, one final time, to seek a standstill agreement, and also passed resolutions delegating the power of the Board to the Committee to determine whether or not to treat Trilogy or its acquisition as "exempt," and nominating Alan Howe as a new member of the Board.

On the evening of December 29, Selectica's Delaware counsel emailed Trilogy's trial counsel at the Board's instruction, seeking a standstill agreement "so that the Board could consider either declaring them an 'Exempt Person' under the Rights Plan . . . or alternatively, settle the litigation altogether in exchange for a long term agreement relating to your clients' ownership of additional shares." The following afternoon, Trilogy's counsel responded that Trilogy was not willing to agree to the proposed standstill.

Two days later, on December 31, the Board met telephonically once again, and was informed of Trilogy's latest rejection of a standstill agreement. The Board discussed its options with its legal advisors and ultimately concluded that the pill should go into effect and that employing an exchange was the best option, and should be done as soon as possible in order to protect the NOLs, even at the risk of disrupting common stock trading. The Board directed advisers to prepare a technical amendment to the NOL Pill to clarify the time at which an exchange would become effective.

The Board Adopts the Amended and Restated Pill and Dilutes Trilogy

On January 2, the Board met telephonically once more, reiterating its delegation of authority to the Committee to make recommendations regarding the implementation of the NOL Pill, and passed a resolution expressly confirming that the Board's delegation of authority included the power to effect an exchange of the rights under the NOL Pill and to declare a new dividend of rights under an amended rights plan (the "Reloaded NOL Pill"). The Board then adjourned and the Committee--comprised of Sems and Arnold--met with legal and financial advisors, who verified that there had been no new contact whatsoever with representatives from Trilogy, reiterated that the NOLs remained "a valuable corporate asset of the Company in connection with the Company's ongoing exploration of strategic alternatives," and advised the Committee members of their fiduciary obligations under Delaware law. Reilly presented information about the current takeover environment and the use of poison pills (specifically, the types of pills commonly employed and their triggering thresholds), and reviewed the Company's then-current anti-takeover defenses compared with those of other public companies.[174] Reilly

[174] PX 38. At that time, Selectica had the following defensive measures in place as indicated in Reilly's presentation: (1) classified board; (2) board fills all director vacancies; (3) shareholders cannot call special meetings; (4) no action by written consent; (5) supermajority vote to remove directors; (6) locked-in charter or bylaw provision; (7) no cumulative voting; and (8) blank check preferred stock. Id. at 21. Selectica has since submitted for stockholder vote a proposal to declassify the staggered board terms. RJN2, Ex. A at 2,

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asserted that "a so-called NOL rights plan with a 4.99% trigger threshold is designed to help protect against stock accumulations that would trigger an 'ownership change,'" and that "implementing appropriate protections of the Company's net operating loss carryforwards was especially important at present," given Trilogy's recent share acquisitions on top of the Company's existing Section 382 ownership levels. Finally, Reilly reviewed the proposed terms and conditions of the Reloaded NOL Pill, discussed the methodology for determining the exercise price of the new rights, and made recommendations regarding the same. The Committee sought reconfirmed assurances by its financial and legal advisors that the NOLs were a valuable corporate asset and that they remained at a significant risk of being impaired, which the advisors provided.

The Committee concluded that Trilogy should not be deemed an "Exempt Person," that its purchase of additional shares should not be deemed an "Exempt Transaction," that an exchange of rights for common stock (the "Exchange") should occur, and that a new rights dividend on substantially similar terms ought to be adopted. It passed resolutions to implement these conclusions, thereby adopting the Reloaded NOL Pill and instituting the Exchange. The Exchange doubled the number of shares of Selectica common stock owned by each shareholder of record, other than Defendants. Consequently, the Exchange reduced Defendants' beneficial holdings from 6.7% to 3.3%. The implementation of the Exchange led to a freeze in the trading of Selectica stock from January 5, 2009 until February 4, 2009, with stock price frozen at $ 0.69. The Reloaded NOL Pill will expire on January 2, 2012, unless the expiration date is advanced or extended, or unless these rights are exchanged or redeemed by the Board some time beforehand.

The Parties' Contentions

Selectica seeks a declaratory judgment that the actions of the Board and the Committee in (1) adopting the NOL pill on November 16; (2) authorizing the Exchange on January 2; and (3) adopting the Reloaded NOL Pill and issuing a new rights dividend on January 2, were valid and proper. Trilogy's counterclaim seeks a declaratory judgment that the NOL Pill and Reloaded NOL Pill are invalid, void and unenforceable, or else unenforceable as to Trilogy, as well as an order enjoining or rescinding the Exchange and requiring Selectica to redeem permanently the new rights dividends issued under the Reloaded NOL Pill. Trilogy also seeks money damages for breaches of fiduciary duty.

Selectica asserts that the actions of the Board and the Committee were valid under Delaware law and were appropriate exercises of their fiduciary responsibilities under Unocal: specifically, that the Board acted reasonably in concluding that the NOLs constituted a potentially valuable asset that was threatened by Trilogy's actions, and that the adoption of the NOL Pill, implementation of the Exchange, and adoption of the Reloaded NOL Pill and declaration of a new rights dividend were not preclusive but were reasonable and proportionate responses to the identified threat.

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To the contrary, Trilogy argues that both the NOL Pill and Reloaded NOL Pill should be declared invalid either because (1) they are both anti-takeover devices that, either per se or on the facts of this case, preclude an effective proxy contest; or (2) they were not a reasonable and proportionate response to a reasonably perceived threat because the Board failed to establish that the NOLs had a value worth protecting and that this value was threatened by Trilogy's purchases.

DISCUSSION

The Poison Pill under Delaware Law

The principal question before the Court is the reasonableness of a board's adoption of a low-threshold poison pill in order to protect assets of speculative and questionable value absent an explicit plan for how such value might be realized.

Since their first appearance nearly thirty years ago, shareholder rights plans--so-called "poison pills"--have been the subject of much debate. Some commentators have suggested that poison pills may be detrimental to shareholder interests because they help perpetuate existing management, preclude value-adding transactions from taking place, and destroy shareholder wealth.[175] In spite of their rather contentious early history and the various arguments made against their use, poison pills remain a common feature of the corporate landscape, and Delaware courts have repeatedly upheld their adoption as consistent with a board's fiduciary duties and business judgment.[176] Indeed, the Delaware Supreme Court's invocation of the doctrine of stare decisis to reaffirm the central holding of Moran in the Leonard Loventhal case is a strong signal that the legitimacy of the poison pill is settled law.

Does the NOL Pill Meet the Unocal Standard?

The Supreme Court in Unocal explained that the business judgment rule does not immediately apply to defensive actions taken by a board in the context of a possible change in control, such as the adoption of a poison pill, "[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders. . . ." Accordingly, "there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business

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[175] See, e.g., Lucian Arye Bebchuk, The Case Against Board Veto Power in Corporate Takeovers, 69 U. Chi. L. Rev. 973 (2002); Randall S. Thomas, Judicial Review of Defensive Tactics in Proxy Contests: When is Using a Rights Plan Right?, 46 Vand. L. Rev. 503 (1993); Michael Ryngaert, The Effect of Poison Pill Securities on Shareholder Wealth, 20 J. Fin. Econ. 377, 411 (1988) (concluding that poison pills do not benefit shareholders); Frank H. Easterbrook & Daniel R. Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161 (1981).

[176] See Moran v. Household Int'l, Inc., 500 A.2d 1346, 1357 (Del. 1985); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 181-82 (Del. 1986); Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1153-54 (Del. 1990); Moore Corp. Ltd. v. Wallace Computer Servs., Inc., 907 F. Supp. 1545, 1563-64 (D. Del. 1995); Leonard Loventhal Account v. Hilton Hotels Corp., 780 A.2d 245, 250-51 (Del. 2001).

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judgment rule may be conferred." Such enhanced scrutiny operates to "ensure that a defensive measure to thwart or impede a takeover is indeed motivated by a good faith concern for the welfare of the corporation and its stockholders" and that the board did not act "solely or primarily out of a desire to perpetuate themselves in office."

Thus, under the Unocal test, in order to be afforded the protection of the business judgment rule with respect to the adoption of a defensive measure, the "directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed . . . [T]hey satisfy that burden 'by showing good faith and reasonable investigation. . . .'" The board must also demonstrate that its "defensive response was reasonable in relation to the threat posed." As explained in Unitrin, a defensive measure is disproportionate (i.e., unreasonable) if it is either coercive or preclusive. Trilogy asserts that the Unocal standard is not met here, as the Selectica directors established neither that the NOLs had a value worth protecting, nor that this value was threatened by Trilogy's purchases.

Should Selectica's Evidence Receive Material Enhancement?

Under Unocal, where the defensive actions were taken by "a majority of outside independent directors," proof of the board's good faith and reasonable investigation is "materially enhanced." Furthermore, the presence of a majority of outside directors, coupled with a showing of reliance on advice by legal and financial advisors, "constitute[s] a prima facie showing of good faith and reasonable investigation."

Selectica asserts that all of its directors were independent at the time that the decisions at issue were made; therefore the evidence showing the Board's good faith and reasonable investigation is entitled to material enhancement. Trilogy claims that three of the Company's then four directors were not outside independent directors and, consequently, that Selectica's proof of good faith and reasonable investigation should not be materially enhanced. Specifically, it argues that Zawatski and Thanos should not be considered "outside" directors due to their roles as Co-Chairs of Selectica during the events at issue, and that their independence is, likewise, compromised by the payment they received to carry out these assignments. Moreover, according to Trilogy, Sems should not be considered independent "with respect to the NOLs" because of an alleged undue influence of Howard and Steel Partners over Sems.

An "outside" director has been defined by our courts as "a non-employee and non-management director"[177] that "receiv[es] no income other than usual directors' fees … ."[178] In contrast to this seemingly bright-line rule, Delaware courts apply a "subjective 'actual person' standard" in considering the question of director independence, making a determination based upon individualized facts about the specific directors.[179] The contextual approach applied to such standard, which "tak[es] into account all circumstances," allows independence determinations to be "tailored to the precise

[177] Unitrin, 651 A.2d at 1375 (citing Grobow v. Perot, 539 A.2d 180, 184 n.1 (Del. 1988)).
[178] Moran v. Household Int'l, Inc., 490 A.2d 1059, 1074-75 (Del. Ch. 1985).
[179] Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1167 (Del. 1995).

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situation at issue."[180] An independent director is one whose decision "is based on the corporate merits of the subject before the board rather than extraneous considerations or influences,"[181] while a director who is not independent is "dominated or otherwise controlled by an individual or entity interested in the transaction." Control is established through facts that demonstrate that "through personal or other relationships the directors are beholden to the controlling person" or so "under their influence that their discretion would be sterilized."

Trilogy points to the emails between Sems and Howard, as well as to the fact that Howard had recommended Sems to the Board as a candidate for director, as evidence that Sems was unduly influenced by Howard and, thus, not an independent director. According to Trilogy, because Steel Partners was seeking to turn the Company into an NOL shell for its own purposes, Sems cannot be considered independent with respect to decisions involving the Company's NOLs. Nevertheless, the record does not support Trilogy's assertions that Sems was controlled by Howard or Steel Partners. Sems, through his personal investment and that of his fund, was Selectica's sixth-largest shareholder, and Selectica was one of Sems Capital LLC's largest positions. Further, there is no evidence in the record that Sems had any reason to defer to Steel Partners' wishes to his own financial detriment. To the contrary, Sems testified that the value of Selectica's NOLs played into his investment rationale as a shareholder. Although Howard did endorse Sems's candidacy, Sems was already favored as a director candidate before Howard's endorsement. In addition, there is little evidence that Sems took any position that was unduly favorable to Howard at the expense of Selectica shareholders during his time on the Board. Indeed, Howard made several suggestions to the Board that the Board chose not to heed. Howard, himself, twice asked to be named as a Selectica director, most recently in November 17, 2008, after Sems had become a director, and was apparently turned down by an undivided board. While there may be cause to suspect that Sems had something of a desire to ingratiate himself with Steel Partners, there is not sufficient evidence to find that Sems was not independent from Howard and Steel Partners.

Trilogy asserts that Zawatski and Thanos similarly cannot be considered outside independent directors with respect to the Board actions at issue due to their Co-Chair positions, which seemingly run afoul of various independence guidelines and which Selectica, itself, concedes was "a capacity similar to that of a chief executive officer." Additionally, from July 2008 until March 2009, Thanos was paid $ 164,125 and Zawatski paid $ 274,273 to serve in this function, in addition to their standard compensation as directors.[182] Trilogy suggests that such a material level of compensation is beyond the customary bounds accorded directors and serves to preclude their independence, further noting that neither is considered independent under Securities and Exchange Commission ("SEC") and NASDAQ rules. Selectica responds that the position is a temporary one and that both Zawatski and Thanos have testified that they have no desire to continue serving in a management role beyond what will be necessary,[183] do not consider themselves

[180] In re Oracle Corp. Deriv. Litig., 824 A.2d 917, 941 (Del. Ch. 2003).
[181] Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984).
[182] Id. Both are paid $ 250/hour for management work.
[183] Indeed, as noted above, Thanos has already since stepped down as Co-Chair, as of August 2009.

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Selectica employees,[184] and that the compensation that they receive as Co-Chairs is not material to them.

Given the nature of Thanos and Zawatski's duties, and the apparent bright-line rule for distinguishing between inside and outside directors, the Court concludes that neither can be considered an "outside" director for material enhancement purposes. However, although nominally not outside directors, the record suggests that both were, nonetheless, independent.

Admittedly, the compensation that Thanos and Zawatski have received in their capacity as Co-Chairs is material by any measure. Nevertheless, determining their respective independence under the "actual person" standard, this Court does not have enough evidence to conclude that such compensation was sufficiently material to either Thanos or Zawatski to preclude their independence. Both Thanos and Zawatski were retired and took on the Co-Chair position following successful careers in the private sector. Both serve on multiple boards and both have testified that the income they receive in these roles is not personally material to them, and that they hope to be able to resign these positions in the near term. While Trilogy characterizes such testimony as "self-serving," the Court has no reason to doubt either director's testimony on this issue, nor has Trilogy provided evidence as to why it should.

The rationale behind materially enhancing the proof of good faith and reasonableness of those decisions made by a majority of outside independent directors is directly related to the primary concern that enhanced scrutiny under Unocal is designed to address: that a board might adopt defensive measures simply to retain control, whether or not those measures are in the best interest of shareholders. Where decisions are made by outside independent directors instead of members of management who have a presumptive desire to retain their employment, the concern that the board's decisions are tainted by self-serving motives is mitigated, and there naturally follows a greater presumption of good faith and reasonable investigation. This is the essence of the material enhancement rubric in Unocal and its progeny.

In this case, while the Board does not meet the specific "requirements" for material enhancement, any concern that the Board's actions stem from a desire for entrenchment is seemingly groundless. At the time that the NOL Pill was adopted, the Company had been actively seeking suitors for nearly six months and the Board was receiving constant updates on the sale process. Both Zawatski and Thanos had previously been outside directors before taking over management duties and had only temporarily assumed these duties in lieu of hiring a new CEO in anticipation of the Company's proximate sale. Further, one may readily presume that, given the financial plight of the Company, attracting additional independent and qualified directors might be difficult. Finally, the Board ultimately delegated final decision-making authority over the adoption of the

[184] Tr. 373-74; 966-67. In addition, Selectica points out that neither director receives a salary, both work, on average, fewer than twenty hours a week in this capacity, and neither signs the Company's periodic securities filings. Tr. 958; Zawatski Dep. at 237.

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Reloaded NOL Pill and the implementation of the Exchange to the Committee, which was comprised only of outside independent directors. Nevertheless, regardless of whether or not the Board is technically entitled to "material enhancement" under Unocal, the Court concludes that there is sufficient evidence to find good faith and reasonable investigation by the Board here.

Were there Reasonable Grounds to Conclude that a Threat Existed?

Is the Preservation of NOLs a Valid Corporate Objective?

The first part of the Unocal test requires a board to show that it had reasonable grounds for concluding that a threat to a corporate objective existed. This case presents unique grounds for establishing this first part of the Unocal test as employing a poison pill for the ostensible purpose of protecting NOLs is a distinct departure from the poison pill's originally intended use: the prevention of hostile takeovers. Delaware courts have only considered the poison pill in the context of an anti-takeover device, and the Unocal test is one that analyzes the board's response to such an outside threat.[185] In contrast, an NOL pill's principal function is to prevent the inadvertent forfeiture of potentially valuable assets, not to protect against hostile takeover attempts.[186]

As a result of its unique objective, a pill designed to protect NOLs necessitates precluding a lesser accumulation of shares than might be appropriate for a pill designed to prevent a hostile acquirer from establishing a control position in the company. Consequently, the 5% trigger necessary for an NOL pill to serve its function imposes a far greater cost on shareholders than the pill thresholds traditionally employed and held as acceptable by our courts in the anti-takeover context. Not surprisingly, pills with a 5% trigger remain fairly uncommon,[187] though they have been employed with greater frequency in recent years.

Trilogy argues that NOLs cannot be viewed as assets worth protecting absent a reasonable expectation of their probable future use. Unlike the corporate objectives traditionally being protected by boards mounting takeover defenses, all NOLs, by their very nature, have the potential of ultimately providing zero value to the company. Granting judicial sanction to low-threshold poison pills employed for the purpose of protecting NOLs guarantees the somewhat unpalatable outcome of acquiescing to the expansion of the universe of reasonable takeover defenses in order to protect assets of questionable, even dubious, value. However, expert testimony has been proferred that NOLs have a material value even absent an obvious mechanism for their use.[188] Trilogy

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[185] But see Paramount Commc'ns, 571 A.2d at 1153 ("The usefulness of Unocal as an analytical tool is precisely its flexibility in the face of a variety of fact scenarios.").
[186] Typically, companies with large NOLs would not be at risk of takeover attempts if the NOLs are the company's principal asset, as the takeover would likely trigger a change in control and impair the asset.
[187] See, e.g., DX 776 at 5 (expert report cataloging academic analyses on the frequency of various pill trigger percentages, reporting that pills with a trigger of 15% or 20% made up at least 90% of each sample studied, and concluding that pills with a trigger below 5% are "quite rare").
[188] See, e.g., PX 130 at 17 (expert report of Professor Merle Erickson, explaining that NOLs are economically valuable assets and concluding that the Board had a rational basis for taking steps to protect

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has put forward contradictory testimony that, because NOLs derive their value from future taxable income, they are not always valuable. Nevertheless, as NOL value is inherently unknowable ex ante, a board may properly conclude that the company's NOLs are worth protecting where it does so reasonably and in reliance upon expert advice. As the Court in Unocal recognized, "our corporate law is not static. It must grow and develop in response to, indeed in anticipation of, evolving concepts and needs."[189] Consequently, the Court concludes that the protection of company NOLs may be an appropriate corporate policy meriting a defensive response when threatened. Indeed, the protection of corporate assets against an outside threat is arguably a more important concern of the Board than restricting who the owners of the Company might be.[190]

Trilogy's Contentions Regarding Board Process

Trilogy argues that, in order to establish the first prong of the Unocal test, the Selectica Board was obligated to have a plan for whether and how the NOLs could be used in the future prior to adopting the NOL Pill. NOLs can only be used upon the creation of taxable income, which occurs by one of three ways: through operations, through the sale of assets, or by way of an acquisition. Yet in Selectica's case, Trilogy argues, none of these would have established an asset worth protecting because (1) Selectica had never generated taxable income and the Board had no reason to think that it would in the near-term, (2) the limits placed on NOLs following a Section 382 change in ownership do not apply when using NOLs to offset a taxable gain achieved through the sale of assets, and (3) any basis for the NOLs' use after an acquisition was purely speculative.[191] In order to determine whether the NOLs were assets worth protecting, the Board, according to Trilogy, needed to have conducted a formal analysis of when the Company could reasonably expect to receive tax savings from the use of its NOLs, as well as the amount of tax savings it could reasonably expect to obtain.

Furthermore, Trilogy claims that, to the extent that the Board did discuss the value of Selectica's NOLs, the discussions suggested that the Board believed they had no value.

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the NOLs); Tr. 502-04 (expert testimony of Patricia W. Pellervo, asserting that NOLs are "always valuable" unless imminently about to expire, and equating the value of NOLs to that of out-of-the-money options).

[189] Unocal, 493 A.2d at 957. As a result of the current economic environment, one might expect that the number of corporations with NOLs worth protecting will continue to increase, as will the number of corporate boards that opt for a 5% poison pill to protect them.

[190] Shareholder advisory firm RiskMetrics Group now supports rights plans with a trigger below 5% on a case-by-case basis if adopted for the stated purpose of preserving a company's net operating losses. PX 129 at 6-7. The factors it will consider in determining whether to support a management proposal to adopt an NOL pill are the pill's trigger, the value of the NOLs, the term of the pill, and any corresponding shareholder protection mechanisms in place (such as a sunset provision, causing expiration of the pill upon exhaustion or expiration of the NOLs). Id. at 7.

[191] Trilogy points out that the Board did not know whether or how Steel Partners might utilize the NOLs (Tr. 810, 991-93), and that Reilly did not have a meeting with Steel Partners regarding the means by which Steel Partners proposed to retain the NOLs until after the events in question, which Trilogy characterizes as evidence that the Board could not have received any meaningful advice from him about the potential for such a transaction.

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Trilogy points to Jurkowski's testimony that concedes that he did not believe the NOLs had much value,[192] and similar assertions by Thanos in August 2008,[193] as well as the fact that the Board voted against the more detailed Brogan study in February 2008. Additionally, in Selectica's annual and quarterly filings with the SEC, the Company did not recognize any deferred tax assets for NOLs on its balance sheet--a determination that it was more likely than not that the Company would not use its NOLs--and continued to make such a representation even after the NOL Pill was adopted. Finally, Trilogy asserts that an ownership change occurred on November 14, 2008, prior to the adoption of the NOL Pill, that severely impaired the value of Selectica's NOLs and made the adoption of the NOL Pill unnecessary, a determination that the Selectica Board would have made before adopting the NOL Pill had it engaged Brogan in a more in-depth Section 382 analysis.[194]

However, the record is replete with evidence suggesting to the contrary that the Board had ample reason to conclude, and did conclude, that the NOLs were an asset worth protecting and, thus, that their preservation was an important corporate objective. The facts show that many of Selectica's largest shareholders, including Steel Partners, Lloyd Miller, and Lloyd Sems, who collectively owned nearly 30% of the Company's shares outstanding, all believed that the NOLs were one of Selectica's most significant assets, and actively worked with the Board to ensure that they were protected. While the Board opted not to spend additional money on an in-depth report by Brogan in February 2008, it first analyzed the NOLs in September 2006, and sought updated Section 382 analyses from Brogan in March 2007, June 2007, July 2008, and November 2008.

DGCL § 141(e) and the Board's Reliance on Experts

The record suggests that the Board placed considerable reliance on the advice of outside experts in making its determination as to the value of Selectica's NOLs and the importance of protecting them from the threat posed by Trilogy. The Delaware General Corporation Law Section § 141(e), states:

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[192] Jurkowski Dep. at 45 (stating that his recommendation was not to move forward with additional study work by Brogan "because [he] did not understand what the value would be.").

[193] PX 80. Trilogy refers to a short reply email written in August 2008 by Thanos agreeing with the statement made by another Selectica employee that "NOL's [sic] do not appear to be of great value," and noting that the investment bankers he had spoken to "didn't put much emphasis on them." Thanos explained his email, stating that, at the time, these investment bankers expected the most likely buyers of Selectica to be more interested in the Company's intellectual property than its NOLs, which Thanos testified changed over time as such buyers dropped out of the process. Tr. 933-34; Thanos Dep. at 238-40.

[194] This conclusion comes from a report prepared by Trilogy's expert witness, Elliott G. Freier, a tax attorney specializing in Section 382 work with the firm of Irell & Manella, LLP. DX 777 at 12-13. Selectica disputes that an ownership change has occurred, and offered up Patricia W. Pellervo, a principal in the Mergers & Acquisition section of the Washington National Tax Services practice of PricewaterhouseCoopers, as a rebuttal witness asserting that a November 2008 Section 382 ownership change did not occur, that Freier's critiques of the Brogan study do not invalidate Brogan's conclusions, and that it was reasonable for the Board to conclude, based upon Brogan's advice, that Selectica was at risk of an ownership change at the time of the adoption of the NOL Pill. PX 123; PX 127. Freier's rebuttal is DX 787.

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A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member's duties, be fully protected in relying in good faith . . . upon such information, opinions, reports or statements presented to the corporation . . . by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.[195]

Under § 141(e), where a board has relied on an expert's advice in making a decision, a due care claim challenging that decision must establish such facts as would make reliance on the expert opinion unreasonable.[196] Trilogy would need to show either that: (a) the Board did not in fact rely on the experts; (b) such reliance was not in good faith; (c) the Board did not reasonably believe that the relevant expert's advice was within that expert's professional competence; (d) the experts were not selected with reasonable care, and the faulty selection was attributable to the directors; (e) the omitted information that the Board allegedly should have considered was so obvious and reasonably available that it was gross negligence for the Board to fail to consider it, regardless of expert advice or lack thereof; or (f) the decision of the Board was so unconscionable as to constitute waste or fraud.[197]

The record indicates that the Board was presented with expert advice on numerous occasions that supported its ultimate findings that the NOLs were a company asset worth protecting, that the NOLs were at risk as a result of Trilogy's actions, and that the steps that the Board ultimately took were reasonable in relation to that threat. Outside experts were present and addressed the Board on these matters at both the November 16 meeting that established the NOL Pill and the Board's December 29 meeting, while the Committee heard from advisers a third time at the January 2 meeting prior to instituting the Exchange and adopting the Reloaded NOL Pill.

Trilogy argues that the Board and the Committee were not justified in relying upon Reilly for advice regarding the value of the NOLs in the context of determining whether they were worth preserving because he was not an expert in NOLs or Section 382. Trilogy claims that the Board and the Committee also could not have reasonably relied on advice from Brogan about the value of the NOLs and the threat that Trilogy's purchases posed, since Brogan only provided his opinion on the level of ownership changes and the amount of available NOLs, not on how the NOLs could be used to generate value.

Additionally, from Trilogy's perspective, any reliance on Brogan was unreasonable because the Board knew that he had been recommended by Steel Partners, had continued communicating with Steel Partners with respect to Selectica after he began work on his analysis, and was aware of the outcome desired by Steel Partners; therefore, his advice was not disinterested. Further, the Board should have known that Brogan had not

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[195] 8 Del. C. § 141 (e).
[196] A board's reliance on expert advice "evidence[s] good faith and the overall fairness of the process." Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1142 (Del. Ch. 1994), aff'd, 663 A.2d 1156 (Del. 1995).
[197] See Brehm v. Eisner, 746 A.2d 244, 262 (Del. 2000).

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completed the in-depth NOL study in February 2008 and did not have time to do such a thorough study between the filing of Trilogy's 13D and the adoption of the NOL Pill, thus, that such analysis was incomplete. In addition, Trilogy points out that Brogan's final refinement of his analysis that calculated an ownership change percentage between 38-39% was less than the 40% he had initially reported to management and included offsetting transactions which should have been a "red flag," that, Trilogy maintains, "should have alerted the Board to question Brogan's analysis."[198]

These allegations aside, there is no evidence in the factual record to conclude that the Board was unreasonable in relying upon expert advice in determining whether and how to respond to Trilogy's actions. Though Reilly is not an expert in Section 382 and NOLs, as an experienced investment banker he was qualified to speak to which assets were worth preserving in the context of a potential company sale, whether or not he was personally qualified to place a specific value on them. Likewise, because Brogan's firm calculated the magnitude of Selectica's NOLs along with the magnitude and timing of the Section 382 ownership change that the Company had experienced, the Board could reasonably rely on Brogan's help in establishing the size of the asset under consideration and the risk of that asset being compromised.

That Steel Partners recommended Brogan's firm is of no consequence, and is not surprising, given Steel Partners' past experience with NOLs. It does not suggest anything untoward that should undermine Brogan's expert advice. In order to reasonably rely on Brogan, the Board needed only to find that Brogan was an expert in the matters to which he was providing advice and that he had been selected with due care. Brogan's work history as a tax attorney, CPA, and partner at several accounting firms specializing in tax accounting in the context of mergers and acquisitions, not to mention the dozens of Section 382 studies he had performed, gave the Board ample cause to consider him an expert qualified to speak on Selectica's NOLs and on the threat of their impairment.[199] Although it was theoretically possible for Brogan to have prepared a more thorough study that could have given the Board a more granular sense of the immediacy of the threat Trilogy posed, its absence did not render his advice unreliable. Within the context of the rushed timeline for determining and responding to Trilogy, the Court cannot conclude that any additional information was readily available but not presented to the Board, or that such information would have contradicted the expert advice that Brogan provided.

Trilogy raises issue with the fact that no expert provided advice as to the precise value of the NOLs to Selectica by estimating the probability of future taxable income, arguing that an expert could have been brought in to model their "potential value by considering various scenarios and assigning probabilities to assess the likelihood of the NOLs being monetized." Yet, such analysis, although arguably helpful, was unnecessary in this case.

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[198] Pre-Trial Br. of Defs. and Counterclaim-Pls. Versata Enterprises, Inc. and Trilogy, Inc. at 43. Yet, Trilogy has also put forward expert testimony arguing that Brogan underestimated the proximity of a Section 382 ownership change and that Selectica suffered a change in control event as a result of Trilogy's November purchases. DX 777.
[199] Brogan is also a former chair of the Corporate Tax Section of the California Bar Association and serves on the faculty of the Graduate School of Taxation at Golden Gate University. Tr. 424, 548-51.

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In order to conclude that a serious threat existed, the Board needed only reasonably conclude that the NOLs were a legitimate asset worth protecting. The Board recognized that the NOLs were material relative to the then-market value of the Company, and that the NOLs, if preserved, had a long window during which they would be available for use. If perhaps somewhat optimistic, they had rational expectations for the Company's near-term profitability.[200]

Trilogy is correct in pointing out that it is not sufficient to conclude that an asset with potential value is worth protecting without considering the probability of that value being realized, and that Selectica's failure to generate taxable income in prior years colors this probability. However, the absence of a formal study calculating such a value does not mean that the directors were unreasonable in concluding that a sufficiently material probability existed to merit the asset's preservation, or that such a determination was not implicit in their calculus.[201] In connection with the expert advice it received, the Court is satisfied that the Board was reasonable in concluding that Selectica's NOLs were worth preserving and that Trilogy's actions presented a serious threat to their impairment.[202]

Were the Board's Actions a Reasonable Response to the Perceived Threat?

The second prong of Unocal requires an evaluation of whether a board's defensive response to the threat was preclusive or coercive and, if not, whether it was "reasonable in relation to the threat" identified. It is the specific nature of the threat that "sets the parameters for the range of permissible defensive tactics." A reasonableness analysis "requires an evaluation of the importance of the corporate objective threatened; alternative methods for protecting that objective; impacts of the 'defensive' action and other relevant factors." The court should evaluate the board's "overall response, including the justification for each defensive measure, and the results achieved thereby." Where all of the defenses "are inextricably related, the principles of Unocal require that such actions be scrutinized collectively as a unitary response to the perceived threat."

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[200] The Court received in camera testimony at trial from Zawatski as to then-upcoming, as yet unaudited quarterly financial results for Selectica, in which she predicted that Selectica would finally turn a profit. Counsel for Selectica advised the Court after trial, however, that Selectica had determined that its audited financial results for the quarter would show a GAAP basis loss and that, as such, there was no need to transcribe this testimony and that the Court should not rely upon it in deciding the matter. Letter, dated June 8, 2009, from Gregory V. Varallo, Esquire at 1.

[201] Similarly, Trilogy's argument that the full valuation allowance recorded for NOLs in Selectica's SEC filings suggests that the Board recognized that utilization of the NOLs was unlikely is unavailing. A company may simultaneously conclude that there is less than a 50% chance of recognizing the value of an asset while reasonably taking steps to preserve that asset.

[202] The Court acknowledges that it is easy to be skeptical about whether Selectica will ultimately be able to recognize all or any of the value of its NOLs. A comparison of Selectica's market capitalization ($ 22.8 million) to a highly optimistic calculated value of, say, $ 58 million in tax offsets as a result of the NOLs (based on accumulated federal NOLs of $ 166.5 million and an assumed tax rate of 35%, and presuming sufficient income to be offset and otherwise full availability of the NOLs) suggests such a skepticism in the market. RJN, Ex. A at 35, 53, 56. Nevertheless, there is sufficient evidence that the Board acted in good faith in concluding that the NOLs had a value worth protecting or, perhaps more importantly, that the directors relied in good faith on the advice of experts in coming to such a conclusion.

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Trilogy asserts that the NOL Pill, the Exchange, and the Reloaded NOL Pill were not a reasonable collective response to the threat of the partial impairment of Selectica's NOLs. Trilogy asserts that the NOL Pill is preclusive, either per se or in conjunction with certain other factors unique to Selectica (most prominently, its staggered board). Trilogy also argues that the Board (1) failed to consider the negative consequences of the NOL Pill and Reloaded NOL Pill; (2) failed to consider any alternatives to these pills; and (3) failed to demonstrate that any benefit achieved by the pills outweighed their negative impact on Trilogy and other Selectica shareholders.

Does the 5% Trigger Make the NOL Pill Preclusive?

Under Unitrin, a defensive measure is disproportionate and unreasonable if it is draconian, being either coercive or preclusive. A coercive response is one that is "aimed at 'cramming down' on its shareholders a management-sponsored alternative."[203] A defensive measure is preclusive where it "operate[s] to unreasonably preclude a takeover"[204] or "preclude[s] effective stockholder action"[205] --specifically, where the measure "makes a bidder's ability to wage a successful proxy contest and gain control either 'mathematically impossible' or 'realistically unattainable.'"[206]

The mere adoption of a garden-variety pill is not in itself preclusive under Delaware law.[207] This is despite the fact that a poison pill "dilutes the would-be acquirer's stake in the company and increases the costs of acquisition."[208] That a combination of defensive measures makes it "more difficult for an acquirer to obtain control" of a board does not make such measures preclusive; indeed "[i]t would . . . be surprising if defensive measures did not have this effect."[209] Preclusive measures are those that are "insurmountable or impossible to outflank."[210]

The Supreme Court in Moran found that a poison pill with a 20% trigger was not per se preclusive because it did not "strip[] stockholders of their rights to receive tender

[203] Id. (citing Paramount, 571 A.2d at 1154-55). The parties do not dispute that the NOL Pill, Exchange, and Reloaded NOL Pill are not coercive.
[204] Gaylord, 753 A.2d at 482 n.72.
[205] Chesapeake Corp. v. Shore, 771 A.2d 293, 320 (Del. Ch. 2000) (quoting Unitrin, 651 A.2d at 1388-89).
[206] Carmody, 723 A.2d at 1195. The Court in Carmody held that "dead hand" pills (poison pills that contain a provision that states that only the original directors that adopted the pill may vote to redeem it) met this standard, as they eliminate the use of a proxy contest as a possible means to gain control since any insurgent directors would be incapable of redeeming the pill. Cf. Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 936 (Del. 2003) (holding that the defensive measures employed by the board made it mathematically impossible and realistically unattainable for any insurgent proposal to succeed because they rendered the board-approved merger a "fait accompli," and therefore were coercive and preclusive).
[207] Gaylord, 753 A.2d at 481. However, the Court in Unitrin recognized the legal scholarship that argues that the poison pill "warrants special attention chiefly because its preclusive effect frequently exceeds that of other takeover defensive tactics. . . . [and] makes it effective even in circumstances where other defensive tactics may not work." Unitrin, 651 A.2d at 1379 n.25 (quoting Jeffery N. Gordon, Corporations, Markets, and Courts, 91 Colum. L. Rev. 1931, 1946 (1991)).
[208] Unitrin, 651 A.2d at 1369 n.6.
[209] Gaylord, 753 A.2d at 482.
[210] Id.

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offers"[211] or "fundamentally restrict[] proxy contests."[212] The court recognized that, while a rights plan "does deter the formation of proxy efforts of a certain magnitude, it does not limit the voting power of individual shares." More importantly, because the purpose of the poison pill was not to provide an impenetrable barrier to control acquisitions but to give the target board leverage over a potential acquirer, where a potential acquirer may secure board control through a proxy contest and thereafter redeem the pill, the pill will not be considered preclusive.[213] The Moran Court found the assertion that a poison pill would preclude proxy fights "highly conjectural" and pointed to "recent corporate takeover battles in which insurgents holding less than 10% stock ownership were able to secure corporate control through a proxy contest or the threat of one."[214]

Trilogy asserts that the NOL Pill and the Reloaded NOL Pill are distinctly more preclusive than those poison pills previously evaluated by Delaware courts and that, consequently, they should be declared invalid. Specifically, Trilogy claims that a 4.99% pill renders the possibility of an effective proxy contest realistically unattainable. Trilogy argues that, because a proxy contest can only be successful where the challenger has sufficient credibility, the 4.99% pill prevents a potential dissident from signaling its financial commitment to the company sufficient to establish such credibility. In addition, a pill with such a low trigger, in conjunction with a staggered board, renders a conditional takeover bid "unrealistic" since a proxy contest would have to be sustained over multiple years, decreasing the probability that a would-be challenger would rationally incur the costs of such a proxy contest. As a result, such a pill would significantly lock in the existing ownership structure absent a board "exemption."[215]

Professor Ferrell, Trilogy's expert witness, additionally testified that the existence of such a pill in conjunction with a charter-based staggered board removes the ability of challengers to issue a conditional takeover bid--a bid conditional on the election of a slate of insurgent directors--in order to improve the likelihood of a successful proxy fight under these constraints. Such a bid would be highly unlikely, according to Professor Ferrell, because the offer would have to remain outstanding across multiple director election cycles. In addition, the 5% cap on ownership exacerbates the free rider problem already experienced by investors considering fielding an insurgent slate of directors, and makes initiating a proxy fight an economically unattractive proposition. Given all of the above, Trilogy asserts that the NOL Pill, particularly within the context of Selectica's other defenses, makes a change in board control "realistically unattainable."[216]

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[211] Moran, 500 A.2d at 1357.
[212] Id.
[213] Gaylord, 753 A.2d at 481.
[214] Moran, 500 A.2d at 1355. The Court additionally noted that "many proxy contests are won with an insurgent ownership of less than 20%," and that "the key variable in proxy contest success is the merit of an insurgent's issues, not the size of his holdings." Id.
[215] These were the findings of Trilogy's expert witness, Professor Allen Ferrell, who reviewed and analyzed eight academic studies, in conjunction with additional data he personally compiled. DX 776 at 3-4; Tr. 1061-62. Selectica's expert witnesses, Professor John C. Coates IV and Peter C. Harkins, dismissed Professor Ferrell's findings in rebuttal reports and in trial testimony. PX 122; Tr. 834-43.
[216] Carmody, 723 A.2d at 1195.

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Selectica counters that the distinguishing feature of the NOL Pill and Reloaded NOL Pill--the 5% trigger--is not sufficient to differentiate them from other poison pills previously blessed by Delaware courts, and that there is no evidence that a challenger starting below 5% could not realistically hope to prevail in a proxy contest at Selectica. Selectica, primarily through Professor Coates's expert testimony, has identified more than 50 publicly held companies that have implemented NOL pills with triggers at roughly 5%, including several large, well-known corporations, including some among the Fortune 1000.[217]

Selectica expert witness Harkins of the D. F. King & Co. proxy solicitation firm analyzed proxy contests over the three-year period ended December 31, 2008, and found that, of the fifteen proxy contests that occurred in micro-cap companies where the challenger controlled less than 5.49% of the outstanding shares, the challenger successfully obtained board seats in ten contests, including in five contests involving companies with classified boards.[218] Selectica also asserts that Trilogy's calculations of the average cost of proxy fights do not take into account Selectica's unique shareholder profile that would considerably reduce the costs associated with such a fight.[219] Trilogy seeks to discount these findings by pointing out that Selectica has failed to indicate any examples where a dissident shareholder in a micro-cap company with less than a 5% stake successfully obtained control over a company with a classified board.

Though Trilogy's expert testimony suggests that a poison pill with a less than 5% trigger "has a substantial preclusive effect,"[220] the Court cannot conclude that the NOL Pill, Exchange, and Reloaded NOL Pill were preclusive, and thereby draconian. Such a high standard operates to exclude only the most egregious defensive responses. As the court in Unitrin noted, "This Court's choice of the term draconian in Unocal was a recognition

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[217] PX 128, Ex. D; Plaintiffs' Third Motion for Judicial Notice at 3. Certainly, the fact that the adoption of pills with 5% triggers "is customary is not proof that it is, in fact, permissible or justifiable under the specific circumstances faced by the board." San Antonio Fire & Police Pension Fund v. Amylin Pharm., Inc., 983 A.2d 304, 2009 WL 1337150, at *10 n.45 (Del. Ch. 2009) (citing La. Mun. Police Employees' Retirement Sys. v. Crawford, 918 A.2d 1172, 1181 n.10 (Del. Ch. 2007)). Likewise, "the fact that the combination [of defenses] might be unusual does not make the combination unreasonable." Gaylord, 753 A.2d at 480 n.64. Nevertheless, the presence of similar pills adopted outside the context of shareholder/control disputes or an imminent takeover offer lends considerable support to the conclusion that the NOL Pill was "a statutorily authorized form of business decision which a board of directors may routinely make in a non-takeover contest" to be considered as part of the reasonableness review. Unitrin, 651 A.2d at 1389.

[218] PX 121. There were eight such contests at micro-cap companies in which the challenging shareholder held less than 4.99% of the outstanding shares. Challengers prevailed in six of these contests, including at three companies that had classified boards. Id.

[219] Selectica points out that six investors control a majority of its outstanding shares, and that twenty-two investors collectively own 62% of the outstanding shares, making the likely cost of a proxy fight at Selectica considerably cheaper than the average cost asserted by Trilogy. PX 121 at 7-9; Tr. 1023-30. Of those investors, only Sems is an "insider." Cf. Unitrin, 651 A.2d at 1383 n.33 ("That institutions held a high percentage of Unitrin stock is not as significant as the fact that the relatively concentrated percentage of stockholdings would facilitate a bidder's ability to communicate the merits of its position.").

[220] Although Professor Ferrell testified that the combination of such a pill with a classified board had a "substantial preclusive effect," he conceded that it was "not 100 percent preclusive" and that it was a "theoretical possibility" for an insurgent to win a proxy contest under such circumstances. Tr. 1085-86.

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that the law affords boards of directors substantial latitude in defending the perimeter of the corporate bastion against perceived threats."[221] The requirement of either the mathematical impossibility or realistic unattainability of a proxy contest reinforces the exactness of the preclusiveness standard. It is not enough that a defensive measure would make proxy contests more difficult--even considerably more difficult.[222] To find a measure preclusive (and avoid the reasonableness inquiry altogether), the measure must render a successful proxy contest a near impossibility or else utterly moot, given the specific facts at hand. The NOL Pill and Reloaded NOL Pill do not meet this standard.

Range of Reasonableness Review

Upon a finding that a defensive measure is neither coercive nor preclusive, the Unocal proportionality test "requires the focus of enhanced judicial scrutiny to shift to 'the range of reasonableness.'" Such a proportionality test is "inherently qualitative."

Trilogy argues that the Board's review of the range of reasonable responses to the threat to Selectica's NOLs failed because there was an inadequate assessment of the impact that the adoption of these defensive measures would have, as seemingly required by the Unocal test. This impact includes that they: (1) make takeovers more difficult; (2) effectively freeze the existing equity ownership structure in place; (3) deter institutional investors from investing in Selectica; and (4) prevent 5% holders from selling their interest as a single block, thereby impacting the liquidity of these investments, while the implementation of the Exchange in this instance essentially cut Selectica's stock price in half, putting the Company at risk of being delisted for non-compliance with NASDAQ rules. Trilogy argues that the Board failed even to consider these consequences, much less weigh their effects against the importance of protecting the NOLs and the likelihood of their impairment, otherwise. Finally, Trilogy asserts that the Board failed to consider whether there were alternative methods for protecting the NOLs other than those the Board ultimately employed. Trilogy asserts that the Board could have amended the corporate charter to add limitations on the transferability of stock--thereby rendering any non-approved acquisitions void ab initio, lowered the poison pill threshold by shareholder vote, or simply diluted only the portion of Trilogy's interest that exceeded the threshold, instead of its entire holding.

There is sufficient evidence, however, that the Board met its obligation to evaluate the reasonableness of its response relative to the danger it faced. Sems testified about the Board's internal debate on how to proceed, noting, "We were trying to do everything to--do a measured approach to a fairly big threat." In addition, Arnold testified that the Board "talked about the impact [of the NOL Pill] to the shareholders," testimony corroborated by Zawatski and Sems.[223] Trilogy points to testimony that Board members did not

[221] Unitrin, 651 A.2d at 1388 n.38.
[222] It is not clear that a 5% threshold would have much of an affect on the ability of a dissident to wage a successful proxy fight. See Unitrin, 651 A.2d at 1383 ("The key variable in a proxy context would be the merit of [the challenger's] issues, not the size of its stockholdings.").
[223] Tr. 751-52 ("Being a shareholder, too, I was in some ways apprehensive about it, because you never want to limit what shareholders can do. . . . But, to me, the trade-off was important, because it was such a large asset compared to the value of the company, once again.").

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specifically consider what effect lowering the pill threshold would have on certain of the consequences its experts have raised in trial, as listed above. However, as Zawatski noted, the Board established the Committee in part to monitor the likelihood of a near-term ownership change and to increase the pill threshold if and when the burden of the Reloaded NOL Pill on shareholders outweighs its benefit in preserving Selectica's NOLs.

Most importantly, Trilogy has failed to suggest any meaningfully different approach that the Board could have taken in November and December 2008 to avoid the seemingly imminent impairment of Selectica's NOLs by Trilogy.[224] The Board was put on notice of Trilogy's presence as a 5% holder and apparent intention to trigger a change in control on November 10.[225] Amending the charter would have required a vote of Selectica's shareholders,[226] which would have necessitated the filing of a proxy statement and delayed any defensive response for several months, making such action implausible as an immediate reaction to the threat that Trilogy posed. Seeking prior shareholder approval of the NOL Pill would have been likewise ineffectual.

Trilogy contends that Selectica's differing reaction to Trilogy's purchases, when compared to other shareholders' purchases in the past, including those by Steel Partners, suggests bias in favor of certain shareholders and animus toward Trilogy, and/or that preserving the NOLs was merely an excuse proffered by the Board in order to freeze out Trilogy.[227] In particular, Trilogy points out that Selectica only took action to protect its NOLs after Trilogy began buying, and had not done so in the immediately preceding months when Steel Partners increased its holdings to the 15% level allowed under the previous pill, which was the cause of the increase in the Section 382 ownership change calculation to 40%. Additionally, Selectica repeatedly sought a standstill agreement with Trilogy to prevent further share purchases following the filing of its 13D, but did not seek out similar agreements with other large shareholders during this same period. Trilogy maintains that the reasonableness of the Board's response should be assessed in light of the fact that the Board would have had considerably more, and less preclusive, options at

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[224] When asked by the Court about what else Selectica could have done to protect its NOLs at the time in question other than employing the NOL Pill, counsel for Trilogy did not offer up any other specific options that would have been less preclusive. Instead, she merely suggested that "[t]here may be a device similar to the pill that has a duration measured to the threat, that has a penalty, if you will, geared to the violation in the first place--in other words, not diluting down, past or beyond the actual amount; and that does not affect the shareholder franchise in the way that this micro-cap company is affected in having a classified board. . . . Another thing they could have done, they said they didn't have enough time, was to ask the shareholders whether they wanted to do it." Post-trial Oral Arg. Tr., 89-90 (unofficial transcript).

[225] Indeed, Trilogy argues that a Section 382 change in control did occur almost immediately thereafter, on November 14. DX 777.

[226] Selectica's charter does not permit shareholder actions by written consent. PX 131 ("Second Amended and Restated Certificate of Incorporation of Selectica (March, 2000)"), Article VIII.

[227] As evidence of this animus, Trilogy points to the testimony of Michael Shaw, former head of Selectica's sales configuration business, who testified that Thanos's general feeling was that Selectica would sell to Trilogy "over my [Thanos's] dead body." Shaw Dep. at 43-44. Likewise, Zawatski admitted at trial that she does not like Trilogy. Tr. 327. Trilogy asserts that Selectica's "well-known dislike for Trilogy" is evidenced by the statement made by an investor during Selectica's Second Quarter 2007 earnings call advocating for a sale to Trilogy, who noted, "I understand you probably hate them. You probably would prefer nothing than--you'd probably stick pins in your eyes rather than sell the Company to them. But that is what the right thing for shareholders is at this point." DX 163 at 6.

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its disposal in the months before a Section 382 ownership change was imminent, and that any precipitous threat arguably necessitating more draconian measures was the result of the Board's failure to act at an earlier date.

A board's timing in moving to protect NOLs through the adoption of a poison pill is certainly relevant to the question of whether the board reasonably perceived a legitimate threat to the corporation. However, under Unocal, the reasonableness of a board's response is judged in relation to the "specific threat" identified, at the time it was identified.[228] In this case, Trilogy posed a distinctly different threat to Selectica's NOLs than the general threat Selectica previously faced of an inadvertent change in ownership triggered by the actions of a careless or unknowing shareholder. Here, the record demonstrates that a longtime competitor sought to employ the shareholder franchise intentionally to impair corporate assets, or else to coerce the Company into meeting certain business demands under the threat of such impairment. It is in relation to that specific threat--and not a more general threat of impaired NOLs--that the Court must consider the reasonableness of Selectica's response.[229]

With respect to Trilogy's argument that Selectica should have more narrowly tailored the amount by which Trilogy's position was diluted by reducing the impact of the NOL Pill, there is no evidence in the record that this was even a plausible option. As it was, the implementation of the Exchange--seemingly the simplest mechanism for transferring the rights--caused trading in Selectica stock to halt for more than four weeks. Besides, taking Trilogy down to under 5% would not have eliminated the threat, at least in the absence of a standstill agreement. However, the Exchange employed by the Board was a more proportional response than the "flip-in" mechanism traditionally envisioned for poison pills. Because the Board opted to use the Exchange instead of the traditional "flip-in" mechanism, Trilogy experienced less dilution in its position than a poison pill is traditionally designed to achieve.[230]

Ultimately, Unocal and its progeny require that the defensive response employed be a proportionate response, not the most narrowly or precisely tailored one. The Supreme Court in QVC explained the nature of judicial function in applying the range of reasonableness inquiry to enhanced judicial scrutiny of board actions:
[A] court applying enhanced judicial scrutiny should be deciding whether the directors made a reasonable decision, not a perfect decision. If a board selected one of several

[228] See, e.g., Moran, 500 A.2d at 1351; Paramount Commc'ns, Inc. v. Time, Inc., 1989 Del. Ch. LEXIS 77, 1989 WL 79880, at *30 (Del. Ch. July 14, 1989).

[229] As Sems noted, "I kept on going through what was their rationale for purposefully tripping the pill. . . . [W]hy would you . . . ruin the value of an NOL that you, the shareholder, are part of that value. It's an asset to you as a shareholder. Why would you destroy your own asset?" Tr. 755.

[230] The Exchange reduced Trilogy's holdings from 6.7% to 3.3%. In contrast, employing the flip-in would have likely reduced the company's holdings to below 1.0%. PX 38 at 29 (Needham presentation estimating that a flip-in pill would reduce a 5.0% triggering stake to 0.7% after the rights were exercised). As Sems testified, "[o]ne of the things you could do, instead of a flip-in, you could do the exchange. We looked at the difference between doing both of those and came to the conclusion that exchange was not only better for shareholders, but better for Trilogy as well, too. We were trying to do everything to--do a measured approach to a fairly big threat." Tr. 753.

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reasonable alternatives, a court should not second guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination. Thus, courts will not substitute their business judgment for that of the directors, but will determine if the directors' decision was, on balance, within a range of reasonableness.

The Unitrin court suggested that the reasonableness of measures ought to be construed broadly by courts and allow defenses to extend beyond an immediate threat: "[T]he board of directors is the defender of the metaphorical medieval corporate bastion and the protector of the corporation's shareholders. The fact that a defensive action must not be coercive or preclusive does not prevent a board from responding defensively before a bidder is at the corporate bastion's gate." Likewise, once a siege has begun, the board is not constrained to repel the threat to just beyond the castle walls.

Finally, the implementation of the Reloaded NOL Pill was a similarly reasonable response in the context of Selectica's other defensive measures. Although the NOL Pill and the Exchange effectively rebuffed Trilogy's immediate threat to Selectica's NOLs, the general threat of a Section 382 change in control was not substantially lessened by their implementation. Following implementation of the Exchange, Selectica still had experienced a roughly 40% ownership change for Section 382 purposes and there was no longer a pill in place to discourage additional acquisitions by 5% holders.[231] As such, the Reloaded NOL Pill was reasonably considered as a necessary defensive measure. In addition, the Reloaded NOL Pill's three-year life is mitigated to an extent by the periodic review process to be employed by the Committee.[232]

Thus, the Court finds that the combination of the NOL Pill, the Exchange, and the Reloaded NOL Pill was a proportionate response to the threatened loss of Selectica's NOLs.

There is, of course, the risk that accumulated net operating losses could provide a convenient pretext for perpetuating a board-preferred shareholder structure. For this reason, shareholder rights plans, such as the ones adopted by Selectica, must be subject to careful review. In this instance, however, the Board reasonably believed, based on the guidance of appropriate experts, that the NOLs had value, a value worth protecting. In its view of the actual value of the NOLs, the Board may have been incorrect. It is not for the Court, however, to substitute its judgment for the reasonable conclusions of the Board protected as they are by 8 Del. C. § 141(e). Moreover, the threat posed by Trilogy was reasonably viewed as qualitatively different from the normal corporate control dispute that leads to the adoption of a shareholder rights plan. In this instance, Trilogy, a competitor with a contentious history, recognized that harm would befall its rival if it purchased sufficient shares of Selectica stock, and Trilogy proceeded to act accordingly.

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[231] See also Gaylord, 753 A.2d at 485 ("[T]he board's decision to put into place seamless defensive coverage efficiently cannot be deemed an unreasonable approach to the situation it faced.).

[232] See Unitrin, 651 A.2d at 1378 ("[T]his Court has upheld the propriety of adopting poison pills in given defensive circumstances. Keeping a poison pill in place may be inappropriate, however, when the circumstances change dramatically.").

It was reasonable for the Board to respond, and the timing of Trilogy's campaign required the Board to act promptly. Moreover, the 4.99% threshold for the NOL Pill was driven by our tax laws and regulations; the threshold, low as it is, was measured by reference to an external standard, one created neither by the Board nor by the Court. Within this context, it is not for the Court to second-guess the Board's efforts to protect Selectica's NOLs.

CONCLUSION

For the foregoing reasons, the Court concludes that the adoption of the NOL Pill and the Reloaded NOL Pill and the implementation of the Exchange were valid exercises of the Board's business judgment. Selectica's declaratory relief is granted. It follows that Trilogy and Versata's claims fail. Counsel are requested to confer and to submit an implementing form of order.

G. Page 196, New Sec. 3.14.G. Delaware Supreme Court's Elaboration on Revlon *Duties*—Lyondell

Page 196, New Sec. 3.14.G.	Add before Sec. 3.15 the following:
New Sec. 3.14.G.	**Delaware Supreme Court's Elaboration on *Revlon* Duties—*Lyondell***

Lyondell Chemical Company v. Ryan,
Delaware Supreme Court, 970 A.2d 235, 2009

BERGER, Justice:

We accepted this interlocutory appeal to consider a claim that directors failed to act in good faith in conducting the sale of their company. The Court of Chancery decided that "unexplained inaction" permits a reasonable inference that the directors may have consciously disregarded their fiduciary duties. The trial court expressed concern about the speed with which the transaction was consummated; the directors' failure to negotiate better terms; and their failure to seek potentially superior deals. But the record establishes that the directors were disinterested and independent; that they were generally aware of the company's value and its prospects; and that they considered the offer, under the time constraints imposed by the buyer, with the assistance of financial and legal advisors. At most, this record creates a triable issue of fact on the question of whether the directors exercised due care. There is no evidence, however, from which to infer that the directors knowingly ignored their responsibilities, thereby breaching their duty of loyalty. Accordingly, the directors are entitled to the entry of summary judgment.

FACTUAL AND PROCEDURAL BACKGROUND

Before the merger at issue, Lyondell Chemical Company ("Lyondell") was the third

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largest independent, publicly traded chemical company in North America. Dan Smith ("Smith") was Lyondell's Chairman and CEO. Lyondell's other ten directors were independent and many were, or had been, CEOs of other large, publicly traded companies. Basell AF ("Basell") is a privately held Luxembourg company owned by Leonard Blavatnik ("Blavatnik") through his ownership of Access Industries. Basell is in the business of polyolefin technology, production and marketing.

In April 2006, Blavatnik told Smith that Basell was interested in acquiring Lyondell. A few months later, Basell sent a letter to Lyondell's board offering $ 26.50 - $ 28.50 per share. Lyondell determined that the price was inadequate and that it was not interested in selling. During the next year, Lyondell prospered and no potential acquirors expressed interest in the company. In May 2007, an Access affiliate filed a Schedule 13D with the Securities and Exchange Commission disclosing its right to acquire an 8.3% block of Lyondell stock owned by Occidental Petroleum Corporation. The Schedule 13D also disclosed Blavatnik's interest in possible transactions with Lyondell.

In response to the Schedule 13D, the Lyondell board immediately convened a special meeting. The board recognized that the 13D signaled to the market that the company was "in play,"[233] but the directors decided to take a "wait and see" approach. A few days later, Apollo Management, L.P. contacted Smith to suggest a management-led LBO, but Smith rejected that proposal. In late June 2007, Basell announced that it had entered into a $ 9.6 billion merger agreement with Huntsman Corporation ("Huntsman"), a specialty chemical company. Basell apparently reconsidered, however, after Hexion Specialty Chemicals, Inc. made a topping bid for Huntsman. Faced with competition for Huntsman, Blavatnik returned his attention to Lyondell.

On July 9, 2007, Blavatnik met with Smith to discuss an all-cash deal at $ 40 per share. Smith responded that $ 40 was too low, and Blavatnik raised his offer to $ 44- $ 45 per share. Smith told Blavatnik that he would present the proposal to the board, but that he thought the board would reject it. Smith advised Blavatnik to give Lyondell his best offer, since Lyondell really was not on the market. The meeting ended at that point, but Blavatnik asked Smith to call him later in the day. When Smith called, Blavatnik offered to pay $ 48 per share. Under Blavatnik's proposal, Basell would require no financing contingency, but Lyondell would have to agree to a $ 400 million break-up fee and sign a merger agreement by July 16, 2007.

Smith called a special meeting of the Lyondell board on July 10, 2007 to review and consider Basell's offer. The meeting lasted slightly less than one hour, during which time the board reviewed valuation material that had been prepared by Lyondell management for presentation at the regular board meeting, which was scheduled for the following day. The board also discussed the Basell offer, the status of the Huntsman merger, and the likelihood that another party might be interested in Lyondell. The board instructed Smith to obtain a written offer from Basell and more details about Basell's financing.

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[233] On the day that the 13D was made public, Lyondell's stock went from $ 33 to $ 37 per share.

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Blavatnik agreed to the board's request, but also made an additional demand. Basell had until July 11 to make a higher bid for Huntsman, so Blavatnik asked Smith to find out whether the Lyondell board would provide a firm indication of interest in his proposal by the end of that day. The Lyondell board met on July 11, again for less than one hour, to consider the Basell proposal and how it compared to the benefits of remaining independent. The board decided that it was interested, authorized the retention of Deutsche Bank Securities, Inc. ("Deutsche Bank") as its financial advisor, and instructed Smith to negotiate with Blavatnik.

Basell then announced that it would not raise its offer for Huntsman, and Huntsman terminated the Basell merger agreement. From July 12 - July 15 the parties negotiated the terms of a Lyondell merger agreement; Basell conducted due diligence; Deutsche Bank prepared a "fairness" opinion; and Lyondell conducted its regularly scheduled board meeting. The Lyondell board discussed the Basell proposal again on July 12, and later instructed Smith to try to negotiate better terms. Specifically, the board wanted a higher price, a go-shop provision,[234] and a reduced break-up fee. As the trial court noted, Blavatnik was "incredulous." He had offered his best price, which was a substantial premium, and the deal had to be concluded on his schedule. As a sign of good faith, however, Blavatnik agreed to reduce the break-up fee from $ 400 million to $ 385 million.

On July 16, 2007, the board met to consider the Basell merger agreement. Lyondell's management, as well as its financial and legal advisers, presented reports analyzing the merits of the deal. The advisors explained that, notwithstanding the no-shop provision in the merger agreement, Lyondell would be able to consider any superior proposals that might be made because of the "fiduciary out" provision. In addition, Deutsche Bank reviewed valuation models derived from "bullish" and more conservative financial projections. Several of those valuations yielded a range that did not even reach $ 48 per share, and Deutsche Bank opined that the proposed merger price was fair. Indeed, the bank's managing director described the merger price as "an absolute home run." Deutsche Bank also identified other possible acquirors and explained why it believed no other entity would top Basell's offer. After considering the presentations, the Lyondell board voted to approve the merger and recommend it to the stockholders. At a special stockholders' meeting held on November 20, 2007, the merger was approved by more than 99% of the voted shares.

The first stockholders to litigate this merger filed suit in Texas on July 23, 2007. Walter E. Ryan, Jr., the plaintiff in this action, participated in the Texas litigation and filed suit in Delaware on August 20, 2007. The Texas court denied an application for a preliminary injunction on November 13, 2007, while the defendants in Delaware were briefing their motion for summary judgment. The Court of Chancery issued its opinion on July 29, 2008, denying summary judgment as to the *"Revlon"* and the "deal protection" claims. This Court accepted the Lyondell directors' application for certification of an interlocutory appeal on September 15, 2008.

[234] A "go-shop" provision allows the seller to seek other buyers for a specified period after the agreement is signed.

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DISCUSSION

The class action complaint challenging this $ 13 billion cash merger alleges that the Lyondell directors breached their "fiduciary duties of care, loyalty and candor ... and . . . put their personal interests ahead of the interests of the Lyondell shareholders." Specifically, the complaint alleges that: 1) the merger price was grossly insufficient; 2) the directors were motivated to approve the merger for their own self-interest;[235] 3) the process by which the merger was negotiated was flawed; 4) the directors agreed to unreasonable deal protection provisions; and 5) the preliminary proxy statement omitted numerous material facts. The trial court rejected all claims except those directed at the process by which the directors sold the company and the deal protection provisions in the merger agreement.

The remaining claims are but two aspects of a single claim, under *Revlon v. MacAndrews & Forbes Holdings, Inc.,* that the directors failed to obtain the best available price in selling the company. As the trial court correctly noted, *Revlon* did not create any new fiduciary duties. It simply held that the "board must perform its fiduciary duties in the service of a specific objective: maximizing the sale price of the enterprise."[236] The trial court reviewed the record, and found that Ryan might be able to prevail at trial on a claim that the Lyondell directors breached their duty of care. But Lyondell's charter includes an exculpatory provision, pursuant to 8 *Del. C*. § 102 (b) (7), protecting the directors from personal liability for breaches of the duty of care. Thus, this case turns on whether any arguable shortcomings on the part of the Lyondell directors also implicate their duty of loyalty, a breach of which is not exculpated. Because the trial court determined that the board was independent and was not motivated by self-interest or ill will, the sole issue is whether the directors are entitled to summary judgment on the claim that they breached their duty of loyalty by failing to act in good faith.

This Court examined "good faith"[237] in two recent decisions. In *In re Walt Disney Co. Deriv Litig.,* the Court discussed the range of conduct that might be characterized as bad faith, and concluded that bad faith encompasses not only an intent to harm but also intentional dereliction of duty:
[A]t least three different categories of fiduciary behavior are candidates for the "bad faith" pejorative label. The first category involves so-called "subjective bad faith," that is, fiduciary conduct motivated by an actual intent to do harm . . . . [S]uch conduct constitutes classic, quintessential bad faith ....

The second category of conduct, which is at the opposite end of the spectrum, involves lack of due care - that is, fiduciary action taken solely by reason of gross negligence and

[235] The directors' alleged financial interest is the fact that they would receive cash for their stock options.
[236] *Malpiede v. Townson*, 780 A.2d 1075, 1083 (Del 2000).
[237] Our corporate decisions tend to use the terms "bad faith" and "failure to act in good faith" interchangeably, although in a different context we noted that, "[t]he two concepts - bad faith and conduct not in good faith are not necessarily identical." *25 Massachusetts Avenue Property LLC v. Liberty Property Limited Partnership*, Del. Supr., No. 188, 2008, Order at p.5, (November 25, 2008). For purposes of this appeal, we draw no distinction between the terms.

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without any malevolent intent .... [W]e address the issue of whether gross negligence (including failure to inform one's self of available material facts), without more, can also constitute bad faith. The answer is clearly no.

* * *

That leaves the third category of fiduciary conduct, which falls in between the first two categories .... This third category is what the Chancellor's definition of bad faith - intentional dereliction of duty, a conscious disregard for one's responsibilities - is intended to capture. The question is whether such misconduct is properly treated as a non-exculpable, nonindemnifiable violation of the fiduciary duty to act in good faith. In our view, it must be ....

The *Disney* decision expressly disavowed any attempt to provide a comprehensive or exclusive definition of "bad faith."

A few months later, in *Stone v. Ritter,"* this Court addressed the concept of bad faith in the context of an "oversight" claim. We adopted the standard articulated ten years earlier, in *In re Caremark Int'l Deriv. Litig.:*
[W]here a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation . . . only a sustained or systematic failure of the board to exercise oversight -- such as an utter failure to attempt to assure a reasonable information and reporting system exists -- will establish the lack of good faith that is a necessary condition to liability.

The *Stone* Court explained that the *Caremark* standard is fully consistent with the *Disney* definition of bad faith. *Stone* also clarified any possible ambiguity about the directors' mental state, holding that "imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations."[238]

The Court of Chancery recognized these legal principles, but it denied summary judgment in order to obtain a more complete record before deciding whether the directors had acted in bad faith. Under other circumstances, deferring a decision to expand the record would be appropriate. Here, however, the trial court reviewed the existing record under a mistaken view of the applicable law. Three factors contributed to that mistake. First, the trial court imposed *Revlon* duties on the Lyondell directors before they either had decided to sell, or before the sale had become inevitable. Second, the court read *Revlon* and its progeny as creating a set of requirements that must be satisfied during the sale process. Third, the trial court equated an arguably imperfect attempt to carry out *Revlon* duties with a knowing disregard of one's duties that constitutes bad faith.

Summary judgment may be granted if there are no material issues of fact in dispute and the moving party is entitled to judgment as a matter of law. The facts, and all reasonable inferences, must be considered in the light most favorable to the nonmoving party. The Court of Chancery identified several undisputed facts that would support the entry of

[238] *Stone*, 911 A.2d at 370.

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judgment in favor of the Lyondell directors: the directors were "active, sophisticated, and generally aware of the value of the Company and the conditions of the markets in which the Company operated."[239] They had reason to believe that no other bidders would emerge, given the price Basell had offered and the limited universe of companies that might be interested in acquiring Lyondell's unique assets. Smith negotiated the price up from $ 40 to $ 48 per share -- a price that Deutsche Bank opined was fair. Finally, no other acquiror expressed interest during the four months between the merger announcement and the stockholder vote.

Other facts, however, led the trial court to "question the adequacy of the Board's knowledge and efforts . . . ." After the Schedule 13D was filed in May, the directors apparently took no action to prepare for a possible acquisition proposal. The merger was negotiated and finalized in less than one week, during which time the directors met for a total of only seven hours to consider the matter. The directors did not seriously press Blavatnik for a better price, nor did they conduct even a limited market check. Moreover, although the deal protections were not unusual or preclusive, the trial court was troubled by "the Board's decision to grant considerable protection to a deal that may not have been adequately vetted under *Revlon."*

The trial court found the directors' failure to act during the two months after the filing of the Basell Schedule 13D critical to its analysis of their good faith. The court pointedly referred to the directors' "two months of slothful indifference despite *knowing* that the Company was in play," and the fact that they "languidly awaited overtures from potential suitors . . . ." In the end, the trial court found that it was this "failing" that warranted denial of their motion for summary judgment:
[T]he Opinion clearly questions whether the Defendants "engaged" in the sale process . . . . This is where the 13D filing in May 2007 and the subsequent two months of (apparent) Board inactivity become critical . . . . [T]he Directors made *no apparent effort* to arm themselves with *specific knowledge* about the present value of the Company in the May through July 2007 time period, despite *admittedly knowing* that the 13D filing . . . effectively put the Company "in play," and, therefore, presumably, also knowing that an offer for the sale of the Company could occur at any time. It is these facts that raise the specter of "bad faith" in the present summary judgment record . . .

The problem with the trial court's analysis is that *Revlon* duties do not arise simply because a company is "in play."[240] The duty to seek the best available price applies only when a company embarks on a transaction -- on its own initiative or in response to an unsolicited offer-- that will result in a change of control.[241] Basell's Schedule 13D did put the Lyondell directors, and the market in general, on notice that Basell was interested in acquiring Lyondell. The directors responded by promptly holding a special meeting to consider whether Lyondell should take any action. The directors decided that they would neither put the company up for sale nor institute defensive measures to fend off a possible

[239] *Ryan v. Lyondell Chemical Co*., 2008 Del. Ch. LEXIS 105, 2008 WL 2923427 at *13 (Del.Ch.) *(Lyondell l).*
[240] *Paramount Communications, Inc. v. Time, Inc*., 571 A.2d 1140, 1151 (Del. 1989).
[241] *In re Santa Fe Pac. Corp. S'holder Litig*., 669 A.2d 59, 71 (1995).

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hostile offer. Instead, they decided to take a "wait and see" approach. That decision was an entirely appropriate exercise of the directors' business judgment. The time for action under *Revlon* did not begin until July 10, 2007, when the directors began negotiating the sale of Lyondell.

The Court of Chancery focused on the directors' two months of inaction, when it should have focused on the one week during which they considered Basell's offer. During that one week, the directors met several times; their CEO tried to negotiate better terms; they evaluated Lyondell's value, the price offered and the likelihood of obtaining a better price; and then the directors approved the merger. The trial court acknowledged that the directors' conduct during those seven days might not demonstrate anything more than lack of due care. But the court remained skeptical about the directors' good faith -- at least on the present record. That lingering concern was based on the trial court's synthesis of the *Revlon* line of cases, which led it to the erroneous conclusion that directors must follow one of several courses of action to satisfy their *Revlon* duties.

There is only one *Revlon* duty -- to "[get] the best price for the stockholders at a sale of the company." No court can tell directors exactly how to accomplish that goal, because they will be facing a unique combination of circumstances, many of which will be outside their control. As we noted in *Barkan v. Amsted Industries, Inc.,* "there is no single blueprint that a board must follow to fulfill its duties. That said, our courts have highlighted both the positive and negative aspects of various boards' conduct under *Revlon.*[242] The trial court drew several principles from those cases: directors must "engage actively in the sale process," and they must confirm that they have obtained the best available price either by conducting an auction, by conducting a market check, or by demonstrating "an impeccable knowledge of the market."

The Lyondell directors did not conduct an auction or a market check, and they did not satisfy the trial court that they had the "impeccable" market knowledge that the court believed was necessary to excuse their failure to pursue one of the first two alternatives. As a result, the Court of Chancery was unable to conclude that the directors had met their burden under *Revlon.* In evaluating the totality of the circumstances, even on this limited record, we would be inclined to hold otherwise. But we would not question the trial court's decision to seek additional evidence if the issue were whether the directors had exercised due care. Where, as here, the issue is whether the directors failed to act in good faith, the analysis is very different, and the existing record mandates the entry of judgment in favor of the directors.

As discussed above, bad faith will be found if a "fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." The trial

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[242] *See, e.g.: Barkan v Amsted Industries, Inc*., 567 A.2d at 1287 (Directors need not conduct a market check if they have reliable basis for belief that price offered is best possible.); *Paramount Communications, Inc. v. QVC Network, Inc*., 637 A.2d 34,49 (Del. 1994) (No-shop provision impermissibly interfered with directors' ability to negotiate with another known bidder); *In re Netsmart Technologies, Inc., Shareholders Litig*., 924 A.2d 171, 199 (Del. Ch. 2007) (Plaintiff likely to succeed on claim based on board's failure to consider strategic buyers.) .

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court decided that the *Revlon* sale process must follow one of three courses, and that the Lyondell directors did not discharge that "known set of *[Revlon]* 'duties'." But, as noted, there are no legally prescribed steps that directors must follow to satisfy their *Revlon* duties. Thus, the directors' failure to take any specific steps during the sale process could not have demonstrated a conscious disregard of their duties. More importantly, there is a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties.

Directors' decisions must be reasonable, not perfect.[243] "In the transactional context, [an] extreme set of facts [is] required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties."[244] The trial court denied summary judgment because the Lyondell directors' "unexplained inaction" prevented the court from determining that they had acted in good faith. But, if the directors failed to do all that they should have under the circumstances, they breached their duty of care. Only if they knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty. The trial court approached the record from the wrong perspective. Instead of questioning whether disinterested, independent directors did everything that they (arguably) should have done to obtain the best sale price, the inquiry should have been whether those directors utterly failed to attempt to obtain the best sale price.

Viewing the record in this manner leads to only one possible conclusion. The Lyondell directors met several times to consider Basell's premium offer. They were generally aware of the value of their company and they knew the chemical company market. The directors solicited and followed the advice of their financial and legal advisors. They attempted to negotiate a higher offer even though all the evidence indicates that Basell had offered a "blowout" price.[245] Finally, they approved the merger agreement, because "it was simply too good not to pass along [to the stockholders] for their consideration." We assume, as we must on summary judgment, that the Lyondell directors did absolutely nothing to prepare for Basell's offer, and that they did not even consider conducting a market check before agreeing to the merger. Even so, this record clearly establishes that the Lyondell directors did not breach their duty of loyalty by failing to act in good faith. In concluding otherwise, the Court of Chancery reversibly erred. \

CONCLUSION

Based on the foregoing, the decision of the Court of Chancery is reversed and this matter is remanded for entry of judgment in favor of the Lyondell directors. Jurisdiction is not retained.

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[243] *Paramount Communications, Inc. v. QVC Network, Inc*., 637 A.2d at 45.
[244] *In re Lear Corp. S'holder Litig*., 967 A.2d 640, 2008 Del. Ch. LEXIS 121, 2008 WL 4053221 at *11 (Del. Ch.).
[245] *Lyondell I* 2008 Del. Ch. LEXIS 105, [WL] at *1. The trial court disparages the Lyondell directors' characterization of $ 48 per share as a "blowout" premium. But the record evidence -- including testimony from Basell directors who voted against the merger because they believed the price was too high -- supports such a description.

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H. Page 230, New Sec. 3.17.E.1. Delaware Chancery Court's Unified Standard for Applying the Business Judgment Rule to a Controlling Party's Tender Offer Followed by Second Step Merger—CNX

Page 230, New Sec. 3.17.E.1. Add before Sec. 3.17.F the following:

New Sec. 3.17.E.1. **Delaware Chancery Court's Unified Standard for Applying the Business Judgment Rule to a Controlling Party's Tender Offer Followed by Second Step Merger—CNX**

In Re CNX Gas Corporation Shareholders Litigation
Delaware Chancery Court, 2010
2010 Del. Ch. LEXIS 119

LASTER, Vice Chancellor.

Representatives of a putative class of minority stockholders have challenged a controlling stockholder freeze-out structured as a first-step tender offer to be followed by second-step short-form merger. The plaintiffs have sued the controlling stockholder, its controlled subsidiary, and the four members of the subsidiary board. Three of the subsidiary directors are also directors of the controller. The fourth is an independent outsider and the sole member of the special committee formed to respond to the controller's tender offer. The plaintiffs have moved for a preliminary injunction against the transaction.

I apply the unified standard for reviewing controlling stockholder freeze-outs described in *In re Cox Communications, Inc. Shareholders Litigation,* 879 A.2d 604 (Del. Ch. 2005). Under that standard, the business judgment rule applies when a freeze-out is conditioned on *both* the affirmative recommendation of a special committee *and* the approval of a majority of the unaffiliated stockholders. Because the special committee did not recommend in favor of the tender offer, the transaction at issue in this case will be reviewed for entire fairness. Although the lack of an affirmative recommendation is sufficient to trigger fairness review under *Cox Communications,* the plaintiffs also have shown that the special committee was not provided with the authority to bargain with the controller on an arms' length basis. The plaintiffs similarly have established a reasonable basis to question the effectiveness of the majority-of-the-minority tender condition.

Because a fairness standard applies to the challenged transaction, any harm to the putative class can be remedied through a post-closing damages action. There are no viable disclosure claims, and the tender offer is not coercive. I therefore decline to issue a preliminary injunction.

FACTUAL BACKGROUND

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The record developed during expedited discovery is limited. I draw the facts from the public disclosures provided in connection with the freeze-out and the few documents and five deposition transcripts submitted by the parties.

CONSOL Forms CNX Gas.

Defendant CONSOL Energy, Inc. ("CONSOL") is a Delaware corporation with its principal place of business in Canonsburg, Pennsylvania. CONSOL is the largest producer of high-Btu bituminous coal in the United States. Its shares trade publicly on the New York Stock Exchange under the symbol "CNX."

CONSOL is also a leader in the production of coalbed methane gas. In the early 1980s, CONSOL began extracting coalbed methane gas to reduce the gas content of its coal and enhance the safety and productivity of its mining operations. From these beginnings sprang a commercial coalbed methane gas business.

In June 2005, CONSOL formed defendant CNX Gas Corporation ("CNX Gas"), also a Delaware corporation, to conduct CONSOL's natural gas operations. CONSOL's board of directors authorized a public offering of less than 20% of the common stock of CNX Gas as the first step towards a potential spin-off. In August 2005, CNX Gas sold approximately 27.9 million shares in a private placement. A registration statement for the shares was declared effective in January 2006, and shares of CNX Gas began trading publicly on the New York Stock Exchange under the symbol "CXG."

In contemplation of the potential spin-off, CONSOL and CNX Gas entered into a number of agreements to govern their relationship, including a Master Separation Agreement, a Master Cooperation and Safety Agreement, a Tax Sharing Agreement, and a Services Agreement. Among other things, the Master Separation Agreement provides that as long as CONSOL beneficially owns at least 50% of the CNX Gas common stock, CNX Gas will not (i) take any action to limit the ability of CONSOL to transfer its shares, (ii) take any action that could reasonably result in CONSOL defaulting under any contract or agreement, or (iii) issue any additional equity without CONSOL's consent if the issuance would result in CONSOL owning less than 80% of CNX Gas' outstanding shares. The Master Separation Agreement gives CONSOL the right to purchase additional shares of common stock in order to maintain at least 80% ownership in CNX Gas or to enable CONSOL to distribute its shares of CNX Gas in a tax-free spin-off. The exercise price under either option is the then-market price for CNX Gas common stock. CNX Gas further agreed not to buy or sell any assets, dispose of any assets, or acquire any equity or debt securities of a third party, in each case in excess of $ 30 million, without CONSOL's prior consent.

As of April 26, 2010, there were 151,021,770 shares of CNX Gas common stock outstanding. CONSOL, its officers and directors, and the officers and directors of CNX Gas own 126,057,300 shares for an aggregate ownership stake of approximately 83.5%.

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The remaining shares of CNX Gas are held principally by institutional investors, with the top twenty-five institutions holding over 87% of the public float. The largest minority stockholder of CNX Gas is T. Rowe Price Associates, Inc. ("T. Rowe Price"). The T. Rowe Price Capital Appreciation Fund and its clones (mirror image portfolios managed for insurance companies) hold approximately four million shares of CNX Gas. David Giroux manages the Capital Appreciation Fund. The T. Rowe Price Mid-Cap Growth Fund and its clones hold approximately five million shares of CNX Gas. John Wakeman and Brian Berghuis manage the Mid-Cap Growth Fund. Other funds in the T. Rowe Price family hold approximately 470,000 additional shares. In total, T. Rowe Price beneficially owns 9,474, 116 shares of CNX Gas, representing 6.3% of the outstanding common stock and approximately 37% of the public float.

T. Rowe Price holds a slightly larger percentage stake in CONSOL, primarily through the Mid-Cap Growth Fund. In the aggregate, the T. Rowe Price fund family, including index funds, owns approximately 11,809,600 CONSOL shares. This represents approximately 6.5% of CONSOL's outstanding common stock. T. Rowe Price also owns CONSOL debt. The Capital Appreciation Fund does not own any CONSOL stock or debt.

CONSOL's 2008 Proposal

In January 2008, CONSOL proposed to acquire the public shares of CNX Gas through an exchange offer. On January 29, 2008, CONSOL publicly announced that it would exchange 0.4425 shares of CONSOL common stock for each share of CNX Gas it did not own. Based on the pre-announcement price of CONSOL common stock, the value of the consideration was $ 33.70. Various institutional investors, including T. Rowe Price, reacted negatively and indicated that they would not tender their shares. Although the board of CNX Gas formed a special committee to evaluate the exchange offer, CONSOL withdrew its proposal without ever formally commencing an exchange offer and before the special committee had a chance to consider it.

CONSOL Reorganizes The Board And Management Of CNX Gas.

In January 2009, CONSOL decided to revamp the corporate governance structure of CNX Gas. All board committees other than the audit committee were eliminated. The size of the board was decreased from eight directors to five. A subsequent resignation reduced its membership to four. The remaining directors are defendants J. Brett Harvey, the Chief Executive Officer of CONSOL; Philip W. Baxter and Raj K. Gupta, both directors of CONSOL; and John R. Pipski, the sole independent director of CNX Gas.

In addition to the board-level changes, Harvey took over as Chairman and CEO of CNX Gas. Nicholas DeIuliis, who had been CEO of CNX Gas, became Chief Operating Officer of CONSOL and CNX Gas. Other senior executives of CONSOL and CNX Gas also hold dual roles. William J. Lyons is Chief Financial Officer of both CONSOL and CNX Gas. F. Jerome Richey is General Counsel of both CONSOL and CNX Gas. Robert P. King is Executive Vice President--Business Advancement and Support Services of both CONSOL and CNX Gas. Robert F. Pusateri is Executive Vice President--Energy

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Sales and Transportation Services of both CONSOL and CNX Gas. Daniel Zajdel is Vice President of Investor Relations for both CONSOL and CNX Gas.

The Tender Agreement With T. Rowe Price

In September 2009, CONSOL approached T. Rowe Price about potentially acquiring its CNX Gas shares. Harvey contacted Wakeman, a co-manager of the Mid-Cap Growth Fund, and asked him whether T. Rowe Price would consider exchanging its CNX Gas shares for CONSOL shares. Wakeman said he would get back to Harvey, but did not, and the discussions lay dormant for six months.

On March 9, 2010, Wakeman and Berghuis, the co-managers of the Mid-Cap Growth Fund, met with DeIuliis and Zajdel while attending an investor conference in Orlando, Florida. None of these gentlemen were deposed. A faxed memo dated March 11 and an email dated March 12, both from Wakeman to DeIuliis, indicate that the meeting participants discussed having CONSOL acquire T. Rowe Price's shares of CNX Gas in connection with a freeze-out transaction. During the meeting, the T. Rowe Price representatives suggested a price in the mid-$ 40s, and DeIuliis indicated that a price of up to $ 40 per share could be acceptable. That same day, T. Rowe Price put CONSOL and CNX Gas on its restricted list. This permitted T. Rowe Price to negotiate with CONSOL over a potential sale.

In his March 11 memo, Wakeman followed up on these discussions. Wakeman stated that he viewed the CONSOL strategy as "pretty smart" and listed ten reasons why a freeze-out at $ 40 to $ 42.50 per share "ma[de] sense" for CONSOL. His reasons included the following:
(3) [CONSOL]'s management team A/K/A [CNX Gas]'s management has done a nice job of working down growth expectations for [CNX Gas] in 2010-2012 so [CNX Gas]'s # 's are too low on the production side.

* * *

(6) Given the low expectations for [CNX Gas], your new growth strategy for [CNX Gas] is not in street models for post 2011. As you ramp up production here starting in the 2H-2010 and into 2011-12 this is upside to the [CONSOL] story.

(7) It is interesting to note that a buy in price of $ 40 or $ 42.50 really has minimal impact on the initial deal dilution so the purchase price should almost be a non-event.
The defendants portray the fax as Wakeman's friendly way of pushing for a price in excess of $ 40 for the CNX Gas shares. I regard it (at least at this preliminary stage) as suggesting Wakeman supported a freeze-out because of the benefits to CONSOL.

On March 15, 2010, CONSOL announced that it had agreed to acquire the gas assets of Dominion Resources, Inc., a CNX Gas competitor, for approximately $ 3.475 billion in cash (the "Dominion Transaction"). Many of Dominion's assets are located near CNX Gas properties. Under the Master Separation Agreement, CNX Gas has a right of first

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refusal on any corporate opportunity involving future gas rights that CONSOL proposes to pursue. The CONSOL board determined not to offer the Dominion Transaction to CNX Gas pursuant to the right of first refusal because it concluded that CNX Gas lacked the financial resources and could not access the capital markets. CNX Gas could not raise sufficient equity financing without CONSOL's consent, and CONSOL was unwilling to permit the necessary issuance. Nevertheless, the long term benefits of consolidating the Dominion and CNX Gas assets were obvious, and CONSOL announced publicly that it was "evaluating a range of structural alternatives to facilitate the operation and development of the acquired assets including, among other things, consideration of the acquisition by CONSOL of the shares of CNX Gas common stock that it does not already own."

On March 16, 2010, one day after the announcement of the Dominion Transaction, Shawn Driscoll, the analyst at T. Rowe Price who covered CNX Gas, contacted Zajdel to schedule a meeting with CONSOL management. A meeting was set for March 19. On March 17, Wakeman e-mailed DeIuliis "to advance the ball in our discussions." He wrote that "based on the belief that you would prefer an all-stock transaction in light of the recent development involving the asset purchase with Dominion Resources we feel that a $ 42.50 price along with a small collar of 5-10% of deal price support would allow us to support any purposed [*sic.*] transaction with [CNX Gas]."

The attendees for CONSOL at the March 19 meeting were Harvey, CEO of both CONSOL and CNX Gas, and Richey, General Counsel of both CONSOL and CNX Gas. The attendees for T. Rowe Price were Driscoll, the analyst; Giroux from the Capital Appreciation Fund; John Linehan, T. Rowe Price's director of equities; and T. Rowe Price's counsel. Wakeman and Berghuis from the Mid-Cap Growth Fund did not attend. They gave Giroux their proxy to negotiate on their behalf.

The meeting was divided into two phases: a negotiation session and an informational meeting about the Dominion Transaction. During the negotiation session, Driscoll presented T. Rowe Price's views on valuation, which relied in part on the Dominion Transaction as a comparable arms' length transaction involving similar assets. Giroux then suggested a range of $ 42 to $ 50 per share. Harvey responded by offering $ 35 per share in cash. Giroux rejected this as "not realistic." A long discussion ensued. Harvey then asked for a break-out room and met with Richey in private. After they returned, Harvey raised his offer to $ 37 per share in cash. Giroux responded, "we need $ 40." Harvey rejected that figure and regarded the negotiations as over.

With the negotiation session finished, Giroux departed. The record suggests that he called Berghuis, although the point is undeveloped. The remaining participants, including Linehan, discussed the Dominion Transaction. The plaintiffs assert that at the conclusion of the Dominion discussion, Linehan retrieved Giroux. Upon returning, Giroux stated that his "final offer" was now $ 38.25 in cash. Harvey agreed to $ 38.25, subject to the approval of the CONSOL board.

The CONSOL board signed off on the transaction with T. Rowe Price on March 20,

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2010. On March 21, CONSOL and T. Rowe Price executed a tender agreement, and CONSOL issued a press release announcing the agreement and the contemplated tender offer. The tender agreement provided that, subject to certain conditions, CONSOL would commence the tender offer no later than May 5, 2010, at a price of no less than \$ 38.25 per share in cash. The tender agreement obligated T. Rowe Price to tender its shares of CNX Gas no later than 10 business days after the commencement of the offer and to not withdraw its shares.

The Tender Offer

On April 28, 2010, CONSOL commenced a tender offer to acquire the outstanding public shares of CNX Gas at a price of \$ 38.25 per share in cash (the "Tender Offer"). The price represents a premium of 45.83% over the closing price of CNX Gas's common stock on the day before CONSOL announced the Dominion Transaction and its intent to acquire the shares of CNX Gas that it did not already own (\$ 26.23). The Tender Offer price represents a 24.19% premium over the closing price of CNX Gas's common stock on the day before CONSOL announced the T. Rowe Price agreement (\$ 30.80).

CONSOL has committed to effect a short-form merger promptly after the successful consummation of the Tender Offer. In the merger, remaining stockholders will receive the same consideration of \$ 38.25 per share in cash. Consummation of the Tender Offer is subject to a non-waivable condition that a majority of the outstanding minority shares be tendered, excluding shares owned by directors or officers of CONSOL or CNX Gas. The T. Rowe Price shares are included in the majority-of-the-minority calculation. With the T. Rowe Price shares locked up, CONSOL only needs to obtain an additional 3,006,316 shares, or approximately 12% of the outstanding stock, to satisfy the condition.

The Special Committee

After the public announcement of the tender agreement with T. Rowe Price, Lyons, the CFO of CONSOL and CNX Gas, discussed with Pipski, the lone independent director of CNX Gas, the possibility that the CNX Gas board might form a special committee in connection with the CONSOL Tender Offer. On April 9, 2010, Pipski met with Harvey and delivered a letter asking that CNX Gas form a special committee to evaluate the proposed Tender Offer and elect an additional director who could join Pipski on the special committee. At a special meeting held on April 15, the CNX Gas board unanimously approved the formation of a special committee consisting of Pipski (the "Special Committee"). The board did not act on Pipski's request for an additional director.

The scope of the authority that the CNX Gas board provided to the Special Committee was limited. The Special Committee was authorized only to review and evaluate the Tender Offer, to prepare a Schedule 14D-9, and to engage legal and financial advisors for those purposes. The resolution did *not* authorize the Special Committee to negotiate the terms of the Tender Offer or to consider alternatives. Pipski asked for the authority to consider alternatives, but the CNX Gas board declined his request. The CNX Gas board

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majority grounded its decision on CONSOL's unwillingness to sell its CNX Gas shares.

After the April 15 board meeting, the Special Committee retained Skadden, Arps, Slate, Meagher & Flom LLP ("Skadden") as its legal advisor and Lazard, Ltd. ("Lazard") as its financial advisor. The next day, Pipski delivered a letter to his fellow directors asking that they expand the Special Committee's authority to include "the full powers and authority of the board of directors" with respect to the Tender Offer. On April 21, the CNX Gas board declined this request, again because CONSOL was unwilling to sell its CNX Gas shares.

On April 22, 2010, CONSOL provided the Special Committee and its advisors with financial information, including projections for CNX Gas. On April 26, representatives from Skadden and Lazard met with executives of CONSOL and CNX Gas, including Harvey, DeIuliis, and Lyons. The Special Committee's advisors also spoke with T. Rowe Price.

On May 5, 2010, Pipski and his advisors met in person to determine how to respond to the Tender Offer. Lazard advised Pipski that it would be able to opine that an offer price of $ 38.25 per share was fair from a financial point of view to holders of CNX Gas common stock other than CONSOL. But Pipski and his advisors believed that CONSOL was not paying the highest price it was prepared to pay.

Even though the Special Committee was technically not authorized to negotiate, Pipski decided to seek a price increase. On May 5, 2010, Skadden advised CONSOL's counsel that Pipski could not recommend the Tender Offer at a price of $ 38.25 but likely could do so at $ 41.20. Five days later, on May 10, the day before the Schedule 14D-9 was due, the CNX Gas board retroactively granted the Special Committee authority to negotiate. On the next day, May 11, Pipski and his advisors held a call with CONSOL senior executives and their advisors. CONSOL declined to increase the price.

Later on May 11, the Special Committee issued the Schedule 14D-9. The Special Committee stated in the Schedule 14D-9 that it "determined not to express an opinion on the offer and to remain neutral with respect to the offer." The Special Committee cited its "concerns about the process by which CONSOL determined the offer price" and its "view that CONSOL was unwilling to negotiate the offer price." The Schedule 14D-9 noted that a member of CONSOL management (apparently DeIuliis) previously that CNX Gas stock was worth more than $ 38.25. The Schedule 14D-9 also reported that the CNX Gas board refused to expand the size of the Special Committee or grant it the full power of the board in connection with the offer.

The Schedule 14D-9 specifically cited the tender agreement with T. Rowe Price as a "potentially negative factor[]" that the Special Committee considered when evaluating the Tender Offer. The Schedule 14D-9 states:
The Tender Agreement with T. Rowe Price increases the certainty of the offer being successful and, as a result, reduces the likelihood of any increase in the offer price by reducing the negotiation leverage of the "majority of the minority" condition. The Special

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Committee considered that T. Rowe Price's interests may not be the same as the other minority shareholders due to the fact that T. Rowe Price beneficially owned 6.51% of the outstanding common stock of CONSOL. In addition, the offer price was determined through relatively short negotiations with T. Rowe Price without the input from any other minority shareholders or the Special Committee.
Trading in CNX Gas stock suggests a market consensus that a price bump was unlikely. Since the announcement of the tender offer agreement, CNX Gas shares have not traded more than a couple of pennies above the $ 38.25 per share agreed to by T. Rowe Price. The plaintiffs argue that by entering into the agreement with T. Rowe Price and announcing it on March 21, CONSOL capped the price of the CNX Gas stock and hamstrung the Special Committee.

The Tender Offer is scheduled to close tomorrow, May 26, 2010, at 5:00 p.m.

LEGAL ANALYSIS

A preliminary injunction will issue if the plaintiffs demonstrate "(1) a reasonable probability of ultimate success on the merits at trial; (2) that the failure to issue a preliminary injunction will result in immediate and irreparable injury before the final hearing; and (3) that the balance of hardships weighs in the movant's favor." *La. Mun. Police Employees' Ret. Sys. v. Crawford,* 918 A.2d 1172, 1185 (Del. Ch. 2007).

The Plaintiffs Have Shown A Reasonable Likelihood Of Success On The Merits Of Their Fairness Claim.

The plaintiffs contend that the Tender Offer should be reviewed for entire fairness. This argument requires that I weigh in on a critical and much debated issue of Delaware law: the appropriate standard of review for a controlling stockholder freeze-out.

The Appropriate Standard Of Review For The Tender Offer

As knowledgeable readers understand all too well, Delaware law applies a different standard of review depending on how a controlling stockholder freeze-out is structured. Under *Kahn v. Lynch Communications Systems, Inc.,* 638 A.2d 1110 (Del. 1994) [hereinafter, "*Lynch*"], a negotiated merger between a controlling stockholder and its subsidiary is reviewed for entire fairness. But under *In re Siliconix Inc. Shareholders Litigation,* 2001 Del. Ch. LEXIS 83, 2001 WL 716787 (Del. Ch. June 19, 2001), a controller's unilateral tender offer followed by a short-form merger is reviewed under an evolving standard far less onerous than *Lynch.* The tension created by the different fiduciary standards has been discussed at length by Vice Chancellor Strine [*see Cox* and *Pure Resources*] and generated reams of scholarly and practitioner commentary. I will set forth my own views in more abbreviated fashion.

I question the soundness of the twin cornerstones on which *Siliconix* rests. The first cornerstone is the statutory distinction between mergers and tender offers and the lack of any explicit role in the General Corporation Law for a target board of directors

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responding to a tender offer. For reasons explained at length in *Pure Resources,* the statutory distinction fails to justify adequately the divergent fiduciary approaches. *See Pure Resources,* 808 A.2d at 433-44, 439-41. Scholars have joined in criticizing the statutory distinction. *See, e.g., Fixing Freezeouts, supra,* at 24-25; Gilson & Gordon, *supra,* at 820-21.

The second cornerstone has been *Solomon v. Pathe Communications Corp.,* 672 A.2d 35 (Del. 1996) [hereinafter, "*Solomon II*"], which has been cited repeatedly for the rule that a tender offeror has no duty to provide a fair price. But *Solomon II* did not involve a freeze-out. * * *

Solomon II . . . does not hold that controllers never owe fiduciary duties when making tender offers, nor does it eliminate the possibility of entire fairness review for a two-step freeze-out transaction. "[T]he *Solomon* line of cases does not eliminate the fiduciary duties of controlling stockholder or target boards in connection with tender offers made by controlling stockholders. Rather, the question is the contextual extent and nature of those duties . . . ." *Pure Resources,* 808 A.2d at 444. Put differently, the question is: What transactional structures result in the controlling stockholder not standing on both sides of a two-step freeze-out?

Pure Resources sought to answer this question and move towards harmonizing the *Siliconix* and *Lynch* lines of authority. The decision did not establish immutable rules for tender offer freeze-outs, as the defendants contend. Vice Chancellor Strine explicitly addressed the doctrinal issues "tentatively, and incompletely," and in a manner which "befits the development of the common law in expedited decisions." 808 A.2d at 445. As confirmed by his subsequent decision in *Cox Communications,* Vice Chancellor Strine did not regard *Pure Resources* as the final word on *Siliconix* tender offers. *See also Next Level,* 834 A.2d at 854 n.106 ("The court agrees that this area of the law [*i.e.,* review of *Siliconix* transactions] is developing . . . .").

Pure Resources set out a series of requirements for a controlling stockholder tender offer. In order to address the prisoner's dilemma problem, our law should consider an acquisition tender offer by a controlling stockholder non-coercive only when: 1) it is subject to a non-waivable majority of the minority tender condition; 2) the controlling stockholder promises to consummate a prompt § 253 merger at the same price if it obtains more than 90% of the shares; and 3) the controlling stockholder has made no retributive threats.

808 A.2d at 445. The decision also imposed a duty on the controlling stockholder to permit the independent directors on the target board both free rein and adequate time to react to the tender offer, by (at the very least) hiring their own advisors, providing the minority with a recommendation as to the advisability of the offer, and disclosing adequate information for the minority to make an informed judgment.
Id.

Pure Resources was an evolutionary decision that raised the bar for two-step squeeze-

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outs. The transaction structures approved in the two preceding Court of Chancery decisions -- *Siliconix* and *Aquila* -- would not have passed muster under the *Pure Resources* test. In *Siliconix,* the controller did not commit to a prompt back-end merger; it merely stated that it would "consider" a follow-on short-form merger. 2001 Del. Ch. LEXIS 83, 2001 WL 716787, at *2. The *Siliconix* court declined to impose a fairness duty in part because the Court regarded a tender offer followed by a short-form merger "as separate events." 2001 Del. Ch. LEXIS 83, [WL] at *8 n.35. In *Aquila,* the tender offeror made a back-end commitment, but the target subsidiary board lacked any independent directors. 805 A.2d at 186. The target board did not attempt to negotiate with the controller or make a recommendation on how to tender; it merely hired an investment banker and disseminated the banker's opinion and analysis. *Id.* at 191. The controller in *Aquila* could not have satisfied its *Pure Resources* duty "to permit the independent directors on the target board both free rein and adequate time to react to the tender offer . . . ." 808 A.2d at 445.

Three years after *Pure Resources,* Vice Chancellor Strine revisited the tension between *Lynch* and *Siliconix* in *Cox Communications.* Commenting on *Pure Resources,* he recalled that in that decision

> the court decided that it was better to formulate protective standards that were more flexible, with the hope that at a later stage the two strands could be made more coherent, in a manner that addressed not only the need to protect minority stockholders but also the utility of providing a non-litigious route to effecting transactions that often were economically efficient both for the minority who received a premium and in the sense of creating more rationally organized corporations.

Cox Commc'ns, 879 A.2d at 624.

Cox Communications rendered the *Lynch* and *Siliconix* standards coherent by explaining that the business judgment rule should apply to any freeze-out transaction that is structured to mirror *both* elements of an arms' length merger, *viz.* approval by disinterested directors *and* approval by disinterested stockholders. *Id.* at 606.

> These steps are in important ways complements and not substitutes. A good board is best positioned to extract a price at the highest possible level because it does not suffer from the collective action problem of disaggregated stockholders. . . . Although stockholders are not well positioned to use the voting process to get the last nickel out of a purchaser, they are well positioned to police bad deals in which the board did not at least obtain something in the amorphous "range" of financial fairness.

Id. at 619. *Accord Fixing Freezeouts, supra,* at 63-64; Letsou & Haas, *supra,* at 81-94; Gilson & Gordon, *supra,* at 838-40. Doctrinally, the use of both structural protections results in the controller standing only on one side of the transaction -- as the buyer -- and renders entire fairness inapplicable. *John Q. Hammons,* 2009 Del. Ch. LEXIS 174, 2009 WL 3165613, at *10.

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Under the *Cox Communications* framework, if a freeze-out merger is both (i) negotiated and approved by a special committee of independent directors and (ii) conditioned on an affirmative vote of a majority of the minority stockholders, then the business judgment standard of review presumptively applies. 90 Conn. App. 312, 876 A.2d 606. If the transaction does not incorporate both protective devices, or if a plaintiff can plead particularized facts sufficient to raise a litigable question about the effectiveness of one of the devices, then the transaction is subject to entire fairness review. *Id.* The viability of a challenge to a controlling stockholder merger in which both protective devices are used thus can be assessed prior to trial, either on the pleadings or via motion for summary judgment. *Id.* at 607, 643-45.

Likewise under the *Cox Communications* framework, if a first-step tender offer is both (i) negotiated and recommended by a special committee of independent directors and (ii) conditioned on the affirmative tender of a majority of the minority shares, then the business judgment standard of review presumptively applies to the freeze-out transaction. *Id.* at 607. As with a merger, if both requirements are not met, then the transaction is reviewed for entire fairness. *Id.*[246]

Post-Lynch experience shows that special committees can negotiate effectively with controllers and that both special committees and minority stockholders can reject squeeze-out proposals. The 2008 exchange offer in this case was withdrawn when minority stockholders responded negatively. I am currently presiding over a challenge to a controlling transaction in which the majority-of-the-minority tender condition failed twice. See Revlon II, 990 A.2d at 957. Last fall the directors of iBasis adopted a rights plan in response to a tender offer by its controlling stockholder, Royal KPN. The iBasis directors filed two lawsuits against Royal KPN, took one of the lawsuits through trial, and ultimately extracted a price increase from $ 2.25 to $ 3 per share. In 2005, minority stockholders at Cablevision Systems Corporation rejected a going private transaction proposed by the Dolan family, which controlled 74% of the company's voting power, despite its 51% premium over market. In 2003, the outside directors of Next Level Communications, Inc. resisted a Siliconix tender offer and filed suit against the

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[246] Careful readers will note that in describing this test, I have departed from the language of Cox Communications in one respect. That decision stated initially that entire fairness would apply "if a special committee recommended that the minority not tender." 879 A.2d at 607. This language suggests that entire fairness might not apply as long as the special committee took no position on the tender offer. As this case demonstrates, and in decided contrast to boards responding to third-party tender offers, there are many "edifying examples of subsidiary directors courageously taking no position on the merits of offers by a controlling stockholder." Pure Resources, 808 A.2d at 443; see also, e.g., Revlon II, 990 A.2d at 946; Siliconix, 2001 Del. Ch. LEXIS 83, 2001 WL 716787, at *9; Chaffin v. GNI Group, Inc., 1999 Del. Ch. LEXIS 182, 1999 WL 721569, at *2 (Del. Ch. Sept. 3, 1999). The animating principle underlying the unified approach is to give judicial deference to processes that simulate arms' length third-party transactional approvals. In a merger, directors must approve and recommend the transaction before it is submitted to stockholders. 8 Del. C. § 251(b). Therefore an affirmative recommendation is required for entire fairness not to apply. The Cox Communications case elsewhere described the approval requirement in these terms. 879 A.2d at 646 (providing for business judgment review if "the tender offer was recommended by an independent special committee").

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controlling stockholder to enjoin the transaction. Next Level, 834 A.2d at 846-47. In Siliconix itself, the exchange offer that was the subject of the decision ultimately failed to satisfy its majority-of-the-minority condition. These examples augur in favor of a unified standard under which independent directors and unaffiliated stockholders are given the tools to negotiate with controllers, backstopped by meaningful judicial review for fairness when those tools are withheld.

I recognize that by applying the unified standard, I reach a different conclusion than the recent *Cox Radio* decision, which opted to follow *Pure Resources. See Cox Radio,* 2010 Del. Ch. LEXIS 102, 2010 WL 1806616, at *10-12 (approving settlement of litigation challenging *Siliconix* transaction). The choice among *Lynch, Pure Resources,* and *Cox Communications* implicates fundamental issues of Delaware law and public policy that only the Delaware Supreme Court can resolve. Until the Delaware Supreme Court has the opportunity to address *Lynch* and *Siliconix* definitively, I believe the unified standard from *Cox Communications* offers the coherent and correct approach.

Applying The Unified Standard To This Case

The Tender Offer does not pass muster under the unified standard. First and most obviously, the Special Committee did not recommend in favor of the transaction. That fact alone is sufficient to end the analysis and impose an obligation on CONSOL to pay a fair price.

Second, the Special Committee was not provided with authority comparable to what a board would possess in a third-party transaction. Initially, the Special Committee was authorized only to review and evaluate the Tender Offer, to prepare a Schedule 14D-9, and to engage legal and financial advisors for those purposes. The Special Committee was not authorized to negotiate or to consider other alternatives. When Pipski asked for the authority to consider alternatives, the CNX Gas board declined his request. Later, when Pipski requested full board authority to respond to the Tender Offer, the CNX Gas board again declined his request.

The CNX Gas board majority grounded its decision on CONSOL's unwillingness to sell its CNX Gas shares. Given CONSOL's position as a controlling stockholder and the additional rights CONSOL possessed under its various agreements with CNX Gas, any effort to explore strategic alternatives likely would have been an exercise in futility. But that was a decision for Pipski and his advisors to make. Armed with an appropriate delegation of authority, Pipski and the creative minds at Skadden and Lazard might have devised ways to increase the Special Committee's leverage. They might have filed litigation against CONSOL. Or they might have considered some form of rights plan.

The defendants have pointed out that *Pure Resources* rejected an argument that the subsidiary board breached its fiduciary duties "by not giving the Special Committee the power to block the Offer by, among other means, deploying a poison pill." 808 A.2d at 446. Vice Chancellor Strine decided that at that point in the evolution of the *Siliconix* standard, it was unnecessary:

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> to burden the common law of corporations with a new rule that would tend to compel the use of a device that our statutory law only obliquely sanctions and that in other contexts is subject to misuse, especially when used to block a high value bid that is not structurally coercive. When a controlling stockholder makes a tender offer that is not coercive in the sense I have articulated, therefore, the better rule is that there is no duty on its part to permit the target board to block the bid through use of the pill. Nor is there any duty on the part of the independent directors to seek blocking power.

Since *Pure Resources,* Vice Chancellor Strine approved the deployment of a rights plan against a controlling stockholder, and the Delaware Supreme Court affirmed this decision. *Hollinger Int'l v. Black,* 844 A.2d 1022 (Del. Ch. 2004) ("*Hollinger I*"), *aff'd,* 872 A.2d 559 (Del. 2005). In *Hollinger I,* the subsidiary board used the rights plan to prevent the controller from selling his control block to a third party. *Id.* at 1088. The rights plan was deemed appropriate "as an inhibition on alienation or additional purchases" by the controller. *Id.* "[T]he board seeks to use the Rights Plan in a manner analogous to that articulated by Chancellor Allen in *Interco,* giving the board the breathing room to identify value-maximizing transactions." *Id.* at 1088-89 (footnote omitted) (citing *City Capital Assocs. Ltd. P'ship v. Interco Inc.,* 551 A.2d 787, 797-99 (Del. Ch. 1988) and Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?,* 44 Bus. Law. 247 (1989) [hereinafter, "*Delaware's Intermediate Standard*"]).

A subsequent decision involving the same controlling stockholder recognizes that director primacy remains the centerpiece of Delaware law, even when a controlling stockholder is present:

> The reality is that controlling stockholders have no inalienable right to usurp the authority of boards of directors that they elect. That the majority of a company's voting power is concentrated in one stockholder does not mean that that stockholder must be given a veto over board decisions when such a veto would not also be afforded to dispersed stockholders who collectively own a majority of the votes. Like other stockholders, a controlling stockholder must live with the informed (i.e., sufficiently careful) and good faith (i.e., loyal) business decisions of the directors unless the DGCL requires a vote. That is a central premise of our law, which vests most managerial power over the corporation in the board, and not in the stockholders.

Hollinger Int'l v. Hollinger Int'l, Inc., 858 A.2d 342, 387 (Del. Ch. 2004) [hereinafter, "*Hollinger II*"], *appeal refused,* 871 A.2d 1128, 2004 WL 1732185 (Del. 2004) (TABLE).

These principles apply directly here. A controller making a tender offer does not have an inalienable right to usurp or restrict the authority of the subsidiary board of directors. A subsidiary board, acting directly or through a special committee, can deploy a rights plan

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legitimately against a controller's tender offer, just as against a third-party tender offer, to provide the subsidiary with time to respond, negotiate, and develop alternatives. The fact that the subsidiary's alternatives may be limited as a practical matter does not require that the controller be given a veto over the board decision-making process. Prolonged and inequitable use of the rights plan by the subsidiary remains subject to traditional review under *Unocal Corp. v. Mesa Petroleum Co.,* 493 A.2d 946 (Del.1985). Unlike dispersed stockholders, a controller typically also will have the ability to use its voting power to remove and replace incumbent directors and, if it wishes, force through its chosen transaction via merger.

Because a board in a third-party transaction would have the power to respond effectively to a tender offer, including by deploying a rights plan, a subsidiary board should have the same power if the freeze-out is to receive business judgment review. This does not mean that a special committee must use that power. The shadow of pill adoption alone may be sufficient to prompt a controller to give a special committee more time to negotiate or to evaluate how to proceed. What matters is that the special committee fulfills its contextualized duty to obtain the best transaction reasonably available for the minority stockholders. Here, the Special Committee was deprived of authority that a board would have in a third-party transaction. Under *Cox Communications,* this fact provides a separate and independent basis to review a controlling stockholder freeze-out for entire fairness.

Third, the plaintiffs have raised sufficient questions about the role of T. Rowe Price to undercut the effectiveness of the majority-of-the-minority tender condition. Economic incentives matter, particularly for the effectiveness of a legitimizing mechanism like a majority-of-the-minority tender condition or a stockholder vote. *See Crown EMAK Partners, LLC v. Kurz,* 992 A.2d 377, 2010 WL 1610487, at *10 (Del. 2010) ("[W]hat legitimizes the stockholder vote as a decision-making mechanism is the premise that stockholders with economic ownership are expressing their collective view as to whether a particular course of action serves the corporate goal of stockholder wealth maximization.") (citation and internal quotation omitted). In *Pure Resources,* the holders of shares subject to put agreements were excluded from the majority-of-the-minority calculation because "it is clear that the Put Agreements can create materially different incentives for the holders than if they were simply holders of Pure common stock." 808 A.2d at 426.

T. Rowe Price as a whole owns 6.5% of CONSOL's outstanding common stock versus 6.3% of CNX Gas. T. Rowe Price's roughly equivalent equity interests leave it fully hedged and indifferent to the allocation of value between CONSOL and CNX Gas. To the extent the Tender Offer shortchanges CNX Gas holders, T. Rowe Price gains proportionately through its CONSOL ownership. To the extent CONSOL overpays, T. Rowe Price gains proportionately through its CNX Gas ownership. T. Rowe Price arguably has an incentive to favor CONSOL because of its slightly larger percentage equity ownership and holdings in CONSOL debt. T. Rowe Price's has materially different incentives than a holder of CNX Gas common stock, thereby calling into question the effectiveness of the majority-of-the-minority condition.

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The defendants respond to this problem by saying I should not consider T. Rowe Price's buy-side interest at all because considering the economic incentives of stockholders "would be unworkable as well as unwarranted." CONSOL Defendants' Answering Br. 26. They continue:

> Sophisticated institutional investors . . . often have diverse holdings that could include shares of both parent and subsidiary; they often own derivatives, have complex hedging arrangements, possess holdings in competitor corporations, and/or have made directional sector bets that could have some conceivable impact on their decision to tender. In most cases, Delaware courts will simply have no way of knowing the extent of institutional stockholders' other investments or of discerning their true motivations for tendering.

Id. at 26-27. But nothing about this case requires that Delaware courts conduct generalized inquiries into "the extent of institutional stockholders' other investments" or "their true motivations for tendering."

It was neither the plaintiffs nor this Court that put the focus on T. Rowe Price and its cross-ownership. It was CONSOL who elected to pre-negotiate the terms of the Tender Offer with T. Rowe Price, a third-party non-fiduciary, rather than negotiating with the Special Committee. It was CONSOL and T. Rowe Price who chose to enter into the tender agreement. T. Rowe Price's incentives are at issue because of decisions that CONSOL and T. Rowe Price chose to make.

This case also is not the result of, nor should it be read to encourage, generalized fishing expeditions into stockholder motives. T. Rowe Price is the largest minority holder of CNX Gas. It controls 37% of the public float. As the Special Committee itself concluded in the Schedule 14D-9, the tender agreement with T. Rowe Price "increases the certainty of the offer being successful and, as a result, reduces the likelihood of any increase in the offer price by reducing the negotiation leverage of the 'majority of the minority' condition." As the Special Committee also observed, "T. Rowe Price's interests may not be the same as the other minority shareholders due to the fact that T. Rowe Price beneficially owned 6.51% of the outstanding common stock of CONSOL." This case is not about "holdings in competitor corporations" or "directional sector bets." It is about a direct economic conflict that at best renders T. Rowe Price indifferent to the allocation of value between CONSOL and CNX Gas and at worst gives T. Rowe Price reason to favor CONSOL.

The defendants next argue that I cannot consider T. Rowe Price as a whole but rather must look through T. Rowe Price's ownership block to consider the separate ownership stakes of the Capital Appreciation Fund and the Mid-Cap Growth Fund. The defendants argue that Giroux, who negotiated with CONSOL, managed the Capital Appreciation Fund, which did not own any CONSOL shares. They observe that Giroux is a fiduciary for his investors and that he testified in deposition about his desire and efforts to obtain the highest price possible for T. Rowe Price's shares of CNX Gas.

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While this argument has significant force, it runs up against CONSOL's decision to enter into the tender agreement with T. Rowe Price for all of its shares, not just the shares owned by the Capital Appreciation Fund. And CONSOL structured the majority-of-the-minority condition to include all of T. Rowe Price's shares in the denominator, not just the shares owned by the Capital Appreciation Fund. CONSOL thus chose to deal with T. Rowe Price as a whole.

There are also serious fact issues that cloud the T. Rowe Price picture. Wakeman was an ardent backer of CONSOL and its management before, during, and after the negotiations over the tender agreement. On March 26, 2010, one week after T. Rowe Price and CONSOL struck the deal on price and five days after they announced the tender agreement, Wakeman emailed Deluliis to express his strong support:

> Now that you guys have all the M/A and funding behind you, [CONSOL] can focus on running the business after 2 weeks on the road . . . . I just wanted to reach out to you and let you know that [the Mid-Cap Growth Fund], who was/is your largest shareholder in [CNX Gas] and [CONSOL] at T. Rowe Price, is still very positive on the management and value creation potential of a [CONSOL] investment going forward. [The Mid-Cap Growth Fund] was the majority of the $ 42.50 order in the [CNX equity raise]. It is interesting to note that another large portfolio manager is very interested in owning [CONSOL] and he might be another 3 million shares [sic.] at some point (limit on the deal was $ 42). [The Mid-Cap Growth Fund] would also be interested in rounding up our increased position size further at the right price. I realize there was a lot of emotions [sic.] surrounding the [CONSOL] buy-in of [CNX Gas] from numerous parties at our firm and your company. At this point it is water over the dam and the key point is making sure [CONSOL continues to be a successful company going forward. [The Mid-Cap Growth Fund] remains a large supporter of you, your management team and the [CONSOL] strategy. I hope [CONSOL] remains comfortable with T. Rowe Price as a very large shareholder. Thanks again for all your hope and we look forward to speaking with you going forward to talk about the next chapter of [CONSOL]'s growth!

Giroux testified that he spoke to Beekhuis, Wakeman's co-manager of the Mid-Cap Growth Fund, during the March 19 negotiations over the tender agreement. The plaintiffs also point to evidence suggesting that T. Rowe Price viewed $ 40 as its bottom line number, arguing that the firm caved in to pressure from CONSOL. The defendants answer that the higher figure assumed a stock deal, and T. Rowe Price was happy with less cash.

It is frankly difficult for me to evaluate the parties' competing positions on a preliminary record. It is difficult to assess the vibrancy of the negotiation process from reading Giroux and Harvey's depositions. Key T. Rowe Price participants like Linehan, Wakeman, and Beekhuis were not deposed. I have not been provided with meaningful information about Giroux's compensation or incentives. Giroux reports to Linehan, the

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head of global equities, who the plaintiffs say orchestrated the ultimate deal on price. I have even less information about Linehan than I do about Giroux.

Were I evaluating the Tender Offer under the *Pure Resources* standard, I would incline toward (i) enjoining the transaction preliminarily until CONSOL modified the Tender Offer to exclude the Mid-Cap Growth Fund shares from the majority-of-the-minority calculation and (ii) requiring disclosure of the change followed by sufficient time for CNX Gas stockholders to consider its implications and respond. But because I am evaluating the Tender Offer under the *Cox Communications* unified standard, I do not need to rule definitively on the effectiveness of the majority-of-the-minority condition.

The absence of Special Committee approval imposes an obligation on the defendants to show that the Tender Offer price is fair. The defendants are free to argue at a later stage of the proceeding and on a fuller record that (i) the negotiations with T. Rowe Price were truly at arms' length and untainted by cross-ownership, and (ii) the majority-of-the-minority condition was effective.

The Plaintiffs' Disclosure Claims Are Meritless. * * *

Irreparable Harm And The Balance Of Hardships

If I had evaluated the Tender Offer under the *Pure Resources* standard, I would face difficult tasks in assessing irreparable harm and balancing hardships. As noted, I harbor serious concern about the structure of the majority-of-the-minority tender condition. I also question whether the limitations CONSOL put on the Special Committee violated its *Pure Resources* duty "to permit the independent directors on the target board both free rein and adequate time to react to the tender offer." 808 A.2d at 445; *see Cox Radio,* 2010 Del. Ch. LEXIS 102, 2010 WL 1806616, at *12 (noting that if a special committee were not granted negotiating power, "the Transaction probably would not be entitled to protection under *Pure Resources,* as the Special Committee would have lacked the requisite free rein to provide the minority with a meaningful recommendation on the Transaction"). Under *Pure Resources,* these problems would weigh in favor of an injunction.

Otherwise, the Tender Offer is not coercive in any traditional *non-Lynch* sense. It is not structurally coercive because of the prompt back-end merger commitment at the same Tender Offer price. *Pure Resources,* 808 A.2d at 438. No one argues that the Tender Offer is substantively coercive. *See Chesapeake Corp. v. Shore,* 771 A.2d 293, 324-25 (Del. Ch. 2000) (discussing substantive coercion as conceived in *Delaware's Intermediate Standard, supra*). The plaintiffs half-heartedly contend that the Schedule TO contains retributive threats, but the Schedule TO's descriptions about actions CONSOL may consider if the Tender Offer fails are facially neutral, balanced, and informative, not threatening. *See Next Level,* 834 A.2d at 853 ("Generally, reports of factual matters that are neutrally stated and not threatening do not amount to wrongful coercion."); *compare Eisenberg v. Chicago Milwaukee Corp.,* 537 A.2d 1051, 1062 (Del. Ch. 1987) (describing explicit threat by controller to delist shares).

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The Tender Offer is an all-cash, premium transaction. No transactional alternative has been identified. Typically such a transaction will not be enjoined absent "not only a special conviction about the strength of the legal claim asserted, but also a strong sense that the risks in granting the preliminary relief of a[n] untoward financial result from the stockholders' point of view [are] small." *Solash v. Telex Corp.,* 1988 Del. Ch. LEXIS 7, 1988 WL 3587, at *13 (Del. Ch. Jan. 19, 1988) (Allen, C.). CONSOL reserved the right in its Schedule TO to withdraw its Tender Offer if an injunction issues. I would be forced to balance the benefits of fuller compliance with the *Pure Resources* framework against the risk of transactional jeopardy.

My decision to apply the *Cox Communications* unified standard simplifies matters. A plaintiff seeking to enjoin a tender offer must show that a post-trial award of money damages would not be a sufficient remedy. *Gradient OC Master, Ltd. v. NBC Universal, Inc.,* 930 A.2d 104, 132 (Del. Ch. 2007). If the defendants fail to establish that the tender price is fair, an award of money damages can be fashioned. No question has been raised, much less evidence presented, to cast doubt on CONSOL's solvency or ability to satisfy a damages award. The plaintiffs therefore have not shown any threat of irreparable harm. Given the availability of monetary relief, the balance of the equities favors the denial of the motion for preliminary injunction. *Abrons v. Maree,* 911 A.2d 805, 810-11 (Del. Ch. 2006).

CONCLUSION

For the foregoing reasons, I deny the plaintiffs' motion for a preliminary injunction. **IT IS SO ORDERED.**

I. Page 232, New Sec. 3.17.G. Failure to Deploy Poison Pill to Prevent Controlling Shareholder from Becoming Majority Shareholder—Fertitta (Landry's Restaurants)

Page 232, New Sec. 3.17.G. Add before Sec. 3.13. the following:

New Sec. 3.17.G. **Failure to Deploy Poison Pill to Prevent Controlling Shareholder from Becoming Majority Shareholder—*Fertitta (Landry's Restaurants)***

Louisiana Municipal Police Employees' Retirement System, v. Fertitta
Court Of Chancery of Delaware, 2009
2009 Del. Ch. LEXIS 144, *

MEMORANDUM OPINION AND ORDER

LAMB, Vice Chancellor.

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In 2008, a Delaware corporation entered into a cash-out merger agreement with an entity controlled by its Chairman, CEO, and 39% stockholder. As events unfolded that made it less likely the merger would be completed, the Chairman began making open market purchases of shares at prices well below the proposed merger price. Although the special committee of directors charged with pursuing the merger objected to these actions, neither the special committee nor the full board of directors took steps to prevent further purchases. Ultimately, the Chairman's market activity resulted in him gaining the status of majority stockholder. Shortly thereafter, the board of directors voted to abandon the merger agreement, thus excusing the Chairman from paying even a $ 15 million reverse-termination fee.

Applying the liberal motion to dismiss standard, the court concludes that the complaint adequately alleges claims for breach of the duty of loyalty against all of the defendants. The court also concludes that the complaint adequately alleges grounds to excuse demand as to the claim for waste. Thus, the motion to dismiss will be denied.

[**PART I]**

The Parties

This case arises out of an abortive going-private transaction between Landry's and its CEO and largest shareholder. The plaintiff, Louisiana Municipal Police Employees' Retirement System, is and has been a shareholder of Landry's Restaurants, Inc., the nominal defendant for the derivative claims, at all relevant times.

Defendant Tilman J. Fertitta has been Landry's Chairman, President, and Chief Executive Officer since 1987. He also had beneficial ownership, before the complained-of events, of 39% of the common stock of Landry's.[247] Defendant Steven L. Scheinthal is Landry's Executive Vice President of Administration, General Counsel, and Secretary, and has been a member of the board of directors since 1993.

Defendants Kenneth Brimmer, Michael S. Chadwick, and Michael Richmond are all members of the Landry's board of directors, and collectively also composed the special committee of independent directors formed to evaluate Fertitta's offer to acquire Landry's in a going-private transaction. Defendant Joe Max Taylor is also a member of the board of directors of Landry's.

Defendant Fertitta Holdings, Inc. ("FHI") is a newly formed Delaware corporation which is wholly owned by Fertitta. Defendant Fertitta Acquisition Co. ("FAC") is a Delaware corporation and a wholly owned subsidiary of FHI.

Nominal defendant Landry's is a Delaware corporation with its principal place of business in Houston, Texas. Landry's is a national restaurant, hospitality, and entertainment company principally engaged in the ownership and operation of full-

[247] He presently is the beneficial owner of 56.7% of the outstanding stock of Landry's.

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service casual dining restaurants. As of December 31, 2007, Landry's owned and operated over 179 restaurants in 28 states. Among its hospitality businesses, Landry's is the owner and operator of the well-known Golden Nugget Hotel and Casino in Las Vegas, Nevada.

The Initial Offer and the June Agreement

On January 27, 2008, Fertitta made an offer to acquire all of the outstanding shares of Landry's common stock for $ 23.50 per share. This represented a 41% premium over the price of Landry's stock on the last trading day before the offer. In response to the offer, the Landry's board of directors formed a special committee of independent directors, consisting of Brimmer, Chadwick, and Richmond. The board charged the special committee with the responsibility to assess Fertitta's offer and to consider any alternate proposals. The special committee retained Cowen & Company LLC as its financial advisor.

On June 16, 2008, the Landry's board entered into a merger agreement (the "June Agreement") with FAC, FHI, and Fertitta. The June Agreement called for FAC to be merged into Landry's, and all of the outstanding common stock (other than the 39% already owned by Fertitta) of Landry's to be cashed out for $ 21 per share. [3] The total consideration to be paid to the Landry's public stockholders in the Agreement was approximately $ 220 million. The June Agreement contained termination fees in both directions, under which: (a) Landry's would be required to pay $ 3 million to FAC if Landry's terminated the transaction during a 45-day "go-shop" period, or $ 24 million if Landry's terminated the agreement at any time after the end of the go-shop period; and (b) FAC would be required to pay Landry's a $ 24 million reverse-termination fee if it failed to close the deal, plus certain of the Landry's expenses arising out of the transaction. Fertitta personally guaranteed the payment of the reverse-termination fee and expenses.

The June Agreement permitted FAC to terminate the agreement without incurring liability for the reverse-termination fee if a material adverse effect occurred to Landry's since December 31, 2007. The agreement defined a material adverse effect, in pertinent part, as:

> any event, development, change or circumstance (any such item, an "Effect") that, either individually or in the aggregate, has caused or would reasonably be expected to cause a material adverse effect on the condition (financial or otherwise), results of operations, assets, liabilities (contingent or otherwise), properties, solvency, business, management or material agreements of the Company and its subsidiaries taken as a whole, *except in each case for any Effect resulting from, arising out of or relating to any of the following, either alone or in combination: . . . (B) any change in interest rates or general economic conditions (i) in the industries or markets in which the Company or any of its subsidiaries operates, (ii) affecting the United States or foreign economies in general or (iii) in the United States or foreign financial, banking or securities markets, in each case*

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> *which changes do not affect the Company and its subsidiaries to a materially disproportionate degree; (C) any natural disaster or act of God; . . . (H) any increase in the cost or availability of financing to Parent or Merger Sub . . .*

In anticipation of the June Agreement, Fertitta also entered into a debt commitment letter dated June 12, 2008 (the "June Debt Commitment Letter") with three entities affiliated with Jefferies & Company, Inc. and Wells Fargo Foothill (the "Lending Banks") to provide the financing for Fertitta's acquisition of Landry's. The June Debt Commitment Letter contained a material adverse effect clause which excused the Lending Banks from funding the going-private transaction under certain conditions which essentially mirrored the MAE clause of the June Agreement.

Hurricane Ike and the Renegotiation

On September 13, 2008, Hurricane Ike made landfall at Galveston, Texas, causing widespread damage in the Galveston area. As a result, a number of Landry's restaurants and other properties in the Galveston area were damaged and closed. Four days later, Landry's issued a press release announcing its interim financial results and addressing the impact of Hurricane Ike on the company's operations. The press release portrayed the damage from Hurricane Ike as limited to three cities and temporary in nature. Landry's disclosed its intention to rebuild the damaged properties and stated that the company's losses from disruption of the business at those locations would be covered by Landry's insurance, and therefore forecasted that the damage would have minimal (if any) negative long-term effect to Landry's.

Promptly after Hurricane Ike hit, Fertitta initiated contact with the Lending Banks. On September 18, 2008, prior to any investigation by the Lending Banks as to the extent of the damage caused to Landry's properties by the hurricane, Fertitta sent a letter to the special committee. Although the letter has never been disclosed publicly, its contents were described in Landry's January 5, 2009 Preliminary Proxy Statement. According to the January 5 proxy statement, Fertitta asserted in the letter that:
due to (a) the damage to [Landry's] properties in Galveston, Kemah and Houston arising out of Hurricane Ike, (b) the turmoil in the credit markets and (c) continued worsening of general economic conditions, he believed that [the Lending Banks] would likely determine that a material adverse effect, as defined in their debt commitment letter issued to Mr. Fertitta, had occurred, which would result in Jefferies and WFF withdrawing the debt commitment letter for the acquisition financing for the merger.
Fertitta further claimed in the letter that if the Lending Banks "withdrew their debt commitment letter because of a material adverse effect, Fertitta [might] have no choice but to exercise his right to terminate the original merger agreement." Finally, Fertitta expressed in the letter his "concern about the willingness of the [Lending Banks] to provide any financing absent a reduction in leverage in the debt financing," but stated that he believed that he could "persuade the Lending Banks to move forward with debt financing if [he] revised his offer to reflect [Landry's] reduced value, which he believed at [that] time was $ 17.00 per share." The description of the letter does not suggest, however, that the Lending Banks had actually taken the position that a material adverse

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effect had occurred that would excuse the banks' performance under the June Debt Commitment Letter, only that Fertitta believed that they might do so.

At the same time, Fertitta began accumulating shares of Landry's stock on the open market, acquiring a total of 400,000 shares over the period from September 17 through September 19, 2008, at prices ranging from $ 11.83 to $ 14.11 per share. On September 19, 2008, the special committee held a telephonic meeting and discussed (1) whether damage to Landry's properties from Hurricane Ike or the increasing turmoil in the credit markets constituted a "material adverse effect," (2) Fertitta's obligation to use his "best efforts" to consummate the financing under the June Debt Commitment Letter, and (3) Fertitta's purchase of shares on the open market.

On September 24, 2008, the special committee's independent counsel sent a letter to Fertitta's counsel requesting information regarding Fertitta's financing efforts. The next day, Fertitta responded by letter to the special committee. In that letter, Fertitta asserted that he had spoken to a number of financial institutions and that no financial institution outside the Lending Banks that he approached expressed any significant interest in financing the agreed-to going-private transaction. Fertitta also attached a letter from Jefferies, in which Jefferies advised Fertitta that, in view of the effects of Hurricane Ike, the Lending Banks believed that the Fertitta entities might not be able to satisfy the conditions precedent in the June Debt Commitment Letter.

The special committee's independent counsel sent a letter in response that same day, stating that (1) the special committee did not view the correspondence between Jefferies and Fertitta as a termination of the Debt Commitment Letter, (2) that Fertitta had not disclosed whether he agreed with Jefferies' assertion, and (3) that the special committee required his response in order to evaluate the situation fully. Fertitta's counsel responded that day by letter reiterating Fertitta's statement that he had contacted several other financial institutions and that none of them expressed any interest in providing debt financing for the merger. That letter also demanded that the deal price be revised down to $ 17 per share from $ 21 per share.

On October 1, 2008, the special committee, in response to Fertitta's demand, proposed a revised deal price of $ 19. On October 6, 2008, Fertitta told the special committee that he believed that the Lending Banks would declare an MAE with regard to the June Debt Commitment Letter. The next day, Landry's issued a press release announcing publicly for the first time that the buyout might be in jeopardy. Following this announcement, the price of Landry's common stock dropped 35% over the following three days, to $ 8.44 per share.

Over the following two weeks, Fertitta continued to press the special committee to agree to a lower buyout price. At the same time, Fertitta reminded the board that absent the consummation of a buyout (which would involve replacement of most of the existing debt of the company with new debt issued under the June Debt Commitment Letter), Landry's would be faced with the possibility of being required to redeem as much as $ 400 million in senior notes starting on February 28, 2009, a particularly unsavory

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prospect given the frozen state of the credit markets at the time.

On October 10, 2008, Fertitta revised his offer downward again, from $ 17 per share to $ 13 per share. On October 17, 2008, the special committee agreed to a revised deal (the "October Amendment"), which it announced by press release the next day. Under the terms of the October Amendment, the company agreed to lower the acquisition price to $ 13.50 per share (from $ 21 per share) and to reduce the reverse-termination fee in the same proportion from $ 24 million to $ 15 million. In exchange, Fertitta and the Lending Banks agreed not to claim the occurrence of a material adverse effect as a result of any event known to them as of the date of the amended merger agreement and commitment letter. In addition, Fertitta (apparently acting on behalf of Landry's), negotiated with the Lending Banks to provide as part of the amended commitment letter an alternative financing commitment, which would provide the necessary refinancing in the event that the merger failed to close.

Fertitta Engages In A Creeping Takeover

As noted earlier, Fertitta, after signing the June Agreement, had purchased 400,000 shares of Landry's common stock in the open market in late September 2008. With the October Amendment in place, Fertitta began making open market purchases of Landry's stock again. Between October 20, 2008 and December 2, 2008, Fertitta made 22 additional purchases of Landry's stock on the open market, for a total of approximately 2.6 million shares. Although the board and its advisors must have been aware of Fertitta's continuing open market purchases, which threatened to (and ultimately did) deliver majority control of the company to Fertitta without his consummation of the merger agreement at a premium price, the board did nothing to stop Fertitta from continuing to accumulate shares. Thus, unobstructed by a standstill agreement or poison pill, by December 2, 2008, Fertitta's holdings of Landry's common stock had reached 56.7% on a fully diluted basis.

The Banks Refuse A Routine Request, And Landry's Terminates The Merger

At some point following the announcement of the October Amendment, the SEC made a routine request to Landry's to "disclose certain information" from the amended debt commitment letter. When the Lending Banks balked at the request that Landry's be permitted to disclose the amended debt commitment letter to the SEC, [17] Landry's responded by terminating the merger agreement. As a result, Landry's waived the $ 15 million reverse-termination fee Fertitta would otherwise have had to pay as a result of his inability to consummate the merger agreement.

On January 12, 2009, Landry's issued a press release explaining its decision as follows: When the [Lending Banks] were informed of the SEC's position, the [Lending Banks] advised both Fertitta and [Landry's] that the [Lending Banks] would not agree to disclosure of the confidential information and that any disclosure by [Landry's] or Fertitta would be in violation of the terms of the commitment letter and result in the [Lending Banks] terminating their commitments for both the going private and

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[refinancing] transactions.

In the event the [Lending Banks] pulled their commitments, there would have been no financing available for the proposed going private transaction, and [Landry's] would have lost its [refinancing] commitment. If the going private transaction was terminated, no proxy statement would be required to be distributed to shareholders, therefore preserving the confidentiality of the terms of the [refinancing] until the final terms are decided. Given the current economic environment and [Landry's] need to refinance its existing approximately $ 400 million in senior notes, [Landry's] informed Fertitta that [Landry's] was not prepared to risk losing its [refinancing] commitment and was therefore unable to comply with a condition of the merger agreement which required distribution of an SEC approved proxy statement to Landry's shareholders to vote on the adoption of the merger proposal. As a result of [Landry's] inability to provide a proxy statement to [Landry's] shareholders, [Landry's] informed Fertitta that it would be unable to consummate the merger transaction.

Procedural History

A class action and derivative complaint was filed on February 5, 2009, alleging four counts: (I) a class claim for breach of fiduciary duty against Fertitta, (II) a class claim for aiding and abetting breach of fiduciary duty against FAC and FHI, (III) a class claim for breach of fiduciary duty against the directors of Landry's, and (IV) in the alternative, a derivative claim for waste against the board for failing to require Fertitta to pay the reverse-termination fee. On April 2, 2009, the defendants responded with a motion to dismiss pursuant to Rules 12(b)(6) and 23.1, and a motion to stay discovery pending the resolution of the motion to dismiss. The court heard oral argument on the motion to dismiss on June 9, 2009.

[PART II]

The defendants move to dismiss the complaint, pursuant to Court of Chancery Rule 12(b)(6), for failure to state a claim upon which relief can be granted. The court may dismiss a complaint under Rule 12(b)(6) only if the court can determine with "reasonable certainty" that "the plaintiff could prevail on no set of facts that may be inferred from the well-pleaded allegations in the complaint." In making that determination, the court assumes as true all well-pleaded allegations of fact in the complaint. Although the court accepts as true "all facts of the pleadings and reasonable inferences to be drawn therefrom, . . . neither inferences nor conclusions of fact unsupported by allegations of specific facts . . . are accepted as true." The court may also take judicial notice of the contents of the certificate of incorporation of a Delaware corporation where, as here, there is no dispute among the parties as to its actual contents (as opposed to the legal effect of those contents). Finally, the court may take judicial notice of public filings with the SEC, along with any documents incorporated by reference in the complaint.

Rather than engaging in a drawn-out analysis of each of the myriad arguments made by the parties, the court instead turns to three key facts which it believes, together, make it

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impossible to dismiss the complaint. These are: 1) Fertitta's negotiation (and the board's acquiescence to his taking that role) of the refinancing commitment on behalf of the company as part of the amended debt commitment letter;[248] 2) the board's apparent and inexplicable impotence in the face of Fertitta's obvious intention to engage in a creeping takeover; 3) the board's agreement to terminate the merger agreement, thus allowing Fertitta to avoid paying the $ 15 million reverse-termination fee.[249]

Each of these, taken individually, might raise the eyebrows of the court to varying degrees. But taken in the aggregate, they make it impossible for the court to state that to a "reasonable certainty" there is no set of facts which may be inferred from the well-pleaded allegations in the complaint that would allow the plaintiff to prevail.[250] Rather, these facts lead to the reasonable inference, though by no means the certain conclusion, that Fertitta used his influence on the corporation as controlling stockholder and/or corporate officer to his own benefit and to the detriment of the interests of the minority stockholders.[251] The same facts also lead to the reasonable inference that the board and/or the special committee willingly acquiesced to Fertitta's scheming because he was the

[248] In particular, the court notes here the surprising structure of the backup refinancing commitment as a part of the same agreement as the acquisition financing commitment, so that the Lending Banks could claim that a material breach of a term in the acquisition financing could also jeopardize the refinancing commitment.

[249] This fact is integral both to the fiduciary duty claim against Fertitta and the derivative waste claim pleaded against the board in count IV of the complaint. Unlike the other fiduciary duty claims against Fertitta, however, this aspect of the claim is properly pleaded as derivative, not direct. This is so because it is the corporation, not the stockholders, which is harmed by the loss of the reverse-termination fee, and it is to the corporation that any recovery must go. Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1035 (Del. 2004). For the reasons set forth with regard to count IV, the court concludes that demand is excused with respect to that aspect of count I that is derivative in nature.

[250] See Malpiede, 780 A.2d at 1082-83.

[251] Because FAC and FHI were vehicles with little existence other than to serve Fertitta's purposes in the acquisition, and were integral to the transactions at issue, the court cannot dismiss the aiding and abetting claim against them. To state a claim for aiding and abetting a breach of fiduciary duty, the plaintiff must allege (i) an underlying breach of fiduciary duty, (ii) that the alleged aider and abettor knowingly participated in that breach, and (iii) damages resulting from the breach. See Gatz v. Ponsoldt, 925 A.2d 1265, 1275 (Del. 2007). Having already determined that the plaintiff has adequately alleged the first prong (and the third prong in this case being beyond contention by the defendants for the purposes of a motion to dismiss) the issue firmly rests on the question of knowing participation by FAC and FHI. "Knowing participation in a . . . fiduciary breach requires that the third party act with the knowledge that the conduct advocated or assisted constitutes such a breach." Id. at 1276 (quoting Malpiede, 780 A.2d at 1097). The defendants contend that the complaint fails to adequately plead the required scienter. In support of this contention, the defendants cite In re Santa Fe Pacific Corp. S'holders Litig., 669 A.2d 59 (Del. 1995), for the proposition that "mere allegations that a defendant 'had knowledge of' the director defendants' fiduciary duties and 'knowingly and substantially participated and assisted' in the alleged breaches, is insufficient to state a cause of action." Defs.' Opening Br. 31 (quoting Sante Fe, 669 A.2d at 72). But Santa Fe is a case involving a claim that an unrelated public-company bidder aided and abetted alleged breaches of fiduciary duty by the board of another publicly-held company, based on the bare conclusory allegation of knowledge. Here, two 100%-owned corporate shells, created for no other purpose than to facilitate related transactions of the fiduciary, are alleged to have "knowledge" of the alleged breach. It would elevate form too far over substance to suggest, in the procedural posture of a Rule 12(b)(6) motion, that it is not a reasonable inference that facts known to Fertitta were also known to FAC and FHI.

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controlling stockholder.[252]

A few simple points serve to strengthen this conclusion and respond to the defendants' contentions in their motion. First, the defendants argue that the plaintiff fails to adequately allege that Fertitta was a controlling stockholder (at least until December, when he had gained majority control), and that all of his complained of actions involved his action *qua* stockholder. Thus, according to the defendants, Fertitta owed no fiduciary duties to the minority stockholders in any of those actions.[253]

The Delaware Supreme Court stated the test for control by a non-majority stockholder in *Citron v. Fairchild Camera & Instrument Corp.:* "[f]or a dominating relationship to exist in the absence of controlling stock ownership, a plaintiff must allege domination by a minority shareholder through actual control of corporation conduct."[254] First, there is no question (at least for the purposes of a motion to dismiss) that Fertitta exercised actual control of Landry's at all relevant times--he was not only the 39% stockholder, but the CEO and chairman of the company as well. Second, and more importantly, Fertitta's actions with respect to the negotiation of the refinancing commitment in the amended debt commitment letter do not fall so neatly into the "only acting as a minority stockholder" basket. It is unclear exactly in what capacity Fertitta was acting when negotiating with the Lending Banks on behalf of Landry's in October 2008. Ultimately, however, there are only two reasonable possibilities: 1) Fertitta was negotiating as CEO of the corporation, with at least tacit permission of the board; or 2) Fertitta was negotiating with the Lending Banks as controlling stockholder of Landry's. Under either circumstance, Fertitta was subject to a fiduciary duty to act in the best interests of the corporation and the stockholders as a whole, and to prefer those interests to any interest of his own. A breach of that duty is the essence of a failure of loyalty. Moreover, with respect to Landry's decision to act to terminate the merger agreement, by January 2009 it is indisputable that Fertitta was actually the majority owner of Landry's, raising a presumption of control on his part.[255]

The court now turns to the claim against the board for breach of fiduciary duty. The

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[252] The court is reminded of the famous charge to the board made by the controlling stockholder in Kahn v. Lynch Commc'n Sys., Inc.: "[y]ou must listen to us. We are 43 percent owner. You have to do what we tell you." 638 A.2d 1110, 1114 (Del. 1994).

[253] See Kahn, 638 A.2d at 1113 ("[A] shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation." (quoting Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987))).

[254] 569 A.2d 53, 70 (Del. 1989).

[255] Kahn, 638 A.2d at 1113. The defendants make much of the fact that Fertitta's shares acquired post-June Agreement were sterilized with respect to the merger vote, and therefore he was not the majority stockholder for these purposes. The sterilization of his shares only for purposes of the merger vote strikes the court as plainly irrelevant when determining whether he constituted a majority stockholder at the time the corporation elected not to proceed with the merger. Because Fertitta was undoubtedly the majority stockholder by the time the decision was made for the company to terminate the merger agreement, the "termination transaction" will be examined under the entire fairness standard. Kahn, 638 A.2d at 1115 ("A controlling or dominating shareholder standing on both sides of a transaction . . . bears the burden of proving its entire fairness.") (citing Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983); Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985)).

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defendants urge that at best the plaintiff has pleaded a breach of the duty of care, which is exculpated by the corporate charter of Landry's pursuant to section 102(b)(7) of the Delaware General Corporation Law, and point to the Delaware Supreme Court's recent decision in *Lyondell Chemical Co. v. Ryan*[256] for good measure. Simply put, this is not a case to which *Lyondell* speaks. *Lyondell* is a case in which the plaintiffs attempted to apply the *Caremark*[257] standard for lack of good faith to the context of a control transaction. To attempt to apply *Lyondell* to the instant case, however, misses entirely the gravamen of the plaintiff's claims. The plaintiff here does not claim that it was harmed by virtue of some sufficiently gross failure of process on the part of the Landry's directors. Rather, the plaintiff's claims are far simpler: the board knowingly preferred the interests of the majority stockholder to those of the corporation or the minority.

Turning first to the board's failure to employ a poison pill to prevent Fertitta from obtaining control without paying a control premium, it is reasonable in the context of a motion to dismiss to infer fiduciary misconduct more serious than a breach of the duty of care. The failure to act in the face of an obvious threat to the corporation and the minority stockholders instead supports a reasonable inference that the board breached its duty of loyalty in choosing not to cross Fertitta.[258]
The court turns now to the board's decision to terminate the merger agreement and relieve Fertitta of the responsibility to pay the reverse-termination fee. The board's contention that it simply had no choice but to terminate the agreement, rather than forcing Fertitta to do so, is not persuasive. The board contends that disclosure of the amended debt commitment letter would have risked the refinancing commitment, and therefore risked default on $ 400 million in notes. Thus, the argument goes, the only rational choice was to terminate the agreement, rather than risking bankruptcy. But the board must have recognized that the risk that Fertitta would have permitted that to happen, rather than terminating the agreement and paying the reverse break-up fee himself, was low. As of the time of the termination of the merger agreement, Fertitta owned 9,658,855 shares of Landry's common stock,[259] worth between $ 78 million (based on the post-termination price) and $ 119 million (based on the pre-termination price). There is no doubt that the value of that stock would have been severely impaired, if not entirely destroyed, had Landry's defaulted on the $ 400 million note redemption and been forced into bankruptcy. Thus, it is unreasonable to think (at this stage at least) that Fertitta would have allowed the company to be forced into bankruptcy rather than paying the $ 15 million reverse-termination fee. It is difficult to imagine that the Landry's board would not have recognized this reality. It therefore raises a question whether the board's decision to terminate and entirely excuse Fertitta's performance constituted a rational

[256] 970 A.2d 235 (Del. 2009).
[257] In re Caremark Int'l Deriv. Litig., 698 A.2d 959, 971 (Del. Ch. 1996).
[258] The defendants state that "no Delaware court has ever held that a board of directors has a per se duty to enact specific defensive measures in response to a stockholder's purchase of additional shares." Defs.' Opening Br. 42. This is true, and this decision will not change that. To say that there is no per se duty to employ a poison pill to block a 46% stockholder from engaging in a creeping takeover does not refute the conclusion that the board's failure to employ a pill, together with other suspect conduct, supports a reasonable inference at the motion to dismiss stage that the board breached its duty of loyalty in permitting the creeping takeover.
[259] January Proxy Statement at 152.

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exercise of business judgment.[260] That question cannot be resolved at this stage of the proceedings, but must await the consideration of detailed facts beyond the scope of a motion to dismiss.[261]

[PART III]

The defendants have also moved to dismiss the derivative claims pursuant to Rule 23.1. Unless the plaintiff can show demand would be futile, it must make a demand on the board of directors of the corporation before a derivative action may be instituted on behalf of the corporation. "The test of demand futility is a two-fold test under *Aronson* and its progeny. The first prong of the futility rubric is 'whether, under the particularized facts alleged, a reasonable doubt is created that . . . the directors are disinterested and independent.' The second prong is whether the pleading creates a reasonable doubt that 'the challenged transaction was otherwise the product of a valid exercise of business judgment.' These prongs are in the disjunctive. Therefore, if either prong is satisfied, demand is excused."

The Delaware Supreme Court has observed that the basis for claiming that demand is excused would generally be one of: "(1) a majority of the board has a material financial or familial interest; (2) a majority of the board is incapable of acting independently for some other reason such as domination or control; or (3) the underlying transaction is not the product of a valid exercise of business judgment." There is nothing in the complaint (other than irrelevant allegations regarding the directors' customary annual compensation) to suggest that the directors are either interested or otherwise lack independence as a result of domination or control. However, as the court has already stated, the complaint raises a reasonable doubt that "the challenged transaction was otherwise the product of a valid exercise of business judgment." As such, the court concludes that demand was excused, and the derivative count cannot be dismissed for failure to make demand upon the board.

[PART IV]

For the foregoing reasons, the defendants' motion to dismiss is DENIED. IT IS SO ORDERED.

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[260] The business judgment rule "is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (citing Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)). To be clear, what the plaintiff has stated here is a claim for waste. See Harbor Fin. P'rs v. Huizenga, 751 A.2d 879, 893 (Del. Ch. 1999) (holding that the fundamental basis for a waste claim rests on the pleading of facts that show that the economics of the transaction were so flawed that no disinterested person of right mind and ordinary business judgment could think the transaction beneficial to the corporation).

[261] Cf. Michelson v. Duncan, 407 A.2d 211, 223 (Del. 1979) ("Claims of gift or waste of corporate assets are seldom subject to disposition by summary judgment; and when there are genuine issues of fact as to the existence of consideration, a full hearing is required regardless of shareholder ratification."); Gottlieb v. McKee, 34 Del. Ch. 537, 107 A.2d 240, 243 (Del. Ch. 1954) ("The determination of whether or not there has been in any given situation a gift of corporate assets does not rest upon any hard and fast rule. It is largely a question of fact.").

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IV. CHAPTER 4, INTRODUCTION TO SECURITIES REGULATION

A. Page 304, New Sec. 4.17.F. 2007 Final Amendments to Rule 144

Page 304, New Sec. 4.17.F. Add after Sec. 4.17.E the following:
New Sec. 4.17.F. **2007 Final Amendments to Rule 144**

Securities Act Release No. 8869, Amendments to Rule 144 and 145
December 6, 2007
(The amended Rule 144 is at the end of this document.)

ACTION: Final rule.

SUMMARY: Rule 144 under the Securities Act of 1933 creates a safe harbor for the sale of securities under the exemption set forth in Section 4(1) of the Securities Act. We are shortening the holding period requirement under Rule 144 for "restricted securities" of issuers that are subject to the reporting requirements of the Securities Exchange Act of 1934 to six months. Restricted securities of issuers that are not subject to the Exchange Act reporting requirements will continue to be subject to a one-year holding period prior to any public resale. The amendments also substantially reduce the restrictions applicable to the resale of securities by non-affiliates. In addition, the amendments simplify the Preliminary Note to Rule 144, amend the manner of sale requirements and eliminate them with respect to debt securities, amend the volume limitations for debt securities, increase the Form 144 filing thresholds, and codify several staff interpretive positions that relate to Rule 144. Finally, we are eliminating the presumptive underwriter provision in Securities Act Rule 145, except for transactions involving a shell company, and revising the resale requirements in Rule 145(d). We believe that the amendments will increase the liquidity of privately sold securities and decrease the cost of capital for all issuers without compromising investor protection. [The amendments to Rule 144 are discussed in Chapter 13.] * * *

BACKGROUND

The Securities Act of 1933 ("Securities Act") requires registration of all offers and sales of securities in interstate commerce or by use of the U.S. mails, unless an exemption from the registration requirement is available. Section 4(1) of the Securities Act provides such an exemption for transactions by any person other than an issuer, underwriter or dealer.

The definition of the term "underwriter" is key to the operation of the Section 4(1) exemption. Section 2(a)(11) of the Securities Act defines an underwriter as "any person

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who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking."[262]The Securities Act does not, however, provide specific criteria for determining when a person purchases securities "with a view to ... the distribution" of those securities. In 1972, the Commission adopted Rule 144 to provide a safe harbor from this definition of "underwriter" to assist security holders in determining whether the Section 4(1) exemption is available for their resale of securities.

Rule 144 regulates the resale of two categories of securities - restricted securities and control securities. Restricted securities are securities acquired pursuant to one of the transactions listed in Rule 144(a)(3). Although it is not a term defined in Rule 144, "control securities" is used commonly to refer to securities held by an affiliate of the issuer, regardless of how the affiliate acquired the securities. Therefore, if an affiliate acquires securities in a transaction that is listed in Rule 144(a)(3), those securities are both restricted securities and control securities. A person selling restricted securities, or a person selling restricted or other securities on behalf of the account of an affiliate, who satisfies all of Rule 144's applicable conditions in connection with the transaction, is deemed not to be an "underwriter," as defined in Section 2(a)(11) of the Securities Act, and therefore may rely on the Section 4(1) exemption for the resale of the securities.

Since its adoption, we have reviewed and revised Rule 144 several times. We last made major changes in 1997 ("1997 amendments"). At that time, we shortened the required holding periods for restricted securities. Before the 1997 amendments, security holders could resell restricted securities under Rule 144, subject to limitation, after two years, and persons who were not affiliates and had not been affiliates during the prior three months, could resell restricted securities without limitation after three years. The 1997 amendments changed these two-year and three-year periods to one-year and two-year periods, respectively.

On the same day that we adopted those changes, we also proposed and solicited comment on several possible additional changes to Rule 144, Rule 145 and Form 144, including reducing the holding period further ("1997 Proposing Release" and "1997 proposals"). We received 38 comment letters on those proposed changes. While some commenters supported further shortening the holding periods, others suggested that we monitor the results of the 1997 amendments before making further changes. We did not take further action to adopt the 1997 proposals.

Rule 144 states that a selling security holder shall be deemed not to be engaged in a distribution of securities, and therefore not an underwriter, with respect to such securities,

[262] 15 U.S.C. 77b(a)(11). Section 2(a)(11) states that the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer. Therefore, any person who purchased securities from an affiliate of an issuer is an underwriter under Section 2(a)(11) if that person purchased with a view to the distribution of the securities.

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thus making available the Section 4(1) exemption from registration, if the resale satisfies specified conditions. The conditions include the following:

l There must be adequate current public information available about the issuer;

l If the securities being sold are restricted securities, the security holder must have held the security for a specified holding period;

l The resale must be within specified sales volume limitations;

l The resale must comply with the manner of sale requirements; and

l The selling security holder must file Form 144 if the amount of securities being sold exceeds specified thresholds.

Rule 144, as it existed before today's amendments, permitted a non-affiliate to publicly resell restricted securities without being subject to the above limitations if the securities had been held for two years or more, provided that the security holder was not, and, for the three months prior to the sale, had not been, an affiliate of the issuer.

On July 5, 2007, we again proposed to amend several aspects of Rule 144 and Rule 145, including by further shortening the holding periods (the "2007 Proposing Release"). We proposed to shorten the holding period requirement in Rule 144(d) for restricted securities of issuers that are subject to the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act") to six months. Restricted securities of issuers that are not subject to Exchange Act reporting requirements would continue to be subject to a one-year holding period under Rule 144(d). We also proposed to relieve non-affiliates of reporting issuers from having to comply with all conditions in Rule 144, except the current public information requirement, after a six-month holding period. Non-affiliates of non-reporting issuers would be allowed to resell their securities freely after a one-year holding period. In addition, we proposed to:

l Simplify the Preliminary Note to Rule 144 and text of Rule 144;

l Toll the holding period during the time that security holders engage in certain hedging transactions;

l Eliminate the "manner of sale" requirements with respect to the resale of debt securities;

l Increase the thresholds triggering the requirement to file Form 144; and

l Codify several staff positions relating to Rule 144.

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We also solicited comment on amending the Form 144 filing deadline to coincide with the deadline for filing a Form 4 under Section 16 of the Exchange Act and permitting persons who are subject to Section 16 to meet their Form 144 filing requirement by filing a Form 4.[263] Finally, we proposed to eliminate the presumptive underwriter provision in Securities Act Rule 145, except for transactions involving a shell company, and to harmonize the resale provisions in Rule 145 with the Rule 144 provisions applicable to resales of securities of shell companies.

We received 32 comment letters from 30 commenters on the proposals in the 2007 Proposing Release. A majority of the commenters expressed support for the proposals in general. Several of these commenters expressed support for the proposed amendments to shorten the holding period requirement in Rule 144 for both affiliates and non-affiliates of Exchange Act reporting issuers. Two commenters opposed shortening the holding period, as proposed.

Some commenters expressed opposition to the proposed reintroduction of a provision that would toll, or suspend, for up to six months, the holding period during any period that a security holder engages in hedging activities with respect to any equity securities of the same class as the restricted securities or any securities convertible into that class (or, in the case of nonconvertible debt, with respect to any nonconvertible debt securities). The commenters thought that the tolling provision could have a negative effect on capital raising transactions. These commenters provided several recommendations on how we should modify the tolling provision, if we decide to adopt it. We received general support for the other aspects of the proposed amendments, including the proposals relating to Form 144, the elimination of the manner of sale requirements for debt securities and the codification of several staff interpretations.

DISCUSSION OF FINAL AMENDMENTS

Simplification of the Preliminary Note and Text of Rule 144

In the 2007 Proposing Release, we noted that the current Preliminary Note is complex and may be confusing to some security holders. We proposed amendments to simplify and clarify the Preliminary Note to Rule 144 and to incorporate plain English principles. The proposed amendments to the Preliminary Note were not intended to alter the substantive operation of the rule. In addition, we proposed changes throughout the rule to make the rule less complex and easier to read.

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[263] Section 16 applies to every person who is the beneficial owner of more than 10% of any class of equity securities registered under Section 12 of the Exchange Act, and each officer and director (collectively, “reporting persons” or “insiders”) of the issuer of such security. Section 16(a) of the Exchange Act generally requires reporting persons to report changes in their beneficial ownership of all equity securities of the issuer on Form 4 before the end of the second business day following the day on which the transaction that caused the change in beneficial ownership was executed.

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We received a few comments on the proposed changes to simplify Rule 144 and the Preliminary Note. One commenter believed that the Preliminary Note to Rule 144 is no longer necessary, because the purpose and meaning of the rule are well-understood. Some commenters recommended that we further explain how Rule 144 can be used for the resale of control securities.

We are adopting the amendments to the Preliminary Note with some modification from the proposed version. The revised Preliminary Note retains an explanation of the relationship among the exemption in Section 4(1) of the Securities Act, the Section 2(a)(11) definition of "underwriter" and the Rule 144 safe harbor. Consistent with the proposal, the revised Preliminary Note also clarifies that any person who sells restricted securities, and any person who sells restricted securities or other securities on behalf of an affiliate, shall be deemed not to be engaged in a distribution of such securities and therefore shall be deemed not to be an underwriter with respect to such securities if the sale in question is made in accordance with all the applicable provisions of the rule. The revised Preliminary Note further states that, although Rule 144 provides a safe harbor for establishing the availability of the Section 4(1) exemption, it is not the exclusive means for reselling restricted and control securities. Therefore, Rule 144 does not eliminate or otherwise affect the availability of any other exemption for resales. Consistent with a statement that was included in the original Rule 144 adopting release, we are adding a statement to the Preliminary Note that the Rule 144 safe harbor is not available with respect to any transaction or series of transactions that, although in technical compliance with the rule, is part of a plan or scheme to evade the registration requirements of the Securities Act. We also are adopting plain English changes throughout the rule text substantially as proposed.

Amendments to Holding Periods for Restricted Securities

Six-Month Rule 144(d) Holding Period Requirement for Exchange Act Reporting Companies

As stated above, in 1997, we reduced the Rule 144 holding periods for restricted securities for both affiliates and non-affiliates. Before the 1997 amendments, security holders could sell limited amounts of restricted securities after holding those securities for two years if they satisfied all other conditions imposed by Rule 144. Under Rule 144(k), non-affiliates could sell restricted securities without being subject to any of the conditions in Rule 144 after holding their securities for three years. The 1997 amendments to Rule 144 reduced the two-year Rule 144(d) holding period to one year and amended the three-year Rule 144(k) holding period to two years.

In the 1997 Proposing Release, we solicited comment on whether the Rule 144(d) holding period should be further reduced for both affiliates and non-affiliates, and whether restrictions applicable to sales by non-affiliates also should be reduced. We received numerous comments on this issue. Twelve commenters recommended that we further reduce the holding period to six months. Two other commenters thought that we should maintain the holding periods that we had just recently adopted. Eight commenters

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recommended that we gain more experience with the new holding periods before proposing further amendments to those holding periods.

In the 2007 Proposing Release, we again proposed to shorten the Rule 144(d) holding period for restricted securities held by affiliates and non-affiliates. The proposal would have permitted both affiliates and non-affiliates to publicly sell restricted securities of Exchange Act reporting issuers after holding the securities for six months, subject to any other applicable condition of Rule 144, if they had not engaged in hedging transactions with respect to the securities. Because of our concern that the market does not have sufficient information and safeguards with respect to non-reporting issuers, we proposed to retain the one-year holding period for restricted securities of issuers that are not subject to Exchange Act Section 13(a) or Section 15(d) reporting obligations for both affiliates and non-affiliates.

Several commenters supported the proposal to shorten the holding period to six months for securities of reporting issuers. These commenters noted that the shortened holding period would increase liquidity for issuers, make capital investment more attractive, and decrease costs of capital for smaller companies without sacrificing investor protection. In this regard, one commenter noted that today’s markets now function at an accelerated pace, and technology, particularly the Internet, has caused the markets to become more efficient. Two commenters advocated an even shorter holding period requirement than the proposed six-month period, with one commenter advocating a four-month holding period and the other a three-month holding period. Two commenters opposed shortening the holding period requirement under Rule 144, as proposed.

The purpose of Rule 144 is to provide objective criteria for determining that the person selling securities to the public has not acquired the securities from the issuer for distribution. A holding period is one criterion established to demonstrate that the selling security holder did not acquire the securities to be sold under Rule 144 with distributive intent. We do not want the holding period to be longer than necessary or impose any unnecessary costs or restrictions on capital formation. After observing the operation of Rule 144 since the 1997 amendments, we believe that a six-month holding period for securities of reporting issuers provides a reasonable indication that an investor has assumed the economic risk of investment in the securities to be resold under Rule 144. Therefore, we are adopting a six-month holding period for reporting companies, as proposed. Most commenters agreed that shortening the holding period to six months for restricted securities of reporting issuers will increase the liquidity of privately sold securities and decrease the cost of capital for reporting issuers, while still being consistent with investor protection. By reducing the holding period for restricted securities, these amendments are intended to help companies to raise capital more easily and less expensively. For example, by making private offerings more attractive, the amendments may allow some companies to avoid certain types of costly financing structures involving the issuance of extremely dilutive convertible securities. Many commenters supported the proposal to maintain the existing one-year holding period for restricted securities of non-reporting issuers.

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Under the amendments that we are adopting, the six-month holding period requirement will apply to the securities of an issuer that has been subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act for a period of at least 90 days before the Rule 144 sale. Restricted securities of a "non-reporting issuer" will continue to be subject to a one-year holding period requirement. A non-reporting issuer is one that is not, or has not been for a period of at least 90 days before the Rule 144 sale, subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act.

We believe that different holding periods for reporting and non-reporting issuers are appropriate given that reporting issuers have an obligation to file periodic reports with updated financial information (including audited financial information in annual filings) that are publicly available on EDGAR, the Commission's electronic filing system. Although non-reporting issuers must make some information publicly available before resales can be made under Rule 144, this information typically is much more limited in scope than information included in Exchange Act reports, is not required to include audited financial information, and is not publicly available via EDGAR. For these reasons, we believe that continuing to require security holders of non-reporting issuers to hold their securities for one year is not unduly burdensome and is consistent with investor protection.

Significant Reduction of Conditions Applicable to Non-Affiliates

Before adoption of these amendments, both non-affiliates and affiliates were subject to all other applicable conditions of Rule 144, in addition to the Rule 144(d) holding period requirement, including the condition that current information about the issuer of the securities be publicly available, the limitations on the amount of securities that may be sold in any three-month period, the manner of sale requirements and the Form 144 notice requirement. However, pursuant to paragraph (k) of Rule 144 as it existed prior to the amendments that we are adopting, a non-affiliate of the issuer at the time of the Rule 144 sale who had not been an affiliate during the three months prior to the sale, could sell the securities after holding them for two years without complying with these other conditions.

In the 2007 Proposing Release, we proposed to permit non-affiliates to resell their restricted securities freely after meeting the applicable holding period requirement (i.e., six months with respect to a reporting issuer and one year with respect to a non-reporting issuer), except that non-affiliates of reporting issuers still would be subject to the current public information requirement in Rule 144(c) for an additional six months after the end of the initial six-month holding period.

In general, commenters supported the proposal to reduce substantially the requirements for the resale of restricted securities by non-affiliates under Rule 144. Noting the importance of the current public information condition, two commenters expressed support for the proposed retention of that requirement for the resales of restricted securities by non-affiliates occurring between six months and one year after acquisition of the securities. Some commenters expressed support for removal of the manner of sale

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requirements and the Form 144 notice requirement, while a few objected to removal of those requirements. The commenters objecting to the removal of those requirements expressed concern about the transparency of Rule 144 transactions and the potential increase in violations of the holding period requirement if the manner of sale requirements and the Form 144 notice requirement were eliminated. The two commenters that opposed shortening the Rule 144(d) holding period also opposed the proposals to permit non-affiliates to resell without being subject to any other condition (except the public information requirement, with respect to resales of securities of reporting companies) after they meet the holding period.

We are adopting the amendments for the sale of restricted securities by non-affiliates after the holding period, as proposed. Under the amendments, after the applicable holding period requirement is met, the resale of restricted securities by a non-affiliate under Rule 144 will no longer be subject to any other conditions of Rule 144 except that, with regard to the resale of securities of a reporting issuer, the current public information requirement in Rule 144(c) will apply for an additional six months after the six-month holding period requirement is met. Therefore, a non-affiliate will no longer be subject to the Rule 144 conditions relating to volume limitations, manner of sale requirements, and filing Form 144.

We believe that the complexity of resale restrictions may inhibit sales by, and imposes costs on, non-affiliates. Because Rule 144 is relied upon by many individuals to resell their restricted securities, we believe that it is particularly helpful to streamline and reduce the complexity of the rule as much as possible while retaining its integrity. We continue to believe that retaining the current public information requirement with regard to resales of restricted securities of reporting issuers for up to one year after the acquisition of the securities is important to help provide the market with adequate information regarding the issuer of the securities. In addition, we generally believe that most abuses in sales of unregistered securities involve affiliates of issuers and securities of shell companies. As discussed below, we are codifying the staff's current interpretive position that Rule 144 cannot be relied upon for the resale of the securities of reporting and non-reporting shell companies.

The final conditions applicable to the resale under Rule 144 of restricted securities held by affiliates and non-affiliates of the issuer can be summarized as follows:

	Affiliate or Person Selling on Behalf of an Affiliate	**Non-Affiliate (and Has Not Been an Affiliate During the Prior Three Months)**
Restricted Securities of Reporting Issuers	<u>During six-month holding period</u> - no resales under Rule 144 permitted. <u>After six-month holding period</u> – may resell in accordance with all Rule 144 requirements including:	<u>During six-month holding period</u> - no resales under Rule 144 permitted. <u>After six-month holding period but before one year</u> – unlimited public resales under Rule 144

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	• Current public information, • Volume limitations, • Manner of sale requirements for equity securities, and • Filing of Form 144.	except that the current public information requirement still applies. After one-year holding period – unlimited public resales under Rule 144; need not comply with any other Rule 144 requirements.
Restricted Securities of Non-Reporting Issuers	During one-year holding period - no resales under Rule 144 permitted. After one-year holding period – may resell in accordance with all Rule 144 requirements including: • Current public information, • Volume limitations, • Manner of sale requirements for equity securities, and • Filing of Form 144.	During one-year holding period - no resales under Rule 144 permitted. After one-year holding period – unlimited public resales under Rule 144;need not comply with any other Rule 144 requirements.

Tolling Provision

In 1990, we eliminated a Rule 144 provision that tolled, or suspended, the holding period of a security holder maintaining a short position in, or any put or other option to dispose of, securities equivalent to the restricted securities owned by the security holder. We eliminated this provision in conjunction with an amendment to broaden a security holder's ability to tack the holding periods of prior owners to the security holder's own holding period.[264]

We previously have expressed concern regarding the effect of hedging activities designed to shift the economic risk of investment away from the security holder with respect to restricted securities. In the 1997 Proposing Release, we solicited comment on several alternatives designed to address these concerns. Seven commenters recommended that we adopt measures to eliminate or restrict hedging activities during the holding period. Six commenters recommended maintaining the status quo. Six other commenters suggested that we adopt a safe harbor for certain hedging activities that would be deemed permissible under Rule 144.

[264] "Tacking" the holding period is the ability of the security holder to include, under certain circumstances, the period that securities were held by a previous owner as part of his or her own holding period for the purposes of meeting the holding period requirement in Rule 144(d). Further discussion about tacking appears in Section II.E.2 of this release.

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In the 2007 Proposing Release, we acknowledged a concern about the effect of hedging activities in connection with the adoption of a six-month holding period for securities of reporting issuers. We noted that, when we eliminated the tolling provision in 1990, the Rule 144 holding periods were longer. We also expressed the view that the proposal to shorten the holding period to six months could make the entry into such hedging arrangements significantly easier and less costly because these arrangements would cover a much shorter period. We therefore proposed to reintroduce a Rule 144 tolling provision that would have suspended the holding period for restricted securities of Exchange Act reporting issuers while a security holder engaged in certain hedging transactions. However, we proposed that any suspension due to hedging would not have caused, under any circumstances, the holding period to extend beyond one year.

Because the proposed tolling provision also would have worked in conjunction with the Rule 144 provisions that permit tacking of holding periods, a selling security holder would have been required to determine whether a previous owner of the securities had engaged in hedging activities with respect to the securities, if the selling security holder wished to tack the previous owner's holding period to the holding period of the selling security holder. The proposed provision would have tolled the holding period during any period in which the previous owner held a short position or put equivalent position with respect to the securities, however, there would have been no tolling of the previous owner's holding period if the security holder for whose account the securities were to be sold reasonably believed that no such short or put equivalent position was held by the previous owner.

In connection with the proposed tolling provision, we also proposed other related changes to Rule 144. First, we proposed to require that information be provided in Form 144 regarding any short or put equivalent position held with respect to the securities prior to the resale of the securities. The second proposal related to the manner of sale requirements in paragraphs (f) and (g) of Rule 144.

Several commenters objected to the proposed reintroduction of the tolling provision and suggested modifications to the proposed provision, if the Commission chose to adopt it. Commenters objecting to the proposed tolling provision provided the following reasons, among others, why the Commission should not adopt the proposed tolling provision:

l Hedging transactions involve costs and risks for the security holder and do not entirely transfer risk of the economic investment of the securities;

l Any concern that the Commission has about hedging activities immediately after the acquisition is outweighed by the belief that hedging activities can enhance private placements as a means of capital formation and should be allowed to continue because they do not raise substantial concerns about unregistered distributions;

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- In the current environment, a security holder may hold long and short positions across multiple trading desks and complex financial institutions and positions may change daily or even intra-day. The task of tracing and processing such positions would necessitate the development of costly custom software and hardware systems. Consequently, security holders might ultimately choose to hold the securities for the default one-year period rather than implement these costly systems, thereby frustrating the intent of the Commission in adopting the six-month holding period;

- There is a natural ceiling on the amount of hedging activity in restricted securities because the supply of unrestricted securities is limited;

- The Commission has adequate enforcement tools to address abuses in hedging with respect to restricted securities; and

- The Commission's reasoning for eliminating the tolling provision in 1990 was that a single holding period running from the date of purchase from the issuer, or an affiliate of the issuer, is sufficient to prevent unregistered distributions to the public. This reasoning still applies, even if the holding period is reduced to six months for securities of reporting issuers.

Some commenters reasoned that if the Commission detects an increase in abuse after implementation of the revised holding period, as proposed, the Commission could modify its treatment of hedging activities. This would be consistent with the approaches taken by the Commission when it first adopted Rule 144, and in 1997 when commenters recommended that the Commission gain more experience with the shortened holding periods before making additional revisions.

After considering the comments, we are not adopting the proposed tolling provision and related amendments. We note, in particular, the comments asserting that, in the current environment; the tolling provision would unduly complicate Rule 144 and could require security holders or brokers to incur significant costs to monitor hedging positions for purposes of determining whether they have met the holding period requirement. This would frustrate our primary objectives to streamline Rule 144 and reduce the costs of capital for issuers. We will revisit the issue if we observe abuse relating to the hedging activities of holders of restricted securities.

Amendments to the Manner of Sale Requirements Applicable to Resales by Affiliates

Before today's amendments, the manner of sale requirements in Rule 144(f) required securities to be sold in "brokers' transactions" or in transactions directly with a "market maker," as that term is defined in Section 3(a)(38) of the Exchange Act. Additionally, the rule prohibits a selling security holder from: (1) soliciting or arranging for the solicitation of orders to buy the securities in anticipation of, or in connection with, the Rule 144 transaction; or (2) making any payment in connection with the offer or sale of the securities to any person other than the broker who executes the order to sell the securities.

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In the 1997 Proposing Release, we proposed to eliminate the manner of sale requirements for the sale of both equity and debt securities alike, reasoning that the manner of sale requirements are not necessary to satisfy the purposes of Rule 144 and limit the liquidity of the security. Some commenters opposed this proposal, asserting that brokers help ensure that selling security holders are complying with the applicable Rule 144 conditions to resale. As discussed below, although we proposed to eliminate the manner of sale requirements only for debt securities and not equity securities in the 2007 Proposing Release, we requested comment on whether it would be appropriate to eliminate the manner of sale requirements for the sale of equity securities as well.

The comments were mixed on this point. One commenter strongly discouraged the elimination of the manner of sale requirements for equity securities, while another supported such a change. One commenter did not object to retaining the manner of sale requirements for resales of equity securities of affiliates, on the grounds that affiliates generally find the assistance of a broker useful in navigating compliance with Rule 144 and thus brokers serve a useful function that is not unduly burdensome. Instead of completely eliminating the manner of sale requirements, some commenters requested that we consider expanding the methods to sell the securities permitted by the manner of sale requirements. For example, two commenters discussed amending the requirement to permit sales through alternative trading systems such as electronic venues where the broker's identity is anonymous prior to trade execution.

In response to comments, we are adopting amendments to the manner of sale requirements that apply to resales of equity securities of affiliates. We last made substantive amendments to the manner of sale requirements in 1978. Since then, the growth of technological and other developments directed at meeting the investment needs of the public and reducing the cost of capital for companies have led us to refine the rules governing the trading of securities. We believe that it is appropriate now to adopt two amendments to the manner of sale requirements so that the restrictions better reflect current trading practices and venues.

First, we are adopting a change to Rule 144(f) to permit the resale of securities through riskless principal transactions in which trades are executed at the same price, exclusive of any explicitly disclosed markup or markdown, commission equivalent, or other fee, and the rules of a self-regulatory organization permit the transaction to be reported as riskless. We believe that these riskless principal transactions are equivalent to agency trades. As with agency trades, in order to qualify as a permissible manner of sale under the revised rule, the broker or dealer conducting the riskless principal transaction must meet all the requirements of a brokers' transaction, as defined by Rule 144(g), except the requirement that the broker does no more than execute the order or orders to sell the securities as agent for the person for whose account the securities are sold. The broker or dealer must neither solicit nor arrange for the solicitation of customers' orders to buy the securities in anticipation of or, in connection with, the transaction, must receive no more than the usual and customary markup or markdown, commission equivalent, or other fee, and must conduct a reasonable inquiry regarding the underwriter status of the person for whose account the securities are to be sold.

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Second, we are amending Rule 144(g) which defines "brokers' transactions" for purposes of the manner of sale requirements. Under the definition of brokers' transactions, a broker must neither solicit nor arrange for the solicitation of customers' orders to buy the securities in anticipation of, or in connection with, the transaction. However, certain activities specified in three subparagraphs of Rule 144(g)(2) are deemed not to be a solicitation. We are adding another subparagraph covering the posting of bid and ask quotations in alternative trading systems that will also be deemed not to be a solicitation. This new provision permits a broker to insert bid and ask quotations for the security in an alternative trading system, as defined in Rule 300 of Regulation ATS, provided that the broker has published bona fide bid and ask quotations for the security in the alternative trading system on each of the last 12 business days.

Changes to Rule 144 Conditions Related to Resales of Debt Securities by Affiliates

Increase of the Thresholds that Trigger the Form 144 Filing Requirement for Affiliates

Before today's amendments, Rule 144(h) required a selling security holder to file a notice on Form 144 if the security holder's intended sale exceeded either 500 shares or $10,000 within a three-month period. These filing thresholds had not been modified since 1972. In the 1997 Proposing Release, we proposed to increase the filing thresholds to 1,000 shares or $40,000. Thirteen commenters supported raising the filing threshold and no commenters opposed the idea. Some commenters suggested that we eliminate Form 144 altogether. One commenter suggested raising the threshold to $100,000. Another commenter suggested raising it to $250,000.

In the 2007 Proposing Release, we proposed to increase the Form 144 filing thresholds to cover sales of 1,000 shares or $50,000 within a three-month period. Some commenters specifically expressed support for raising the Form 144 filing thresholds. One of these commenters recommended filing thresholds of 10,000 shares or $100,000, if the Commission chose to retain a Form 144 filing requirement for affiliates.

We are adopting the increased Form 144 filing thresholds with some modification. As proposed, we are raising the dollar threshold to $50,000 to adjust for inflation since 1972. After considering the comments, we are raising the share threshold to 5,000 shares, rather than the proposed 1,000 shares. We believe that the 5,000 share threshold is an appropriate alternate threshold for trades in amounts that may not reach the $50,000 dollar threshold, but that merit notice to the market.

In the 2007 Proposing Release, we also solicited comment on whether we should coordinate the Form 144 filing requirements with Form 4 filing requirements. Many commenters supported a combination of the two forms. Although we are not adopting those changes today, we expect to issue a separate release in the future to provide affiliates that are subject to both the Form 4 and Form 144 filing requirements with greater flexibility in satisfying their requirements.

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Codification of Several Staff Positions

In the 2007 Proposing Release, we proposed to codify several interpretive positions issued by the staff of the Division of Corporation Finance. We proposed to codify the first three staff positions listed below in both the 1997 Proposing Release and the 2007 Proposing Release, but we proposed to codify the last four staff positions listed below only in the 2007 Proposing Release.

Some commenters expressed general support for the proposed codifications of staff interpretations relating to Rule 144. One commenter specifically expressed the view that the action should help to resolve any lingering confusion regarding the calculation of holding periods in the circumstances addressed by the interpretations. We are adopting all of the codifications substantially as proposed. The codifications should make these interpretations more transparent and readily available to the public.

Securities Acquired under Section 4(6) of the Securities Act are Considered "Restricted Securities"

In 1997, we first proposed to codify the Division of Corporation Finance's interpretive position that securities acquired from the issuer pursuant to an exemption from registration under Section 4(6) of the Securities Act are considered "restricted securities" under Rule 144(a)(3). We did not receive any comments on this proposal at the time. In the 2007 Proposing Release, we again proposed to codify this position. We did not receive any comments.

Section 4(6) provides for an exemption from registration for an offering that does not exceed $5,000,000 that is made only to accredited investors, that does not involve any advertising or public solicitation by the issuer or anyone acting on the issuer's behalf and for which a Form D has been filed. Because the resale status of securities acquired in Section 4(6) exempt transactions should be the same as securities received in other non-public offerings that are included in the definition of restricted securities, we are of the view that securities acquired under Section 4(6) should be defined as restricted securities for purposes of Rule 144. Therefore, we are adopting an amendment to add securities acquired under Section 4(6) of the Securities Act to the definition of restricted securities, as proposed.

Tacking of Holding Periods When a Company Reorganizes into a Holding Company Structure

In 1997, we also proposed to codify the Division of Corporation Finance's interpretive position that holders may tack the Rule 144 holding period in connection with transactions made solely to form a holding company. When "tacking," holders may count the period during which they held the restricted securities of the predecessor company before the predecessor company reorganized into a holding company structure when calculating the holding period of the restricted securities of the holding company received in the reorganization. We did not receive any comments on this proposal.

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We again proposed to codify this interpretive position in the 2007 Proposing Release. Two commenters recommended codification of the staff interpretive position covering tacking, in certain circumstances, in connection with the reincorporation of the issuer in a different state. We did not receive any comments opposing this proposal.

We are adopting this amendment to Rule 144(d), as proposed. This provision will permit tacking of the holding period if the following three conditions are satisfied:

- The newly formed holding company's securities were issued solely in exchange for the securities of the predecessor company as part of a reorganization of the predecessor company into a holding company structure;
- Security holders received securities of the same class evidencing the same proportional interest in the holding company as they held in the predecessor company, and the rights and interests of the holders of such securities are substantially the same as those they possessed as holders of the predecessor company's securities; and
- Immediately following the transaction, the holding company had no significant assets other than securities of the predecessor and its existing subsidiaries and had substantially the same assets and liabilities on a consolidated basis as the predecessor had before the transaction.

In such transactions, tacking is appropriate because the securities being exchanged are substantially equivalent, and there is no significant change in the economic risk of the investment in the restricted securities. The amendment that we are adopting does not change the staff interpretive position that permits tacking in connection with the reincorporation of the issuer in a different state in certain situations.

Tacking of Holding Periods for Conversions and Exchanges of Securities

The 1997 Proposing Release proposed codifying the Division of Corporation Finance's position that, if the securities to be sold were acquired from the issuer solely in exchange for other securities of the same issuer, the newly acquired securities shall be deemed to have been acquired at the same time as the securities surrendered for conversion or exchange, even if the securities surrendered were not convertible or exchangeable by their terms. As noted in the 1997 release, Rule 144 does not state whether the surrendered securities must have been convertible by their terms in order for tacking to be permitted, which led to some confusion on how to calculate the Rule 144 holding period. We did not receive any comments on this proposal.

We again proposed this amendment to Rule 144(d)(3)(ii) in the 2007 Proposing Release. In addition, we proposed a note to this provision that clarifies the Division's position that if:

- The original securities do not permit cashless conversion or exchange by their terms;

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- The parties amend the original securities to allow for cashless conversion or exchange; and
- The security holder provides consideration, other than solely securities of the issuer, for that amendment,

then the newly acquired securities will be deemed to have been acquired on the date that the original securities were so amended.

One commenter expressed support for this proposed amendment. Another commenter provided a suggestion for a technical change to the proposed note, that the phrase "so long as the conversion or exchange itself meets the conditions of this section," be deleted. We are adopting the changes to Rule 144(d), substantially as proposed. In response to comment, we are further clarifying the note to Rule 144(d)(3)(ii) to clarify that the newly acquired securities shall be deemed to have been acquired at the same time as the amendment to the surrendered securities, so long as, in the conversion or exchange, the securities to be sold were acquired from the issuer solely in exchange for other securities of the same issuer.

Cashless Exercise of Options and Warrants

Aggregation of Pledged Securities

Treatment of Securities Issued by "Reporting and Non-Reporting Shell Companies"

Representations Required from Security Holders Relying on Exchange Act Rule 10b5-1(c)

Conforming and Other Amendments

Regulation S Distribution Compliance Period for Category Three Issuers

The purpose of the distribution compliance period in Regulation S is to ensure that during the offering period and in the subsequent aftermarket trading that takes place offshore, the persons complying with the Rule 903 safe harbor (issuers, distributors and their affiliates) are not engaged in an unregistered, non-exempt distribution of securities into the United States capital markets. In the 2007 Proposing Release, we requested comment on whether to amend Regulation S to conform the one-year distribution compliance period in Rule 903(b)(3)(iii) for Category 3 issuers (U.S. reporting issuers) to the proposed six-month Rule 144(d) holding period, or to retain the one-year distribution compliance period.

Several commenters recommended revising the Regulation S distribution compliance period in Rule 903(b)(3)(iii) to coincide with the six-month holding period under a revised Rule 144. Commenters reasoned, among other things, that such a revision is logical and would promote consistency among the rules. We did not receive any comment letters objecting to such an amendment to Regulation S.

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When Regulation S was amended in 1998, the distribution compliance period was revised to coincide with the Rule 144(d) holding period. In making this revision, we noted that a distribution compliance period that is longer than the Rule 144 holding period is unnecessary and could be confusing to apply. For the same reason, we are amending Regulation S to conform the distribution compliance period in Rule 903(b)(3)(iii) for Category 3 reporting issuers to the amendments to the Rule 144 holding period. As a result, U.S. reporting issuers will be subject to a distribution compliance period of six months under Regulation S. * * *

Rule 144 as amended

§ 230.144 Persons deemed not to be engaged in a distribution and therefore not underwriters.

Preliminary Note: Certain basic principles are essential to an understanding of the registration requirements in the Securities Act of 1933 (the Act or the Securities Act) and the purposes underlying Rule 144:

> 1. If any person sells a non-exempt security to any other person, the sale must be registered unless an exemption can be found for the transaction.
>
> 2. Section 4(1) of the Securities Act provides one such exemption for a transaction "by a person other than an issuer, underwriter, or dealer." Therefore, an understanding of the term "underwriter" is important in determining whether or not the Section 4(1) exemption from registration is available for the sale of the securities.

The term "underwriter" is broadly defined in Section 2(a)(11) of the Securities Act to mean any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates, or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking. The interpretation of this definition traditionally has focused on the words "with a view to" in the phrase "purchased from an issuer with a view to * * * distribution." An investment banking firm which arranges with an issuer for the public sale of its securities is clearly an "underwriter" under that section. However, individual investors who are not professionals in the securities business also may be "underwriters" if they act as links in a chain of transactions through which securities move from an issuer to the public.
Since it is difficult to ascertain the mental state of the purchaser at the time of an acquisition of securities, prior to and since the adoption of Rule 144, subsequent acts and circumstances have been considered to determine whether the purchaser took the securities "with a view to distribution" at the time of the acquisition. Emphasis has been placed on factors such as the length of time the person held the securities and whether there has been an unforeseeable change in circumstances of the holder. Experience has

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shown, however, that reliance upon such factors alone has led to uncertainty in the application of the registration provisions of the Act.

The Commission adopted Rule 144 to establish specific criteria for determining whether a person is not engaged in a distribution. Rule 144 creates a safe harbor from the Section 2(a)(11) definition of "underwriter." A person satisfying the applicable conditions of the Rule 144 safe harbor is deemed not to be engaged in a distribution of the securities and therefore not an underwriter of the securities for purposes of Section 2(a)(11). Therefore, such a person is deemed not to be an underwriter when determining whether a sale is eligible for the Section 4(1) exemption for "transactions by any person other than an issuer, underwriter, or dealer." If a sale of securities complies with all of the applicable conditions of Rule 144:

1. Any affiliate or other person who sells restricted securities will be deemed not to be engaged in a distribution and therefore not an underwriter for that transaction;

2. Any person who sells restricted or other securities on behalf of an affiliate of the issuer will be deemed not to be engaged in a distribution and therefore not an underwriter for that transaction; and

3. The purchaser in such transaction will receive securities that are not restricted securities.

Rule 144 is not an exclusive safe harbor. A person who does not meet all of the applicable conditions of Rule 144 still may claim any other available exemption under the Act for the sale of the securities. The Rule 144 safe harbor is not available to any person with respect to any transaction or series of transactions that, although in technical compliance with Rule 144, is part of a plan or scheme to evade the registration requirements of the Act.

(a) *Definitions.* The following definitions shall apply for the purposes of this section.

(1) An *affiliate* of an issuer is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer.

(2) The term *person* when used with reference to a person for whose account securities are to be sold in reliance upon this section includes, in addition to such person, all of the following persons:

(i) Any relative or spouse of such person, or any relative of such spouse, any one of whom has the same home as such person;

(ii) Any trust or estate in which such person or any of the persons specified in paragraph (a)(2)(i) of this section collectively own 10 percent or more of the total

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beneficial interest or of which any of such persons serve as trustee, executor or in any similar capacity; and

(iii) Any corporation or other organization (other than the issuer) in which such person or any of the persons specified in paragraph (a)(2)(i) of this section are the beneficial owners collectively of 10 percent or more of any class of equity securities or 10 percent or more of the equity interest.

(3) The term *restricted securities* means:

(i) Securities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering;

(ii) Securities acquired from the issuer that are subject to the resale limitations of §230.502(d) under Regulation D or §230.701(c);

(iii) Securities acquired in a transaction or chain of transactions meeting the requirements of §230.144A;

(iv) Securities acquired from the issuer in a transaction subject to the conditions of Regulation CE (§230.1001);

(v) Equity securities of domestic issuers acquired in a transaction or chain of transactions subject to the conditions of §230.901 or §230.903 under Regulation S (§230.901 through §230.905, and Preliminary Notes);

(vi) Securities acquired in a transaction made under §230.801 to the same extent and proportion that the securities held by the security holder of the class with respect to which the rights offering was made were, as of the record date for the rights offering, "restricted securities" within the meaning of this paragraph (a)(3);

(vii) Securities acquired in a transaction made under §230.802 to the same extent and proportion that the securities that were tendered or exchanged in the exchange offer or business combination were "restricted securities" within the meaning of this paragraph (a)(3); and

(viii) Securities acquired from the issuer in a transaction subject to an exemption under section 4(6) (15 U.S.C. 77d(6)) of the Act.

(4) The term *debt securities* means:

(i) Any security other than an equity security as defined in §230.405;

(ii) Non-participatory preferred stock, which is defined as non-convertible capital stock, the holders of which are entitled to a preference in payment of dividends

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and in distribution of assets on liquidation, dissolution, or winding up of the issuer, but are not entitled to participate in residual earnings or assets of the issuer; and

(iii) Asset-backed securities, as defined in §229.1101 of this chapter.

(b) *Conditions to be met*. Subject to paragraph (i) of this section, the following conditions must be met:

(1) *Non-affiliates.* (i) If the issuer of the securities is, and has been for a period of at least 90 days immediately before the sale, subject to the reporting requirements of section 13 or 15(d) of the Securities Exchange Act of 1934 (the Exchange Act), any person who is not an affiliate of the issuer at the time of the sale, and has not been an affiliate during the preceding three months, who sells restricted securities of the issuer for his or her own account shall be deemed not to be an underwriter of those securities within the meaning of section 2(a)(11) of the Act if all of the conditions of paragraphs (c)(1) and (d) of this section are met. The requirements of paragraph (c)(1) of this section shall not apply to restricted securities sold for the account of a person who is not an affiliate of the issuer at the time of the sale and has not been an affiliate during the preceding three months, provided a period of one year has elapsed since the later of the date the securities were acquired from the issuer or from an affiliate of the issuer.

(ii) If the issuer of the securities is not, or has not been for a period of at least 90 days immediately before the sale, subject to the reporting requirements of section 13 or 15(d) of the Exchange Act, any person who is not an affiliate of the issuer at the time of the sale, and has not been an affiliate during the preceding three months, who sells restricted securities of the issuer for his or her own account shall be deemed not to be an underwriter of those securities within the meaning of section 2(a)(11) of the Act if the condition of paragraph (d) of this section is met.

(2) *Affiliates or persons selling on behalf of affiliates.* Any affiliate of the issuer, or any person who was an affiliate at any time during the 90 days immediately before the sale, who sells restricted securities, or any person who sells restricted or any other securities for the account of an affiliate of the issuer of such securities, or any person who sells restricted or any other securities for the account of a person who was an affiliate at any time during the 90 days immediately before the sale, shall be deemed not to be an underwriter of those securities within the meaning of section 2(a)(11) of the Act if all of the conditions of this section are met.

(c) *Current public information.* Adequate current public information with respect to the issuer of the securities must be available. Such information will be deemed to be available only if the applicable condition set forth in this paragraph is met:

(1) *Reporting issuers.* The issuer is, and has been for a period of at least 90 days immediately before the sale, subject to the reporting requirements of section 13 or 15(d) of the Exchange Act and has filed all required reports under section 13 or 15(d) of the

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Exchange Act, as applicable, during the 12 months preceding such sale (or for such shorter period that the issuer was required to file such reports), other than Form 8–K reports (§249.308 of this chapter); or

(2) *Non-reporting issuers.* If the issuer is not subject to the reporting requirements of section 13 or 15(d) of the Exchange Act, there is publicly available the information concerning the issuer specified in paragraphs (a)(5)(i) to (xiv), inclusive, and paragraph (a)(5)(xvi) of §240.15c2–11 of this chapter, or, if the issuer is an insurance company, the information specified in section 12(g)(2)(G)(i) of the Exchange Act (15 U.S.C. 78 *l* (g)(2)(G)(i)).

Note to §230.144(c). With respect to paragraph (c)(1), the person can rely upon:

> 1. A statement in whichever is the most recent report, quarterly or annual, required to be filed and filed by the issuer that such issuer has filed all reports required under section 13 or 15(d) of the Exchange Act, as applicable, during the preceding 12 months (or for such shorter period that the issuer was required to file such reports), other than Form 8–K reports (§249.308 of this chapter), and has been subject to such filing requirements for the past 90 days; or
>
> 2. A written statement from the issuer that it has complied with such reporting requirements.
> 3. Neither type of statement may be relied upon, however, if the person knows or has reason to believe that the issuer has not complied with such requirements.

(d) *Holding period for restricted securities.* If the securities sold are restricted securities, the following provisions apply:

(1) *General rule.* (i) If the issuer of the securities is, and has been for a period of at least 90 days immediately before the sale, subject to the reporting requirements of section 13 or 15(d) of the Exchange Act, a minimum of six months must elapse between the later of the date of the acquisition of the securities from the issuer, or from an affiliate of the issuer, and any resale of such securities in reliance on this section for the account of either the acquiror or any subsequent holder of those securities.

(ii) If the issuer of the securities is not, or has not been for a period of at least 90 days immediately before the sale, subject to the reporting requirements of section 13 or 15(d) of the Exchange Act, a minimum of one year must elapse between the later of the date of the acquisition of the securities from the issuer, or from an affiliate of the issuer, and any resale of such securities in reliance on this section for the account of either the acquiror or any subsequent holder of those securities.

(iii) If the acquiror takes the securities by purchase, the holding period shall not begin until the full purchase price or other consideration is paid or given by the person acquiring the securities from the issuer or from an affiliate of the issuer.

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(2) *Promissory notes, other obligations or installment contracts.* Giving the issuer or affiliate of the issuer from whom the securities were purchased a promissory note or other obligation to pay the purchase price, or entering into an installment purchase contract with such seller, shall not be deemed full payment of the purchase price unless the promissory note, obligation or contract:

(i) Provides for full recourse against the purchaser of the securities;

(ii) Is secured by collateral, other than the securities purchased, having a fair market value at least equal to the purchase price of the securities purchased; and

(iii) Shall have been discharged by payment in full prior to the sale of the securities.

(3) *Determination of holding period.* The following provisions shall apply for the purpose of determining the period securities have been held:

(i) *Stock dividends, splits and recapitalizations.* Securities acquired from the issuer as a dividend or pursuant to a stock split, reverse split or recapitalization shall be deemed to have been acquired at the same time as the securities on which the dividend or, if more than one, the initial dividend was paid, the securities involved in the split or reverse split, or the securities surrendered in connection with the recapitalization.

(ii) *Conversions and exchanges*. If the securities sold were acquired from the issuer solely in exchange for other securities of the same issuer, the newly acquired securities shall be deemed to have been acquired at the same time as the securities surrendered for conversion or exchange, even if the securities surrendered were not convertible or exchangeable by their terms.

Note to §230.144(d)(3)(ii). If the surrendered securities originally did not provide for cashless conversion or exchange by their terms and the holder provided consideration, other than solely securities of the same issuer, in connection with the amendment of the surrendered securities to permit cashless conversion or exchange, then the newly acquired securities shall be deemed to have been acquired at the same time as such amendment to the surrendered securities, so long as, in the conversion or exchange, the securities sold were acquired from the issuer solely in exchange for other securities of the same issuer.

(iii) *Contingent issuance of securities.* Securities acquired as a contingent payment of the purchase price of an equity interest in a business, or the assets of a business, sold to the issuer or an affiliate of the issuer shall be deemed to have been acquired at the time of such sale if the issuer or affiliate was then committed to issue the securities subject only to conditions other than the payment of further consideration for such securities. An agreement entered into in connection with any such purchase to remain in the employment of, or not to compete with, the issuer or affiliate or the rendering of services pursuant to such agreement shall not be deemed to be the payment of further consideration for such securities.

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(iv) *Pledged securities.* Securities which are bona-fide pledged by an affiliate of the issuer when sold by the pledgee, or by a purchaser, after a default in the obligation secured by the pledge, shall be deemed to have been acquired when they were acquired by the pledgor, except that if the securities were pledged without recourse they shall be deemed to have been acquired by the pledgee at the time of the pledge or by the purchaser at the time of purchase.

(v) *Gifts of securities.* Securities acquired from an affiliate of the issuer by gift shall be deemed to have been acquired by the donee when they were acquired by the donor.

(vi) *Trusts.* Where a trust settlor is an affiliate of the issuer, securities acquired from the settlor by the trust, or acquired from the trust by the beneficiaries thereof, shall be deemed to have been acquired when such securities were acquired by the settlor.

(vii) *Estates.* Where a deceased person was an affiliate of the issuer, securities held by the estate of such person or acquired from such estate by the estate beneficiaries shall be deemed to have been acquired when they were acquired by the deceased person, except that no holding period is required if the estate is not an affiliate of the issuer or if the securities are sold by a beneficiary of the estate who is not such an affiliate.
Note to §230.144(d)(3)(vii). While there is no holding period or amount limitation for estates and estate beneficiaries which are not affiliates of the issuer, paragraphs (c) and (h) of this section apply to securities sold by such persons in reliance upon this section.
(viii) *Rule 145(a) transactions.* The holding period for securities acquired in a transaction specified in §230.145(a) shall be deemed to commence on the date the securities were acquired by the purchaser in such transaction, except as otherwise provided in paragraphs (d)(3)(ii) and (ix) of this section.

(ix) *Holding company formations.* Securities acquired from the issuer in a transaction effected solely for the purpose of forming a holding company shall be deemed to have been acquired at the same time as the securities of the predecessor issuer exchanged in the holding company formation where:

> (A) The newly formed holding company's securities were issued solely in exchange for the securities of the predecessor company as part of a reorganization of the predecessor company into a holding company structure;
> (B) Holders received securities of the same class evidencing the same proportional interest in the holding company as they held in the predecessor, and the rights and interests of the holders of such securities are substantially the same as those they possessed as holders of the predecessor company's securities; and
> (C) Immediately following the transaction, the holding company has no significant assets other than securities of the predecessor company and its existing subsidiaries and has substantially the same assets and liabilities on a consolidated basis as the predecessor company had before the transaction.
> (x) *Cashless exercise of options and warrants.* If the securities sold were acquired from the issuer solely upon cashless exercise of options or warrants issued by the

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issuer, the newly acquired securities shall be deemed to have been acquired at the same time as the exercised options or warrants, even if the options or warrants exercised originally did not provide for cashless exercise by their terms.

Note 1 to §230.144(d)(3)(x). If the options or warrants originally did not provide for cashless exercise by their terms and the holder provided consideration, other than solely securities of the same issuer, in connection with the amendment of the options or warrants to permit cashless exercise, then the newly acquired securities shall be deemed to have been acquired at the same time as such amendment to the options or warrants so long as the exercise itself was cashless.

Note 2 to §230.144(d)(3)(x). If the options or warrants are not purchased for cash or property and do not create any investment risk to the holder, as in the case of employee stock options, the newly acquired securities shall be deemed to have been acquired at the time the options or warrants are exercised, so long as the full purchase price or other consideration for the newly acquired securities has been paid or given by the person acquiring the securities from the issuer or from an affiliate of the issuer at the time of exercise.

(e) *Limitation on amount of securities sold.* Except as hereinafter provided, the amount of securities sold for the account of an affiliate of the issuer in reliance upon this section shall be determined as follows:

(1) If any securities are sold for the account of an affiliate of the issuer, regardless of whether those securities are restricted, the amount of securities sold, together with all sales of securities of the same class sold for the account of such person within the preceding three months, shall not exceed the greatest of:

(i) One percent of the shares or other units of the class outstanding as shown by the most recent report or statement published by the issuer, or

(ii) The average weekly reported volume of trading in such securities on all national securities exchanges and/or reported through the automated quotation system of a registered securities association during the four calendar weeks preceding the filing of notice required by paragraph (h), or if no such notice is required the date of receipt of the order to execute the transaction by the broker or the date of execution of the transaction directly with a market maker, or

(iii) The average weekly volume of trading in such securities reported pursuant to an *effective transaction reporting plan* or an *effective national market system plan* as those terms are defined in §242.600 of this chapter during the four-week period specified in paragraph (e)(1)(ii) of this section.

(2) If the securities sold are debt securities, then the amount of debt securities sold for the account of an affiliate of the issuer, regardless of whether those securities are restricted, shall not exceed the greater of the limitation set forth in paragraph (e)(1) of this section or, together with all sales of securities of the same tranche (or class when the securities

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are non-participatory preferred stock) sold for the account of such person within the preceding three months, ten percent of the principal amount of the tranche (or class when the securities are non-participatory preferred stock) attributable to the securities sold.

(3) *Determination of amount.* For the purpose of determining the amount of securities specified in paragraph (e)(1) of this section and, as applicable, paragraph (e)(2) of this section, the following provisions shall apply:

(i) Where both convertible securities and securities of the class into which they are convertible are sold, the amount of convertible securities sold shall be deemed to be the amount of securities of the class into which they are convertible for the purpose of determining the aggregate amount of securities of both classes sold;

(ii) The amount of securities sold for the account of a pledgee of those securities, or for the account of a purchaser of the pledged securities, during any period of three months within six months (or within one year if the issuer of the securities is not, or has not been for a period of at least 90 days immediately before the sale, subject to the reporting requirements of section 13 or 15(d) of the Exchange Act) after a default in the obligation secured by the pledge, and the amount of securities sold during the same three-month period for the account of the pledgor shall not exceed, in the aggregate, the amount specified in paragraph (e)(1) or (2) of this section, whichever is applicable;
Note to §230.144(e)(3)(ii). Sales by a pledgee of securities pledged by a borrower will not be aggregated under paragraph (e)(3)(ii) with sales of the securities of the same issuer by other pledgees of such borrower in the absence of concerted action by such pledgees.

(iii) The amount of securities sold for the account of a donee of those securities during any three-month period within six months (or within one year if the issuer of the securities is not, or has not been for a period of at least 90 days immediately before the sale, subject to the reporting requirements of section 13 or 15(d) of the Exchange Act) after the donation, and the amount of securities sold during the same three-month period for the account of the donor, shall not exceed, in the aggregate, the amount specified in paragraph (e)(1) or (2) of this section, whichever is applicable;

(iv) Where securities were acquired by a trust from the settlor of the trust, the amount of such securities sold for the account of the trust during any three-month period within six months (or within one year if the issuer of the securities is not, or has not been for a period of at least 90 days immediately before the sale, subject to the reporting requirements of section 13 or 15(d) of the Exchange Act) after the acquisition of the securities by the trust, and the amount of securities sold during the same three-month period for the account of the settlor, shall not exceed, in the aggregate, the amount specified in paragraph (e)(1) or (2) of this section, whichever is applicable;

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(v) The amount of securities sold for the account of the estate of a deceased person, or for the account of a beneficiary of such estate, during any three-month period and the amount of securities sold during the same three-month period for the account of the deceased person prior to his death shall not exceed, in the aggregate, the amount specified in paragraph (e)(1) or (2) of this section, whichever is applicable: *Provided,* that no limitation on amount shall apply if the estate or beneficiary of the estate is not an affiliate of the issuer;

(vi) When two or more affiliates or other persons agree to act in concert for the purpose of selling securities of an issuer, all securities of the same class sold for the account of all such persons during any three-month period shall be aggregated for the purpose of determining the limitation on the amount of securities sold;

(vii) The following sales of securities need not be included in determining the amount of securities to be sold in reliance upon this section:

(A) Securities sold pursuant to an effective registration statement under the Act;
(B) Securities sold pursuant to an exemption provided by Regulation A (§230.251 through §230.263) under the Act;

(C) Securities sold in a transaction exempt pursuant to section 4 of the Act (15 U.S.C. 77d) and not involving any public offering; and

(D) Securities sold offshore pursuant to Regulation S (§230.901 through §230.905, and Preliminary Notes) under the Act.

(f) *Manner of sale.* (1) The securities shall be sold in one of the following manners:

(i) *Brokers' transactions* within the meaning of section 4(4) of the Act;

(ii) Transactions directly with a *market maker*, as that term is defined in section 3(a)(38) of the Exchange Act; or

(iii) *Riskless principal transactions* where:

(A) The offsetting trades must be executed at the same price (exclusive of an explicitly disclosed markup or markdown, commission equivalent, or other fee);

(B) The transaction is permitted to be reported as riskless under the rules of a self-regulatory organization; and

(C) The requirements of paragraphs (g)(2)(applicable to any markup or markdown, commission equivalent, or other fee), (g)(3), and (g)(4) of this section are met.

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Note to §230.144(f)(1): For purposes of this paragraph, a *riskless principal transaction* means a principal transaction where, after having received from a customer an order to buy, a broker or dealer purchases the security as principal in the market to satisfy the order to buy or, after having received from a customer an order to sell, sells the security as principal to the market to satisfy the order to sell.

(2) The person selling the securities shall not:

(i) Solicit or arrange for the solicitation of orders to buy the securities in anticipation of or in connection with such transaction, or

(ii) Make any payment in connection with the offer or sale of the securities to any person other than the broker or dealer who executes the order to sell the securities.

(3) Paragraph (f) of this section shall not apply to:

(i) Securities sold for the account of the estate of a deceased person or for the account of a beneficiary of such estate provided the estate or estate beneficiary is not an affiliate of the issuer; or

(ii) Debt securities.

(g) *Brokers' transactions.* The term *brokers' transactions* in section 4(4) of the Act shall for the purposes of this rule be deemed to include transactions by a broker in which such broker:

(1) Does no more than execute the order or orders to sell the securities as agent for the person for whose account the securities are sold;

(2) Receives no more than the usual and customary broker's commission;

(3) Neither solicits nor arranges for the solicitation of customers' orders to buy the securities in anticipation of or in connection with the transaction; *Provided,* that the foregoing shall not preclude:

(i) Inquiries by the broker of other brokers or dealers who have indicated an interest in the securities within the preceding 60 days;

(ii) Inquiries by the broker of his customers who have indicated an unsolicited bona fide interest in the securities within the preceding 10 business days;

(iii) The publication by the broker of bid and ask quotations for the security in an inter-dealer quotation system provided that such quotations are incident to the maintenance of a bona fide inter-dealer market for the security for the broker's own account and that the broker has published

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bona fide bid and ask quotations for the security in an inter-dealer quotation system on each of at least twelve days within the preceding thirty calendar days with no more than four business days in succession without such two-way quotations; or

(iv) The publication by the broker of bid and ask quotations for the security in an alternative trading system, as defined in §242.300 of this chapter, provided that the broker has published bona fide bid and ask quotations for the security in the alternative trading system on each of the last twelve business days; and
Note to §230.144(g)(3)(ii). The broker should obtain and retain in his files written evidence of indications of bona fide unsolicited interest by his customers in the securities at the time such indications are received.

(4) After reasonable inquiry is not aware of circumstances indicating that the person for whose account the securities are sold is an underwriter with respect to the securities or that the transaction is a part of a distribution of securities of the issuer. Without limiting the foregoing, the broker shall be deemed to be aware of any facts or statements contained in the notice required by paragraph (h) of this section.

Notes: (i) The broker, for his own protection, should obtain and retain in his files a copy of the notice required by paragraph (h) of this section.
(ii) The reasonable inquiry required by paragraph (g)(3) of this section should include, but not necessarily be limited to, inquiry as to the following matters:

(*a*) The length of time the securities have been held by the person for whose account they are to be sold. If practicable, the inquiry should include physical inspection of the securities;

(*b*) The nature of the transaction in which the securities were acquired by such person;

(*c*) The amount of securities of the same class sold during the past 3 months by all persons whose sales are required to be taken into consideration pursuant to paragraph (e) of this section;

(*d*) Whether such person intends to sell additional securities of the same class through any other means;

(*e*) Whether such person has solicited or made any arrangement for the solicitation of buy orders in connection with the proposed sale of securities;

(*f*) Whether such person has made any payment to any other person in connection with
the proposed sale of the securities; and

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(*g*) The number of shares or other units of the class outstanding, or the relevant trading volume.

(h) *Notice of proposed sale.* (1) If the amount of securities to be sold in reliance upon this rule during any period of three months exceeds 5,000 shares or other units or has an aggregate sale price in excess of $50,000, three copies of a notice on Form 144 (§239.144 of this chapter) shall be filed with the Commission. If such securities are admitted to trading on any national securities exchange, one copy of such notice also shall be transmitted to the principal exchange on which such securities are admitted.
(2) The Form 144 shall be signed by the person for whose account the securities are to be sold and shall be transmitted for filing concurrently with either the placing with a broker of an order to execute a sale of securities in reliance upon this rule or the execution directly with a market maker of such a sale. Neither the filing of such notice nor the failure of the Commission to comment on such notice shall be deemed to preclude the Commission from taking any action that it deems necessary or appropriate with respect to the sale of the securities referred to in such notice. The person filing the notice required by this paragraph shall have a bona fide intention to sell the securities referred to in the notice within a reasonable time after the filing of such notice.

(i) *Unavailability to securities of issuers with no or nominal operations and no or nominal non-cash assets.* (1) This section is not available for the resale of securities initially issued by an issuer defined below:

(i) An issuer, other than a business combination related shell company, as defined in §230.405, or an asset-backed issuer, as defined in Item 1101(b) of Regulation AB (§229.1101(b) of this chapter), that has:
(A) No or nominal operations; and
(B) Either:
(*1*) No or nominal assets;
(*2*) Assets consisting solely of cash and cash equivalents; or
(*3*) Assets consisting of any amount of cash and cash equivalents and nominal other assets; or
(ii) An issuer that has been at any time previously an issuer described in paragraph (i)(1)(i).

(2) Notwithstanding paragraph (i)(1), if the issuer of the securities previously had been an issuer described in paragraph (i)(1)(i) but has ceased to be an issuer described in paragraph (i)(1)(i); is subject to the reporting requirements of section 13 or 15(d) of the Exchange Act; has filed all reports and other materials required to be filed by section 13 or 15(d) of the Exchange Act, as applicable, during the preceding 12 months (or for such shorter period that the issuer was required to file such reports and materials), other than Form 8-K reports (§249.308 of this chapter); and has filed current “Form 10 information” with the Commission reflecting its status as an entity that is no longer an issuer described in paragraph (i)(1)(i), then those securities may be sold subject to the requirements of this section after one year has elapsed from the date that the issuer filed “Form 10 information” with the Commission.

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(3) The term "Form 10 information" means the information that is required by Form 10 or Form 20-F (§249.210 or §249.220f of this chapter), as applicable to the issuer of the securities, to register under the Exchange Act each class of securities being sold under this rule. The issuer may provide the Form 10 information in any filing of the issuer with the Commission. The Form 10 information is deemed filed when the initial filing is made with the Commission.

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V. CHAPTER 6, INTRODUCTION TO ACCOUNTING FOR MERGERS AND ACQUISITIONS

A. Page 347, New Sec. 6.4.C. FASB Summary of Statement No. 141 Revised (2007)

Page 347, New Sec. 6.4.C. Add before Sec. 6.5 the following:
New Sec. 6.4.C. **FASB Summary of Statement No. 141 Revised (2007)**

FASB Summary of Statement No. 141 (revised 2007)

BUSINESS COMBINATIONS

SUMMARY

Why Is the FASB Issuing This Statement?

The objective of this Statement is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial reports about a business combination and its effects. To accomplish that, this Statement establishes principles and requirements for how the acquirer:

- Recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree
- Recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase
- Determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.

What Is the Scope of This Statement?

This Statement applies to all transactions or other events in which an entity (the acquirer) obtains control of one or more businesses (the acquirer), including those sometimes referred to as "true mergers" or "mergers of equals" and combinations achieved without the transfer of consideration, for example, by contract alone or through the lapse of minority veto rights. This Statement applies to all business entities, including mutual entities that previously used the pooling-of-interests method of accounting for some business combinations. It does not apply to:

- The formation of a joint venture
- The acquisition of an asset or a group of assets that does not constitute a business
- A combination between entities or businesses under common control
- A combination between not-for-profit organizations or the acquisition of a for-profit business by a not-for-profit organization.

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How Will This Statement Improve Current Accounting Practice?

This Statement replaces FASB Statement No. 141, Business Combinations. This Statement retains the fundamental requirements in Statement 141 that the acquisition method of accounting (which Statement 141 called the purchase method) be used for all business combinations and for an acquirer to be identified for each business combination. This Statement defines the acquirer as the entity that obtains control of one or more businesses in the business combination and establishes the acquisition date as the date that the acquirer achieves control. Statement 141 did not define the acquirer, although it included guidance on identifying the acquirer, as does this Statement. This Statement's scope is broader than that of Statement 141, which applied only to business combinations in which control was obtained by transferring consideration. By applying the same method of accounting—the acquisition method—to all transactions and other events in which one entity obtains control over one or more other businesses, this Statement improves the comparability of the information about business combinations provided in financial reports.

This Statement retains the guidance in Statement 141 for identifying and recognizing intangible assets separately from goodwill. The main features of this Statement and the more significant improvements it makes to how the acquisition method was applied in accordance with Statement 141 are described below.

Recognizing and Measuring the Identifiable Assets Acquired, the Liabilities Assumed, and Any Noncontrolling Interest in the Acquiree

This Statement requires an acquirer to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date, with limited exceptions specified in the Statement. That replaces Statement 141's cost-allocation process, which required the cost of an acquisition to be allocated to the individual assets acquired and liabilities assumed based on their estimated fair values. Statement 141's guidance resulted in not recognizing some assets and liabilities at the acquisition date, and it also resulted in measuring some assets and liabilities at amounts other than their fair values at the acquisition date. For example, Statement 141 required the acquirer to include the costs incurred to effect the acquisition (acquisition-related costs) in the cost of the acquisition that was allocated to the assets acquired and the liabilities assumed. This Statement requires those costs to be recognized separately from the acquisition. In addition, in accordance with Statement 141, restructuring costs that the acquirer expected but was not obligated to incur were recognized as if they were a liability assumed at the acquisition date. This Statement requires the acquirer to recognize those costs separately from the business combination. Therefore, this Statement improves the relevance, completeness, and representational faithfulness of the information provided in financial reports about the assets acquired and the liabilities assumed in a business combination.

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This Statement also requires the acquirer in a business combination achieved in stages (sometimes referred to as a step acquisition) to recognize the identifiable assets and liabilities, as well as the noncontrolling interest in the acquiree, at the full amounts of their fair values (or other amounts determined in accordance with this Statement). In accordance with Statement 141 and related interpretative guidance, an entity that acquired another entity in a series of purchases (a step acquisition) identified the cost of each investment, the fair value of the underlying identifiable net assets acquired, and the goodwill on each step. Statement 141 did not provide guidance on measuring the noncontrolling interest's share of the consolidated subsidiary's assets and liabilities at the acquisition date. The result of applying Statement 141's guidance on recognizing and measuring assets and liabilities in a step acquisition was to measure them at a blend of historical costs and fair values—a practice that provided less relevant, representationally faithful, and comparable information than will result from applying this Statement. In addition, this Statement's requirement to measure the noncontrolling interest in the acquiree at fair value will result in recognizing the goodwill attributable to the noncontrolling interest in addition to that attributable to the acquirer, which improves the completeness of the resulting information and makes it more comparable across entities.

Assets and Liabilities Arising from Contingencies

This Statement improves the completeness of the information reported about a business combination by changing the requirements for recognizing assets acquired and liabilities assumed arising from contingencies. Statement 141 permitted deferred recognition of preacquisition contingencies until the recognition criteria for FASB Statement No. 5, Accounting for Contingencies, were met. This Statement requires an acquirer to recognize assets acquired and liabilities assumed arising from contractual contingencies as of the acquisition date, measured at their acquisition-date fair values. An acquirer is required to recognize assets or liabilities arising from all other contingencies (contractual contingencies) as of the acquisition date, measured at their acquisition-date fair values, only if it is more likely than not that they meet the definition of an asset or a liability in FASB Concepts Statement No. 6, Elements of Financial Statements. If that criterion is not met at the acquisition date, the acquirer instead accounts for a noncontractual contingency in accordance with other applicable generally accepted accounting principles, including Statement 5, as appropriate.

This Statement provides specific guidance on the subsequent accounting for assets and liabilities arising from contingencies acquired or assumed in a business combination that otherwise would be in the scope of Statement 5. It requires that an acquirer continue to report an asset or a liability arising from a contingency recognized as of the acquisition date at its acquisition-date fair value absent new information about the possible outcome of the contingency. When new information is obtained, the acquirer evaluates that new information and measures a liability at the higher of its acquisition-date fair value or the amount that would be recognized if applying Statement 5, and measures an asset at the lower of its acquisition-date fair value or the best estimate of its future settlement amount.

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Recognizing and Measuring Goodwill or a Gain from a Bargain Purchase

This Statement requires the acquirer to recognize goodwill as of the acquisition date, measured as a residual, which in most types of business combinations will result in measuring goodwill as the excess of the consideration transferred plus the fair value of any noncontrolling interest in the acquiree at the acquisition date over the fair values of the identifiable net assets acquired.

Statement 141 also required goodwill to be recognized and measured as a residual. However, as described below, this Statement improves the way in which an acquirer's obligations to make payments conditioned on the outcome of future events (often called contingent consideration) are recognized and measured, which in turn improves the measure of goodwill. This Statement also includes in the definition of contingent consideration arrangements that give the acquirer the right to the return of previously transferred consideration if specified conditions are met.

This Statement requires the acquirer to recognize contingent consideration at the acquisition date, measured at its fair value at that date. Under Statement 141, in contrast, contingent consideration obligations usually were not recognized at the acquisition date. Rather, they usually were recognized when the contingency was resolved and consideration was issued or became issuable. In addition, the issuance of additional securities or distribution of additional cash or other assets upon resolution of contingencies based on reaching particular earnings levels was recognized as an adjustment to the accounting for the business combination, but issuance of shares or distribution of assets upon resolution of contingencies based on security prices was recognized differently. This Statement therefore improves the representational faithfulness and completeness of the information provided about an acquirer's obligations and rights under contingent consideration arrangements.

A Bargain Purchase

This Statement defines a bargain purchase as a business combination in which the total acquisition-date fair value of the identifiable net assets acquired exceeds the fair value of the consideration transferred plus any noncontrolling interest in the acquiree, and it requires the acquirer to recognize that excess in earnings as a gain attributable to the acquirer. In contrast, Statement 141 required the "negative goodwill" amount to be allocated as a pro rata reduction of the amounts that otherwise would have been assigned to particular assets acquired. This Statement therefore improves the representational faithfulness and completeness of the information provided about both the acquirer's earnings during the period in which it makes a bargain purchase and the measures of the assets acquired in the bargain purchase.

What Other Changes Does This Statement Make to Existing Accounting Pronouncements?

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This Statement makes significant amendments to other Statements and other authoritative guidance. For example, this Statement supersedes FASB Interpretation No. 4, Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method, which required research and development assets acquired in a business combination that have no alternative future use to be measured at their acquisition-date fair values and then immediately charged to expense. Therefore, the acquirer will recognize separately from goodwill the acquisition-date fair values of research and development assets acquired in a business combination, which improves the representational faithfulness and completeness of the information provided in financial reports about the assets acquired in a business combination.

This Statement amends FASB Statement No. 109, Accounting for Income Taxes, to require the acquirer to recognize changes in the amount of its deferred tax benefits that are recognizable because of a business combination either in income from continuing operations in the period of the combination or directly in contributed capital, depending on the circumstances. (Such changes arise through the increase or reduction of the acquirer's valuation allowance on its previously existing deferred tax assets because of the business combination.) Previously, Statement 109 required a reduction of the acquirer's valuation allowance because of a business combination to be recognized through a corresponding reduction to goodwill or certain noncurrent assets or an increase in so-called negative goodwill. This Statement therefore improves the representational faithfulness of the information provided about the effect of a business combination on both the acquirer's deferred tax assets and the related valuation allowance and the goodwill and noncurrent assets acquired in the business combination.

This Statement makes various other amendments to the authoritative literature intended to provide additional guidance or to conform the guidance in that literature to that provided in this Statement. For example, this Statement amends FASB Statement No. 142, Goodwill and Other Intangible Assets, to, among other things, provide guidance on the impairment testing of acquired research and development intangible assets and assets that the acquirer intends not to use.
This Statement also eliminates many EITF issues and other interpretative guidance on accounting for business combinations and incorporates the parts of that guidance that remain pertinent. Therefore, in addition to improving the guidance provided about accounting for a business combination in the authoritative literature, this Statement makes that guidance easier to use.

What Is the Effect of This Statement on Convergence with International Reporting Standards?

This Statement, together with the IASB's IFRS 3, Business Combinations (as revised in 2007), completes a joint effort by the FASB and the IASB to improve financial reporting about business combinations and to promote the international convergence of accounting standards. Statement 141 and IFRS 3 (as issued in 2004) both required use of the acquisition method rather than the pooling-of-interests method to account for business combinations. In this Statement and the revised IFRS 3, the Boards in large part achieved

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their goal of reaching the same conclusions on the more significant issues involving application of the acquisition method of accounting for a business combination. Appendix G describes the substantive differences between this Statement and IFRS 3 (as revised in 2007). One significant difference is the measurement requirements for a noncontrolling interest in an acquiree. This Statement requires an acquirer to measure a noncontrolling interest at its acquisition-date fair value. IFRS 3 (as revised in 2007) provides the acquirer a choice for each business combination to measure a noncontrolling interest either at its fair value or on the basis of its proportionate interest in the identifiable net assets of the acquiree. The Boards' requirements for recognizing at the acquisition date assets and liabilities arising from contingencies also differ, in part because the IASB decided to carry forward IFRS 3's requirements for those assets and liabilities on an interim basis, pending completion of its project to revise IAS 37, Provisions, Contingent Liabilities and Contingent Assets.

What Is the Effective Date of This Statement?

This Statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. An entity may not apply it before that date. The effective date of this Statement is the same as that of the related FASB Statement No. 160, Noncontrolling Interests in Consolidated Financial Statements.

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VI. CHAPTER 7, MODERN VALUATION TECHNIQUES IN MERGERS AND ACQUISITIONS

A. Page 370, New Sec. 7.3.E. The Final Rule on Fairness Opinions by FINRA the Successor to the NASD

Page 370, New Sec. 7.3.E. Add before Sec. 7.4 the following:
New Sec. 7.3.E. **The Final Rule on Fairness Opinions by FINRA, the Successor to the NASD**

Financial Industry Regulatory Authority (FINRA)
Fairness Opinions
SEC Approves New NASD Rule 2290 Regarding
Fairness Opinions
Effective Date: December 8, 2007

BACKGROUND AND DISCUSSION

A fairness opinion addresses, from a financial point of view, the fairness of the consideration in a transaction. Fairness opinions are routinely used by directors of companies in connection with a change of control transaction, such as a merger or sale or purchase of assets, to satisfy their fiduciary duties to act with due care and in an informed manner.

Although not required by statute or regulation, fairness opinions have become commonplace in change of control transactions following the 1985 Delaware Supreme Court case of *Smith v. Van Gorkom*, 2 in which a corporate board was held to have breached its fiduciary duty of care by approving a merger without adequate information on the transaction, including information on the value of the company and the fairness of the offering price.

In addition to providing a basis for the exercise of care by the board of directors, a fairness opinion, or information about a fairness opinion, is often provided to shareholders as a part of the proxy materials relating to a change of control transaction. Fairness opinions express a conclusion as to the whether the consideration offered in a transaction is within the range of what would be considered "fair"; such opinions generally do not offer an opinion as to whether the consideration offered is the best price that could likely be attained or reach other matters, such as solvency issues, that may arise from the transaction.

Under the SEC's proxy rules, which apply to issuers, certain disclosures about potential conflicts of interest are provided to investor-shareholders. NASD Rule 2290 is a complementary rule that requires broker-dealers that render fairness opinions to inform investor-shareholders about the potential conflicts of interest that may exist between the

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firm rendering the fairness opinion and the issuer. The Rule also addresses specific procedures concerning the issuance of fairness opinions.

Disclosures Required by NASD Rule 2290(a)

The Rule sets forth the parameters when the disclosures are required to be contained in a fairness opinion. If a member firm knows or has reason to know, at the time a fairness opinion is issued to a company's board, that the opinion will be provided or described to the company's public shareholders, the firm must make the enumerated disclosures in the fairness opinion. A firm will be deemed to have a reason to know that the fairness opinion will be provided or described to public shareholders, if, for example, the structure of the transaction will require a shareholder vote. The fairness opinions covered by the Rule include those issued to the board of directors, and/or any special committee or other subset or committee of the board.

Acting as Financial Advisor and Contingent Compensation

A member firm is required to disclose if the firm has acted as a financial advisor to any party to the transaction that is the subject of the fairness opinion, and, if applicable, that it will receive compensation that is contingent upon the successful completion of the transaction, for rendering the fairness opinion and/or serving as an advisor. This requirement includes significant payments or compensation from related transactions (*e.g.*, stapled financings) if such transactions are contingent upon the completion of the transaction for which the fairness opinion was issued. This disclosure, along with the disclosures in paragraphs (a)(2) and (a)(3), requires descriptive information rather than quantitative information. In addition, FINRA notes that none of the Rule's disclosure provisions requires a member to breach any of its confidentiality obligations.

Other Significant Payment or Compensation

A member firm must disclose if it will receive any other significant payment or compensation contingent upon the successful completion of the transaction. FINRA has chosen not to establish a particular dollar or percentage figure as to what may be considered "significant" out of a concern that establishing a specific figure may become a de facto standard for such payments. Given that the nature of the provision is to inform investors of conflicts of interest, and that paragraph (a)(2) is to prevent circumvention of the provisions in paragraph (a)(1), the receipt of *de minimis* fees (such as trading fees or other small incremental fees from account assets or activity) would not be required to be disclosed. FINRA believes that a "significant" payment or contingent compensation is one that a reasonable person, who reads a fairness opinion, would have an interest in knowing about in order to assess whether the member firm authoring the fairness opinion has a potential conflict of interest.

Material Relationships

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A member firm is required to disclose any material relationships that existed during the past two years or that are mutually understood to be contemplated in which any compensation was received or is intended to be received as a result of the relationship between the firm and any party to the transaction that is the subject of the fairness opinion. FINRA notes that this disclosure requirement attaches to material relationships between the member firm and all parties to the transaction, not just the party whose board of directors selected the member firm to render the fairness opinion; *e.g.*, in the case of a takeover, a member issuing a fairness opinion to the target's board of directors would also have to disclose any material relationships it had with the acquiror. As noted above, the disclosure is not required to be quantified, but each of the material relationships should be identified in the fairness opinion.

Independent Verification of Information

A member firm is required to disclose if any information that formed a substantial basis for the fairness opinion that was supplied to the firm by the company requesting the opinion concerning the companies that are parties to the transaction has been independently verified by the firm, and if so, a description of the information or categories of information that were verified. When no information has been verified, a blanket statement to that effect is sufficient. On the other hand, if a member firm independently verifies some or all of the information supplied to it concerning the companies that are parties to the transaction, it must describe the information or the categories of information that were verified. In those instances, FINRA notes that a firm making such a representation may also wish to explain in the fairness opinion its process or standards for independent verification.

Use of Fairness Committee

A disclosure of whether or not the fairness opinion was approved or issued by a fairness committee is required. For purposes of the Rule, the term, "fairness committee" includes any committee or group that approves a fairness opinion in accordance with the requirements of paragraph (b) regardless of whether the member firm calls it a "fairness committee."

Compensation to Insiders

Finally, member firms are required to disclose whether or not the fairness opinion expresses an opinion about the fairness of the amount or nature of the compensation to any of the company's officers, directors or employees, or class of such persons, relative to the compensation to the public shareholders of the company. This disclosure highlights to the investor the potential conflict of interest between the member issuing the fairness opinion and the issuer receiving the opinion by requiring disclosure of whether the member did or did not take into account the amount and nature of compensation flowing to certain insiders relative to the benefits to shareholders in reaching a fairness determination.

Procedures Required by NASD Rule 2290(b)

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NASD Rule 2290(b) requires that any member firm issuing a fairness opinion must have written procedures for approval of a fairness opinion. The firm must have procedures regarding the types of transactions and the circumstances in which the firm will use a fairness committee to approve or issue a fairness opinion, and in those transactions in which it uses a fairness committee:

(A) the process for selecting personnel to be on the fairness committee; (B) the necessary qualifications of persons serving on the fairness committee; and (C) the process to promote a balanced review by the fairness committee, which shall include the review and approval by persons who do not serve on the deal team to the transaction.

FINRA notes that paragraph (b)(1)(C) does not require that the fairness committee be comprised entirely of persons not serving on or advising the deal team. Rather, the provision requires that the firm have procedures to promote a balanced review by including on the fairness committee persons who are not serving on the deal team. Whether a person is considered to be part of the deal team requires an analysis of the particular facts and circumstances, and will not necessarily be determined by whether a person is included on all document distributions or participated in certain meetings. The determination of whether a person is part of a deal team will depend on the nature and substance of his or her contacts and the advice rendered to the firm. Firms are also required to have a process to determine whether the valuation analyses used in the fairness opinion are appropriate.

The new rule becomes effective on December 8, 2007. An outline of the disclosure and procedural requirements under the Rule is included in Attachment B.

Fairness Opinions

Disclosures

If at the time a fairness opinion is issued to the board of directors of a company the member issuing the fairness opinion knows or has reason to know that the fairness opinion will be provided or described to the company's public shareholders, the member must disclose in the fairness opinion:

> (1) if the member has acted as a financial advisor to any party to the transaction that is the subject of the fairness opinion, and, if applicable, that it will receive compensation that is contingent upon the successful completion of the transaction, for rendering the fairness opinion and/or serving as an advisor;
> (2) if the member will receive any other significant payment or compensation contingent upon the successful completion of the transaction;
> (3) any material relationships that existed during the past two years or that are mutually understood to be contemplated in which any compensation was received or is intended to be received as a result of the relationship between the member and any party to the transaction that is the subject of the fairness opinion;

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(4) if any information that formed a substantial basis for the fairness opinion that was supplied to the member by the company requesting the opinion concerning the companies that are parties to the transaction has been independently verified by the member, and if so, a description of the information or categories of information that were verified;
(5) whether or not the fairness opinion was approved or issued by a fairness committee; and
(6) whether or not the fairness opinion expresses an opinion about the fairness of the amount or nature of the compensation to any of the company's officers, directors or employees, or class of such persons, relative to the compensation to the public shareholders of the company.

Procedures Any member issuing a fairness opinion must have written procedures for approval of a fairness opinion by the member, including: (1) the types of transactions and the circumstances in which the member will use a fairness committee to approve or issue a fairness opinion, and in those transactions in which it uses a fairness committee:
(A) the process for selecting personnel to be on the fairness committee;
(B) the necessary qualifications of persons serving on the fairness committee;
(C) the process to promote a balanced review by the fairness committee, which shall include the review and approval by persons who do not serve on the deal team to the transaction; and
(2) the process to determine whether the valuation analyses used in the fairness opinion are appropriate.

* * *

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VII. CHAPTER 8, INTRODUCTION TO ANTITRUST LAW ASPECTS OF M&A

A. Page 475, New Sec. 8.21.C. 2010 PROPOSED AMENDED GUIDELINES

Page 475, New Sec. 8.21.C. Add before Sec. 8.22:
New Sec. 8.21.C. 2010 Proposed Amended Guidelines

DOJ/FTC, Proposed Horizontal Merger Guidelines For Public Comment:
Released on April 20, 2010

OVERVIEW

These Guidelines outline the principal analytical techniques, practices, and the enforcement policy of the Department of Justice and the Federal Trade Commission (the "Agencies") with respect to mergers and acquisitions involving actual or potential competitors ("horizontal mergers") under the federal antitrust laws.[265] The relevant statutory provisions include Section 7 of the Clayton Act, 15 U.S.C. § 18, Sections 1 and 2 of the Sherman Act, 15 U.S.C. §§ 1, 2 and Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45. Most particularly, Section 7 of the Clayton Act prohibits mergers if "in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly."

The Agencies seek to identify and challenge competitively harmful mergers while avoiding unnecessary interference with mergers that are either competitively beneficial or neutral. Most merger analysis is necessarily predictive, requiring an assessment of what will likely happen if a merger proceeds as compared to what will likely happen if it does not. Given this inherent need for prediction, these Guidelines reflect the Congressional intent that merger enforcement should interdict competitive problems in their incipiency and that certainty about anticompetitive effect is seldom possible and not required for a merger to be illegal.

These Guidelines describe the principal analytical techniques and the main types of evidence on which the Agencies usually rely to predict whether a horizontal merger may

[265] These Guidelines replace the Horizontal Merger Guidelines issued in 1992, revised in 1997. They reflect the ongoing accumulation of experience at the Agencies. The Commentary on the Horizontal Merger Guidelines issued by the Agencies in 2006 remains a valuable supplement to these Guidelines. These Guidelines may be revised from time to time as necessary to reflect significant changes in enforcement policy, to clarify existing policy, or to reflect new learning. These Guidelines do not cover vertical or other types of non-horizontal acquisitions.

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substantially lessen competition. They are not intended to describe how the Agencies analyze cases other than horizontal mergers. These Guidelines are intended to assist the business community and antitrust practitioners by increasing the transparency of the analytical process underlying the Agencies' enforcement decisions. They may also assist the courts in developing an appropriate framework for interpreting and applying the antitrust laws in the horizontal merger context.

These Guidelines should be read with the awareness that merger analysis does not consist of uniform application of a single methodology. Rather, it is a fact-specific process through which the Agencies, guided by their extensive experience, apply a range of analytical tools to the reasonably available and reliable evidence to evaluate competitive concerns in a limited period of time. Where these Guidelines provide examples, they are illustrative and do not exhaust the applications of the relevant principle.[266]

The unifying theme of these Guidelines is that mergers should not be permitted to create, enhance, or entrench market power or to facilitate its exercise. For simplicity of exposition, these Guidelines generally refer to all of these effects as enhancing market power. A merger enhances market power if it is likely to encourage one or more firms to raise price, reduce output, diminish innovation, or otherwise harm customers as a result of diminished competitive constraints or incentives. In evaluating how a merger will likely change a firm's behavior, the Agencies focus primarily on how the merger affects conduct that would be most profitable for the firm.

A merger can enhance market power simply by eliminating competition between the merging parties. This effect can arise even if the merger causes no changes in the way other firms behave. Adverse competitive effects arising in this manner are referred to as "unilateral effects." A merger also can enhance market power by increasing the risk of coordinated, accommodating, or interdependent behavior among rivals. Adverse competitive effects arising in this manner are referred to as "coordinated effects." In any given case, either or both types of effects may be present, and the distinction between them may be blurred.

These Guidelines describe how the Agencies analyze mergers between rival suppliers that may enhance their market power as sellers. Enhancement of market power by sellers often elevates the prices charged to customers. For simplicity of exposition, these Guidelines generally discuss the analysis in terms of such price effects. Enhanced market power can also be manifested in non-price terms and conditions that adversely affect customers, including reduced product quality, reduced product variety, reduced service, or diminished innovation. Such non-price effects may coexist with price effects, or can arise in their absence. When the Agencies investigate whether a merger may lead to a substantial lessening of non-price competition, they employ an approach analogous to that used to evaluate price competition. Enhanced market power may also make it more likely that the merged entity can profitably and effectively engage in exclusionary conduct. Regardless of how enhanced market power likely would be manifested, the Agencies normally evaluate mergers based on their impact on customers. The Agencies

[266] These Guidelines are not intended to describe how the Agencies will conduct the litigation of cases they decide to bring. Although relevant in that context, these Guidelines neither dictate nor exhaust the range of evidence the Agencies may introduce in litigation.

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examine effects on either or both of the direct customers and the final consumers. The Agencies presume, absent convincing evidence to the contrary, that adverse effects on direct customers also cause adverse effects on final consumers.

Enhancement of market power by buyers, sometimes called “monopsony power,” has adverse effects comparable to enhancement of market power by sellers. The Agencies employ an analogous framework to analyze mergers between rival purchasers that may enhance their market power as buyers. See Section 12.

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VIII. CHAPTER 9, HART-SCOTT-RODINO PRE-MERGER NOTIFICATION

A. Page 538, New Sec. 9.6.C. 2010 Thresholds

Page 538, New Sec. 9.6.C. Add at the bottom of the page:
New Sec. 9.6.C. **Thresholds**

On February 22, 2010, the FTC promulgated revised thresholds under HSR, including adjusting (1) the $200M threshold in Section 7A(a)(2)(A) to $253.7M, and (2) the $50M threshold in Section 7A(a)(2)(B)(i) to $63.4M. These thresholds are lower than the 2009 thresholds.

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IX. CHAPTER 13, ACQUISITION OF A PUBLICLY HELD TARGET IN A NEGOTIATED MERGER

A. Page 645, New Sec. 13.7.C.4. Shareholders Seek Injunction on Revlon Claim Resulting from Deal Protection Devices—Bernal (Data Domain)

Page 645, New Sec. 13.7.C.4. Add before Sec. 13.8 the following:

New Sec. 13.7.C.4. **Shareholders Seek Injunction on Revlon Claim Resulting from Deal Protection Devices—*Bernal (Data Domain)***

Police & Fire Ret. Sys. of The City of Detroit v. Bernal
Court of Chancery of Delaware, 2009
2009 Del. Ch. LEXIS 111

OPINION BY: William B. Chandler III

Plaintiff, a shareholder of Data Domain, Inc., has moved for expedited proceedings in connection with its motion to enjoin certain provisions of the Agreement and Plan of Merger between Data Domain and NetApp, Inc (the "Merger Agreement"). In March 2009, the Data Domain board of directors began discussions with NetApp regarding a potential business combination. On May 11, at a meeting to continue discussing such a combination, the Data Domain board was informed of EMC Corporation's interest in meeting with Data Domain. A meeting was scheduled for May 27, 2009. On May 20, however, Data Domain and NetApp entered into the Merger Agreement whereby Data Domain would be merged into two NetApp subsidiaries, with the Data Domain shareholders receiving a combination of cash and NetApp stock worth approximately $ 25 for each Data Domain share.

According to plaintiff, the Merger Agreement contained a number of "deal protection mechanisms," including: (1) a "matching right" that gives NetApp five business days to revise its proposal in response to a proposal from a third party bidder; (2) a "no solicitation" clause that prevents Data Domain from soliciting the submission or announcement of another offer to acquire Data Domain; and (3) a termination fee. The board and executive officers of Data Domain also entered into a voting agreement whereby they pledged to vote their shares, representing approximately 20% of Data Domain's outstanding shares, in favor of the NetApp merger. Plaintiff argues that these measures lock up the deal between Data Domain and NetApp and dissuade interested parties from making an offer for the company. Plaintiff further alleges that Data Domain's officers and directors will receive benefits separate and apart from Data

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Domain's shareholders, including: (1) assumption and conversion of their Data Domain options, (2) indemnification from liability for matters arising from the completion of the merger, and (3) for certain individuals, positions with the company after the merger.

On June 1, EMC launched an all cash tender offer for Data Domain at a tender price of $ 30 per share. Plaintiff contends that EMC was prepared to execute an agreement if Data Domain would terminate the NetApp agreement. On June 3, NetApp increased the cash component of the merger consideration by $ 5, raising the overall value of its offer to $ 30 per share. Data Domain's board agreed to this revised offer, and left all the deal protection measures in place. The Data Domain board has stated that it is unable to negotiate with EMC because of the deal protection provisions of the Merger Agreement, and that if it failed to reject the EMC bid, Data Domain would be at risk of losing the NetApp transaction.

In deciding whether to expedite proceedings, the Court must determine "whether in the circumstances the plaintiff has articulated a sufficiently colorable claim and shown a sufficient possibility of a threatened irreparable injury, as would justify imposing on the defendants and the public the extra (and sometimes substantial) costs of an expedited preliminary injunction proceeding." At this procedural stage, I accept as true the well-pleaded factual allegations in the complaint.

Plaintiff contends that Data Domain's directors have violated their fiduciary duties in the context of a sale of control of the company, as those duties are described in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* and its progeny. Those cases counsel that when there will be a sale of control of the company, the "board must perform its fiduciary duties in the service of a specific objective: maximizing the sale price of the enterprise." Plaintiff argues that the Data Domain directors have agreed to a deal that results in a change of control because the majority of the current Data Domain shareholders' equity stakes is being paid off with cash. Thus, plaintiff alleges that the Data Domain directors breached their fiduciary duties by failing to take any steps to secure the best price reasonably available, by granting preclusive deal protection measures that deter any other bidders, and by failing to inform themselves about the possibilities for greater value to be obtained for Data Domain shareholders through the EMC bid.

Defendants, of course, contend that the board's process was reasonable, and will result in the highest reasonably available value for the Data Domain shareholders. Defendants argue that the deal protection measures are common, permissible features of merger agreements, and that the Merger Agreement advances Data Domain shareholders' interests, as evidenced by EMC's bid for Data Domain notwithstanding the deal protection measures.

While I have not done justice to the arguments presented in the parties' written submissions and during today's oral argument, I need only determine if plaintiff has stated a sufficiently *colorable* claim to justify proceeding on an expedited schedule. Here, plaintiff has stated such a colorable claim. It is well established that there is no blueprint that a board must follow to fulfill its duties in a change of control transaction. The board,

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however, must exercise its duties in service of obtaining the maximum price reasonably available for the company. Plaintiff has alleged facts that state a colorable claim that the Data Domain board is favoring one bidder over others, thereby deterring bids from third parties that could provide greater value to Data Domain shareholders. Moreover, on a motion for a preliminary injunction, the plaintiff does not have to overcome the hurdle of an exculpatory provision that, as permitted by 8 *Del. C.* § 102(b)(7), exculpates directors from personal liability for *monetary damages* for certain breaches of fiduciary duty.

Plaintiff has also established a sufficient likelihood of irreparable injury. Plaintiff alleges that the deal protection measures in the Merger Agreement are currently having an adverse impact on Data Domain shareholders by deterring potential bidders, including EMC. Harm resulting from such deterrence is incalculable. Moreover, it would be impossible to "unscramble the eggs" by attempting to unwind the merger once it has been completed. Defendants argue that plaintiff is not threatened with irreparable harm because the shareholders will have an opportunity to vote on the NetApp merger. The opportunity for a shareholder vote sometime in the future, however, does not address the alleged current deterrent effect of the deal protection measures.

Finally, I note that injunctive relief may be the only relief reasonably available to shareholders for certain breaches of fiduciary duty in connection with a sale of control transaction, particularly where the company has adopted a provision exculpating its directors from personal liability for monetary damages for breaches of the duty of care. As explained in *Lyondell Chemical Co. v. Ryan,* a plaintiff faces a significant burden in showing that a board acted in bad faith by failing to reasonably inform themselves or otherwise carry out their fiduciary duties in a sale of control.[267] Thus, in cases such as this one, the shareholders' only realistic remedy for certain breaches of fiduciary duty in connection with a sale of control transaction may be injunctive relief.

For the reasons set forth above, plaintiff's motion for expedited proceedings is granted. A preliminary injunction hearing will be held at 10:00 a.m. on Thursday, August 13, 2009 in Georgetown.

IT IS SO ORDERED.

Very Truly yours,

/s/ William B. Chandler III

William B. Chandler III

[267] Lyondell, 970 A.2d at 243-44 ("[I]f the directors failed to do all that they should have under the circumstances, they breached their duty of care. Only if they knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty.").

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B. Page 651, New Sec. 13.8.D. Target's Statements During Merger Negotiations Did Not Violate Rule 10b-5—Sears

Page 651, New Sec. 13.8.D. Add before Sec. 13.9 the following:

New Sec. 13.8.D. **Target's Statements During Merger Negotiations Did Not Violate Rule 10b-5—*Sears***

Maurice Levie v. Sears Roebuck & Co
United States District Court, Northern District of Illinois, 2009
676 F. Supp. 2d 680

OPINION BY: Robert W. Gettleman

MEMORANDUM OPINION AND ORDER

Co-lead plaintiffs Maurice Levie and H. Robert Monsky, "individually and on behalf of all others similarly situated," have brought a three count amended class action complaint against defendants Sears Roebuck & Co and its Chief Executive Officer, President and Chairman of the Board Alan J. Lacy (together, the "Sears defendants"), and ESL Partners, L.P. and its controlling person Edward S. Lampert (the "ESL defendants") alleging violations of §§ 10(b) and 20(a) of the Exchange Act, 15 U.S.C. §§ 78j(b) and 78t(a) and Rule 10b-5 promulgated thereunder by the Securities Exchange Commission ("SEC"), 17 C.F.R. § 240.10b-5. After denying defendants' motion to dismiss, *Levie v. Sears Roebuck & Co.,* 2006 U.S. Dist. LEXIS 12725, 2006 WL 756063 (N.D. Ill. 2006), the court certified a class consisting of: (1) investors who sold Sears stock during the class period (September 9, 2004 through the close of trading on November 16, 2004) and the "in-and-out" investors, but excluding short sellers except those who were in a short position at the close of trading on November 16, 2004.

After extensive discovery, each set of defendants has filed a separate motion for summary judgment. Having immersed itself in the rather extensive record, the court concludes that the following facts are uncontested:

(1) In February 2004, Lacy (of Sears) began to explore a potential transaction between Sears and Kmart. He was considering potentially acquiring Kmart by buying Kmart shares. He reached out to Lampert, who was Chairman of Kmart's Board of Directors. Both Lacy and Lampert agreed that Lampert explicitly stated that he was acting solely on behalf of Kmart and not on behalf of ESL Partners, which at that time owned greater than 5% of Sears.

(2) On March 10, 2004, Lacy told the Sears' Board of Directors that he had had very preliminary discussions with Kmart about a Sears' acquisition.

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(3) On March 16, 2004, Sears and Kmart executed a one way "Confidentiality Agreement" by which Kmart would disclose certain confidential information to Sears to allow Sears to evaluate Kmart. At this time there had been no discussion of Kmart acquiring Sears.

(4) By late April 2004 both sides agreed that there would be no broad transaction of Sears acquiring Kmart in its entirety. Instead, the parties began discussion of an "alternative transaction" with Sears purchasing specific Kmart (stand alone) stores. The Sears' Board of Directors described this alternative plan ("Plan B") as just a smaller test of the original "Plan A," in which Sears would acquire all of Kmart.

(5) On April 28, 2004, Kmart requested that Sears return or destroy the confidential information given to it pursuant to the March 16, 2004, agreement because the Sears acquisition of Kmart was no longer on the table.

(6) The following day, April 29, 2004, Lacy reported to the Sears' Board of Directors on the status of what had been termed "Project Bay" (the potential acquisition of Kmart). "Bay" was the code name for Kmart and "Harbor" was the code name for Sears. Lacy reviewed the original intent of Project Bay as a retail merger with "opportunity for a significant number of conversions into the Harbor (Sears) format." He commented on valuation estimates and expectations and governance issues, the result of which was that the "management team has reached the conclusion that a merger ("Plan A") would not be an appropriate transaction at this point in time." Lacy then described "Plan B" and the opportunity for a Sears off-mall expansion, and a report was presented regarding the purchase of Kmart stores. Sears started with 329 stores, Kmart countered with 200 stores. After modification there was a discussion in the Sears' Board of Directors of Sears' purchase of approximately 93 stores. Lacy asked for and was given permission to talk to Kmart about the 93 stores in the price range of $ 800 million to $ 1.2 billion.

(7) Sears and Kmart then entered into fairly lengthy discussions about which stores would be involved in any potential deal with the result ultimately funneling down to which stores Kmart wanted to sell and those that Sears wanted to buy.

(8) On May 19, 2004, Sears sent a letter to Kmart certifying that Sears had destroyed all confidential material given to it under the March 16, 2004, agreement except for certain information relevant to the more limited ongoing transaction.

(9) On June 30, 2004, the parties announced to the market that Sears would purchase 54 Kmart stores for $ 621 million.

(10) On August 30, 2004, Sears certified to Kmart that it had destroyed all remaining confidential information in its possession except for Board materials and materials related to the specific 54 stores to be sold. There were no longer any discussions at this point of a merger or combination of any form, and certainly there had never been any discussion of a Kmart acquisition of Sears.

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(11) For the period September 1, 2004, through October 31, 2004, there were no discussions between Sears and Kmart, Lacy or Lampert, regarding a Sears acquisition of Kmart, a Kmart acquisition of Sears, or any other form of merger or combination.

(12) On October 15, 2004, there were emails between Lacy's staff and Lampert's staff regarding an attempt to schedule a meeting for November 1, 2004. Lacy said he was preparing for talks of some sort of deal but nothing specific.

(13) On October 21, 2004, Sears announced its third quarter financial results. Lampert and Lacy spoke on the phone and set up an October 31, 2004, meeting.

(14) Also on October 21, 2004, Vernado Realty Trust told Lampert of its acquisition of a large ownership position in Sears. Lampert told Lacy of the acquisition without revealing Vernado's name. The possibility of cooperation between Sears and Kmart was identified as a topic for the October 31, 2004, meeting.

(15) On October 31, 2004, Lacy and Lampert met at Lampert's house. Lampert broached the subject of a business combination in which Kmart would acquire Sears. Sears common stock would be exchanged for Kmart common stock. This is undeniably the first time that the subject of a Kmart acquisition of Sears had come up. There was certainly no agreement at this point in time. And again, Lampert made clear that he was acting solely in his capacity as Chairman of the Board of Kmart.

(16) On November 1, 2004, Lacy reported to the Sears' Board of Directors on his conversation with Lampert. Both sides raised the subject with outside advisors.

(17) Between November 1 and November 5, 2004, Sears and Kmart senior management had internal discussions regarding strategic combinations and retained financial and legal advisors. Also on November 5, 2004, Vernado announced its acquisition of 4.3% of Sears. Sears stock jumped from $ 37.18 per share to $ 45.88 per share. Lampert viewed the announcement as a potential accelerant for something and also as potentially diminishing the chances that something would happen.

(18) On November 8 and 9, 2004, Lacy and Lampert briefed their respective board of directors on the progress of the discussions. The minutes of these meetings indicate a shared interest in accelerating talks because of the volatility of Sears shares in light of the Vernado announcement. By this time Kmart had expressed its desire to acquire Sears. The parties had talked about price and the form of consideration. There was a "general agreement" that any transaction would be a combination of stock and cash, but no ratios had been finalized and there was much work to be done. No due diligence had been done at this time.

(19) On November 10, 2004, Sears and Kmart executed a new confidentiality agreement that allowed Kmart to examine Sears' confidential materials. This was the first time that Kmart had seen Sears' information.

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(20) Two days later, on Friday, November 12, 2004, Kmart's counsel sent Sears' counsel an initial draft. That weekend, November 13 and 14, 2004, Kmart and its financial advisor Lehman Brothers, and Sears and its advisor Morgan Stanley performed due diligence in New York. A draft contract was reviewed and revised by both sides.

(21) On November 13, 2004, a new draft was re-circulated that contained the first reference to a support agreement by ESL to a change in the ownership of Sears.

(22) In an email two days later on November 15, 2004, Sears' financial advisor estimated a 50-50 chance for an announcement on Wednesday and a 50-50 chance for a deal. At that point, at 8:32 a.m. on November 15, 2004, it is clear that the parties had not yet reached an agreement. Two and a half hours later, however, Lampert and Lacy reached a handshake deal to present to their respective boards.

(23) The following day on November 16, 2004, both boards approved a deal, with final approval coming from Sears' board at approximately 4:00 p.m.

(24) On November 17, 2004, before the exchanges opened the transaction was publically announced.

DISCUSSION

The Sears Defendants
In Count II, plaintiffs allege that the Sears defendants violated § 10(b) and Rule 10b-5 by failing to disclose the merger negotiations during the class period. Section 10(b) and Rule 10b-5 make it unlawful for any person "to make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5(b). In their motion to dismiss the Sears defendants argued that they were under no duty to disclose any discussions, relying on the general proposition that silence, absent a duty to disclose, is not misleading under Rule 10b-5. *Basic Inc v. Levinson,* 485 U.S. 224, 239 n.17, 108 S. Ct. 978, 99 L. Ed. 2d 194 (1988). They then argued that because under Seventh Circuit precedent merger negotiations do not become "material" until the price and structure of the deal have become agreed upon, which did not happen until immediately before the merger announcement, any announcement made by Sears during the class period could not create a duty to disclose the merger negotiations because those negotiations had not yet become material.

The court rejected this argument because under *Basic,* the materiality of merger negotiations "depends upon the probability that the transaction will be consummated and its significance to the issuer of the securities. This determination is fact-specific and must be made on a case by case basis" and cannot be decided on a motion to dismiss. Because Rule 10b-5 makes it unlawful for any person to omit a material fact necessary to make a statement made in light of the circumstances under which it was made not misleading,

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this court concluded *(Levie v. Sears Roebuck & Co.,* 2006 U.S. Dist. LEXIS 12725, 2006 WL 756063 at * 5):

> If the merger negotiations became material at a point in time when the Sears defendants were making announcements about the purchase of Kmart stores, a jury could find that the existence of the merger negotiations was a material fact necessary to make the store purchase statements not misleading.

The Sears defendants' current motion for summary judgment, now buttressed by the undisputed facts set out above, argues that they were correct all along. First, the facts demonstrate that the merger negotiations began on October 31, 2004, not prior to the start of the class period as alleged in the complaint. Second, the Sears defendants argue that the facts show that they were never under a duty to disclose the negotiations, even after they became material.

Because there is no general duty to disclose merger negotiations even when material, *Basic,* 485 U.S. at 239 n.17, plaintiffs' case is premised entirely on the omission to disclose the merger negotiations in order to make the statements made during the class period non-misleading. The complaint identifies and plaintiffs rely on five class period statements made by Sears to create the duty to disclose. To determine whether plaintiffs' case can survive summary judgment, the court must analyze those statements, including when they were made, and then compare them to the state of the discussions between Sears and Kmart, to determine if the statements made were misleading in light of those discussions.

Three of the statements on which plaintiffs rely, a presentation by Sears' CFO Glenn Richter at a September 9, 2004, conference setting out Sears' strategic objectives, a September 29, 2004, press release announcing the completion of the acquisition of the 50 Kmart stores, and the October 21, 2004, press release announcing Sears' third quarter earnings, predate the start of the merger negotiations on October 31, 2004. Obviously, these statements could not create a duty to disclose something that had yet to occur. *Stransky v. Cummins Engine Co., Inc.,* 51 F.3d 1329, 1332 (7th Cir. 1995) (Rule 10b-5 "implicitly precludes basing liability on circumstances that arise after the speaker makes the statement.").[268]

The next statement upon which plaintiffs rely to create a duty to disclose the merger negotiations is Sears' November 5, 2004, response to Vernado's announcement that it had acquired a 4.3% interest in Sears' equity. In response to Vernado's announcement, Sears released a statement to certain members of the press:

> We are pleased that Vernado sees value in our stock. We are taking strong, concerted actions to improve our full-line store performance, continuing to

[268] This same reasoning applies to plaintiffs' claim that Sears violated Rule 10b-5 by engaging in a repurchase plan without disclosing the potential merger. It is undisputed that Sears had ceased repurchasing its stock prior to October 31, 2004.

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> expand our direct-to-customer channels and building our home services business, while simultaneously pursuing an aggressive off-mall growth strategy.

For this statement to be actionable, plaintiffs must show that it was misleading in light of the circumstances under which it was made, which would then require Sears to provide material facts it had omitted, in order to make this statement non-misleading. In other words, the statement must have been misleading in light of the merger negotiations that had, at that point in time, already become material under *Basic.* Plaintiffs cannot prevail on either prong.

First, there is nothing inaccurate or misleading in the statement with or without disclosure of the merger discussions. To support the claim, the alleged material omission (the merger discussions) should relate directly to or be sufficiently linked to the express statements made so as to render them inaccurate or misleading. *Kaufman v. Motorola,* 1999 U.S. Dist. LEXIS 6303, 1999 WL 688780 at *8 (N.D. Ill. 1999); *Kas v. Caterpillar, Inc.,* 815 F. Supp. 1158, 1172-73 (C.D. Ill. 1992). Obviously, nothing in the Vernado response refers to the merger negotiations or in any way implies that Sears was not engaged in such negotiations. Plaintiffs have not identified anything in this statement that is in direct conflict with the merger negotiations, *see Caremark, Inc. v. Coram Healthcare, Corp.,* 113 F.3d 645, 650 n.7 (7th Cir. 1997), and nothing Sears said about its off-mall strategy is in conflict with the notion of a potential merger. Nor is there any evidence that Sears intended to or did abandon that strategy after the merger.

Additionally, the undisputed evidence demonstrates that on November 5, 2004, the negotiations had not yet become material. At the time of the statement, none of the factual or legal predicates for a merger were in place. There were no board resolutions, no actual negotiations and no instructions to investment bankers to facilitate or explore a merger. *See Basic,* 485 U.S. at 239. It is true that each company had raised the subject with outside advisors, and senior management of the two companies held discussions about strategic combinations, but it was not until November 9 that there was even a "general agreement" that any transaction would involve a combination of stock and cash. Even at that time no structure had been reached and the parties had not begun due diligence. In fact, Kmart did not acquire the confidential information it needed to assess the prospect of a merger until after November 10, when the companies executed the Confidentiality Agreement.

In short, the status of the merger negotiations on November 5, 2004, were preliminary in nature. Indeed, the chances of a deal were assessed at only 50-50 on the morning of the day the agreement was actually reached, ten days after the Vernado response. The materiality of information concerning a proposed merger is directly related to the likelihood that the merger would be accomplished. "The more [t]entative the discussions the less useful such information will be to a reasonable investor in reaching a decision. Information of speculative and tentative discussions is of dubious and marginal significance to that decision. To hold otherwise would result in endless and bewildering guesses as to the need for disclosure, operate as a deterrent to the legitimate conduct of corporate operations, and threaten to 'bury the shareholders in an avalanche of trivial

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information;' the very perils that the limit on disclosure imposed by the materiality requirement serves to avoid." *Taylor v. First Union Corporation of South Carolina,* 857 F.2d 240, 244-45 (4th Cir. 1988) (*quoting TSC Industries Inc. v. Northway Inc.,* 426 U.S. 438, 448-49, 96 S. Ct. 2126, 48 L. Ed. 2d 757 (1976)).

Finally, the last statement on which plaintiffs rely to create a duty to disclose the merger negotiations is Sears' Third Quarter 10-Q filed on November 9, 2004. The 10-Q contained an MD&A section (Management, Discussion and Analysis of Financial Condition) as required by 17 C.F.R. § 229.303. According to plaintiffs, the 10-Q falsely stated that the "company's primary need for liquidity will be to fund the seasonal working capital requirements of its retail businesses and capital expenditures," when in fact Sears was seeking to conserve and acquire additional capital to fund the planned merger. This argument makes little sense given that it was Kmart than needed capital to purchase Sears. As Sears points out, it is also irreconcilable with the explicit mandate of the SEC that when disclosure of merger negotiations "is not otherwise required, and has not otherwise been made, the MD&A need not contain a discussion of the impact of such negotiations where, in the registrant's view, inclusion of such information would jeopardize completion of the transaction." SEC Rel. No. 33-6835, 1989 WL 270492 at *22436 (May 24, 1989). Accordingly, plaintiffs cannot base their 10b-5 claim on a failure to disclose merger negotiations in a Form 10-Q.

For the reasons explained above, the Sears defendants' motion for summary judgment is granted.

CONCLUSION

C. Page 667, New Sec. 13.10.G. 2007 Final Amendments to Rule 145

Page 667, New Sec. 13.10.G. Add before Sec. 13.11 the following:
New Sec. 13.10.G. **2007 Final Amendments to Rule 145**

Securities Act Release No. 8869, Amendments to Rule 144 and 145
(The amended rule is at the end of this document)
December 6, 2007

ACTION: Final rule.

SUMMARY: Rule 144 under the Securities Act of 1933 creates a safe harbor for the sale of securities under the exemption set forth in Section 4(1) of the Securities Act. We are shortening the holding period requirement under Rule 144 for "restricted securities" of issuers that are subject to the reporting requirements of the Securities Exchange Act of 1934 to six months. Restricted securities of issuers that are not subject to the Exchange Act reporting requirements will continue to be subject to a one-year holding period prior

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to any public resale. The amendments also substantially reduce the restrictions applicable to the resale of securities by non-affiliates. In addition, the amendments simplify the Preliminary Note to Rule 144, amend the manner of sale requirements and eliminate them with respect to debt securities, amend the volume limitations for debt securities, increase the Form 144 filing thresholds, and codify several staff interpretive positions that relate to Rule 144. [The amendments to Rule 144 are discussed in Chapter 4.] Finally, we are eliminating the presumptive underwriter provision in Securities Act Rule 145, except for transactions involving a shell company, and revising the resale requirements in Rule 145(d). We believe that the amendments will increase the liquidity of privately sold securities and decrease the cost of capital for all issuers without compromising investor protection. * * *

Amendments to Rule 145

Securities Act Rule 145 [269] [footnotes are at the end of the document] provides that exchanges of securities in connection with reclassifications of securities, mergers or consolidations or transfers of assets that are subject to shareholder vote constitute sales of those securities. Unless an exemption from the registration requirement is available, Rule 145(a) requires the registration of these sales. Rule 145(c) deems persons who were parties to such a transaction, other than the issuer, or affiliates of such parties to be underwriters. Rule 145(d) permits the resale, subject to specified conditions, of securities received in such transactions by persons deemed underwriters. In the 1997 Proposing Release, we proposed to eliminate the presumed underwriter and resale provisions in Rule 145(c) and (d). Many commenters supported the 1997 proposal.[270]

In the 2007 Proposing Release, we proposed amendments to Rule 145(c) and (d) that would:

- Eliminate the presumed underwriter provision in Rule 145(c), except with regard to Rule 145(a) transactions that involve a shell company (other than a business combination related shell company);[271] and

- Harmonize the requirements in Rule 145(d) with the proposed provisions in Rule 144 that would apply to securities of shell companies.

Under the proposed rule, where a party to a Rule 145(a) transaction, other than the issuer, is a shell company (other than a business combination related shell company), the party and its affiliates could resell securities acquired in connection with the transaction only in accordance with Rule 145(d).

[269] 17 CFR 230.145.

[270] See comment letters on the 1997 Proposing Release from ABA; ASCS; AT&T; BG&E; Brobeck, Phleger & Harrison, LLP ("Brobeck"); Corporate Counsel; Intel; NY Bar; NY City Bar; SIA; Smith Barney; Sullivan; and Testa Hurwitz.

[271] The terms "shell company" and "business combination related shell company" are defined in Securities Act Rule 405. See also Release No. 33-8587 (Jul. 15, 2005) [70 FR 42233].

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Five commenters expressly supported the proposed changes to Rule 145.[272] Two commenters requested that we reassess the impact of the proposed Rule 145 amendments on the staff's position that stock received in a reorganization that is exempt from registration pursuant to Section 3(a)(10) of the Securities Act[273]could be publicly resold pursuant to Rule 145(d)(2).[274]

After considering the comments, we believe that it is appropriate to adopt the amendments to Rule 145, as proposed. The presumptive underwriter provision in Rule 145 is no longer necessary in most circumstances. However, based on our experience with transactions involving shell companies that have resulted in abusive sales of securities, we believe that there continues to be a need to apply the presumptive underwriter provision to reporting and non-reporting shell companies and their affiliates and promoters. We are amending Rule 145 to eliminate the presumptive underwriter provision except when a party to the Rule 145(a) transaction is a shell company.[275] Rule 145(c) now provides that any party, other than the issuer, to a Rule 145(a) transaction involving a shell company (but not a business combination related shell company), including any affiliate of such party, who publicly offers or sells securities of the issuer acquired in connection with the transaction, will continue to be deemed an underwriter.[276]

Under the amendments to Rule 145 that we are adopting, if the issuer has met the requirements of new paragraph (i)(2) of Rule 144,[277] the persons and parties deemed underwriters will be able to resell their securities subject to paragraphs (c), (e), (f), and (g) of Rule 144 after at least 90 days have elapsed since the securities were acquired in the transaction. After six months have elapsed since the securities were acquired in the Rule 145(a) transaction, the persons and parties will be permitted to resell their securities, subject only to the Rule 144(c) current public information condition, provided that the sellers are not affiliates of the issuer at the time of sale and have not been affiliates during the three months before the sale. After one year has elapsed since the securities were acquired in the transaction, the persons and parties will be permitted to resell their securities without any limitations under Rule 145(d), provided that they are non-affiliates at the time of sale and have not been affiliates during the three months before the sale.

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[272] See comment letters on the 2007 Proposing Release from ABA; Cleary Gottlieb; Fried Frank; Financial Associations; and SCSGP.
[273] 15 U.S.C. 77c(a)(10).
[274] See comment letters on the 2007 Proposing Release from Barron and Fried Frank.
[275] With respect to a transaction that is exempt from registration pursuant to Section 3(a)(10) of the Securities Act that falls within Rule 145(a), if any party to the transaction is a shell company, then any party to the transaction, other than the issuer, and its affiliates will be permitted to resell their securities in accordance with the restrictions of Rule 145(d). Also, the staff intends to issue a revised Staff Legal Bulletin No. 3 concurrently with the effective date of the amendments that we are adopting that will address the treatment of parties to a transaction and their affiliates that have acquired securities in a transaction exempt from registration pursuant to Section 3(a)(10) of the Securities Act.
[276] We are also adding the definition of "affiliate" to paragraph (e) and transferring the definition of "party" from paragraph (c) to paragraph (e).
[277] The requirement in the newly added Rule 144(i)(2) that Form 10 information be filed reflecting a company's status as no longer a shell company is fulfilled with respect to a Rule 145(a) transaction through the filing of the registration statement.

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In addition, we are adopting, as proposed, a note to paragraphs (c) and (d) of Rule 145 that paragraph (d) is not available with respect to any transaction or series of transactions that, although in technical compliance with the rule, is part of a plan or scheme to evade the registration requirements of the Securities Act. [278]We have included a similar statement in the Preliminary Note to Rule 144. We also are adopting, as proposed, the clarification to the language in Rule 145(d) regarding the securities that were acquired in a transaction specified in Rule 145(a).[279]

Rule 145 Reclassification of securities, mergers, consolidations and acquisitions of assets

Preliminary Note: Rule 145 (§230.145 of this chapter) is designed to make available the protection provided by registration under the Securities Act of 1933, as amended (Act), to persons who are offered securities in a business combination of the type described in paragraphs (a) (1), (2) and (3) of the rule. The thrust of the rule is that an *offer, offer to sell, offer for sale,* or *sale* occurs when there is submitted to security holders a plan or agreement pursuant to which such holders are required to elect, on the basis of what is in substance a new investment decision, whether to accept a new or different security in exchange for their existing security. Rule 145 embodies the Commission's determination that such transactions are subject to the registration requirements of the Act, and that the previously existing *no-sale* theory of Rule 133 is no longer consistent with the statutory purposes of the Act. *See* Release No. 33–5316 (October 6, 1972) [37 FR 23631]. Securities issued in transactions described in paragraph (a) of Rule 145 may be registered on Form S–4 or F–4 (§239.25 or §239.34 of this chapter) or Form N–14 (§239.23 of this chapter) under the Act.

Transactions for which statutory exemptions under the Act, including those contained in sections 3(a)(9), (10), (11) and 4(2), are otherwise available are not affected by Rule 145.

Note 1: Reference is made to Rule 153a (§230.153a of this chapter) describing the prospectus delivery required in a transaction of the type referred to in Rule 145.

Note 2: A reclassification of securities covered by Rule 145 would be exempt from registration pursuant to section 3(a)(9) or (11) of the Act if the conditions of either of these sections are satisfied.

(a) *Transactions within this section.* An *offer, offer to sell, offer for sale,* or *sale* shall be deemed to be involved, within the meaning of section 2(3) of the Act, so far as the security holders of a corporation or other person are concerned where, pursuant to statutory provisions of the jurisdiction under which such corporation or other person is organized, or pursuant to provisions contained in its certificate of incorporation or similar controlling instruments, or otherwise, there is submitted for the vote or consent of such security holders a plan or agreement for:

[278] See new Note to Rule 145(c) and (d).
[279] See amendments to Rule 145(d) relating to "securities acquired in a transaction specified in paragraph (a) that was registered under the Act."

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(1) *Reclassifications.* A reclassification of securities of such corporation or other person, other than a stock split, reverse stock split, or change in par value, which involves the substitution of a security for another security;

(2) *Mergers of consolidations.* A statutory merger or consolidation or similar plan or acquisition in which securities of such corporation or other person held by such security holders will become or be exchanged for securities of any person, unless the sole purpose of the transaction is to change an issuer's domicile solely within the United States; or

(3) *Transfers of assets.* A transfer of assets of such corporation or other person, to another person in consideration of the issuance of securities of such other person or any of its affiliates, if:

(i) Such plan or agreement provides for dissolution of the corporation or other person whose security holders are voting or consenting; or

(ii) Such plan or agreement provides for a pro rata or similar distribution of such securities to the security holders voting or consenting; or

(iii) The board of directors or similar representatives of such corporation or other person, adopts resolutions relative to paragraph (a)(3) (i) or (ii) of this section within 1 year after the taking of such vote or consent; or

(iv) The transfer of assets is a part of a preexisting plan for distribution of such securities, notwithstanding paragraph (a)(3) (i), (ii), or (iii) of this section.

(b) *Communications before a Registration Statement is filed.* Communications made in connection with or relating to a transaction described in paragraph (a) of this section that will be registered under the Act may be made under §230.135, §230.165 or §230.166.

(c) *Persons and parties deemed to be underwriters.* For purposes of this section, if any party to a transaction specified in paragraph (a) of this section is a shell company, other than a business combination related shell company, as those terms are defined in §230.405, any party to that transaction, other than the issuer, or any person who is an affiliate of such party at the time such transaction is submitted for vote or consent, who publicly offers or sells securities of the issuer acquired in connection with any such transaction, shall be deemed to be engaged in a distribution and therefore to be an underwriter thereof within the meaning of Section 2(a)(11) of the Act.

(d) *Resale provisions for persons and parties deemed underwriters.* Notwithstanding the provisions of paragraph (c), a person or party specified in that paragraph shall not be deemed to be engaged in a distribution and therefore not to be an underwriter of securities acquired in a transaction specified in paragraph (a) that was registered under the Act if:

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(1) The issuer has met the requirements applicable to an issuer of securities in paragraph (i)(2) of §230.144; and

(2) One of the following three conditions is met:

(i) Such securities are sold by such person or party in accordance with the provisions of paragraphs (c), (e), (f), and (g) of §230.144 and at least 90 days have elapsed since the date the securities were acquired from the issuer in such transaction; or

(ii) Such person or party is not, and has not been for at least three months, an affiliate of the issuer, and at least six months, as determined in accordance with paragraph (d) of §230.144, have elapsed since the date the securities were acquired from the issuer in such transaction, and the issuer meets the requirements of paragraph (c) of §230.144; or

(iii) Such person or party is not, and has not been for at least three months, an affiliate of the issuer, and at least one year, as determined in accordance with paragraph (d) of §230.144, has elapsed since the date the securities were acquired from the issuer in such transaction.

Note to §230.145(c) and (d): Paragraph (d) is not available with respect to any transaction or series of transactions that, although in technical compliance with the rule, is part of a plan or scheme to evade the registration requirements of the Act.

(e) *Definitions.* (1) The term *affiliate* as used in paragraphs (c) and (d) of this section shall have the same meaning as the definition of that term in §230.144.

(2) The term *party* as used in paragraphs (c) and (d) of this section shall mean the corporations, business entities, or other persons, other than the issuer, whose assets or capital structure are affected by the transactions specified in paragraph (a) of this section.

(3) The term *person* as used in paragraphs (c) and (d) of this section, when used in reference to a person for whose account securities are to be sold, shall have the same meaning as the definition of that term in paragraph (a)(2) of §230.144.

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X. CHAPTER 15, DRAFTING STOCK PURCHASE AGREEMENTS, ASSET ACQUISITION AGREEMENTS, AND MERGER AGREEMENTS

A. Page 788, New Sec. 15.13.E. Acquiror's Assertion of Fraud Resulting from Target's Failure to Apprise Acquiror of Post-Signing Significant Increase in Potential Property Tax Liability—Ameristar

Page 788, New Sec. 15.13.E.	Add before Sec. 15.14. the following:
New Sec. 15.13.E.	**Acquiror's Assertion of Fraud Resulting from Target's Failure to Apprise Acquiror of Post-Signing Significant Increase in Potential Property Tax Liability—*Ameristar***

Ameristar Casinos, Inc. v, Resorts International Holdings, LLC.
Delaware Chancery Court, 2010
2010 Del. Ch. LEXIS 107

MEMORANDUM OPINION

STRINE, Vice Chancellor.

INTRODUCTION

This case arises out of Resorts International Holdings, LLC's ("Resorts") agreement to sell Resorts East Chicago, a casino-hotel (the "Casino") located in East Chicago, Indiana, to Ameristar Casinos, Inc. ("Ameristar"). The dispute centers around a property tax assessment (the "Assessment") that occurred between the time the purchase agreement for the Casino was executed and the time the deal closed. That Assessment increased the Casino's assessed value by 248% over the prior year's value. Allegedly, Resorts did not disclose the magnitude of the Assessment before the deal closed, but rather made a selective disclosure that (1) it had received an Assessment; and (2) it intended to appeal that Assessment.

In its original complaint, Ameristar alleged that the 248% increase in the Casino's assessed value was a Material Adverse Effect under the terms of the purchase agreement. But, Ameristar dropped that allegation in its amended complaint after the property tax appeal, which Ameristar continued to prosecute after it acquired the Casino from Resorts, successfully reduced most of the increase in the Casino's property tax liability. Still, Ameristar argues that Resorts' failure to properly notify Ameristar of the magnitude of

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the Assessment was fraudulent and a breach of Resorts' representations under the purchase agreement. And therefore Ameristar seeks damages, specific performance, and indemnification in order to recoup the alleged losses it sustained from Resorts' misrepresentations, and the costs of prosecuting the appeal of the Assessment.

Of the various claims included in Ameristar's amended complaint, only the counts for breach of contract, fraud, and indemnification survive this decision on Resorts' motion to dismiss under Court of Chancery Rules 9(b) and 12(b)(6). Ameristar's breach of contract claim survives because it has pled facts adequate to support a reasonable inference that Resorts breached its representation that no extraordinary taxes had been incurred since December 31, 2006. Ameristar's fraud claim survives because it has pled facts indicating that Resorts made a false representation of material fact when it failed to indicate in its closing certificate that its prior representation that no extraordinary taxes had been incurred was no longer true. That failure constituted an affirmative statement that the prior representation remained true. And, Ameristar's claim for indemnification survives because it has adequately pled a willful breach of contract, which can negate application of the threshold the purchase agreement places on the damages Ameristar can recover.

But, Ameristar's equitable fraud claim must be dismissed because Resorts did not owe fiduciary duties to Ameristar, and because Ameristar has not made a credible request for an equitable remedy. And, Ameristar's request that this court specifically enforce a provision of the purchase agreement that requires a party, who has requested the other party's cooperation in a proceeding such as the property tax appeal, reimburse that other party for the costs of that participation must be dismissed because Ameristar's complaint indicates that Resorts never affirmatively requested that Ameristar participate in the appeal. Finally, Ameristar's unjust enrichment and quantum meruit claims are dismissed because such claims cannot lie when the subject of those claims is addressed by the parties' written contract.

FACTUAL BACKGROUND

These facts are drawn from the complaint and the documents it incorporates.

Ameristar Agrees To Acquire One Of Resorts' Casinos

Ameristar is a public company with its principal place of business in Las Vegas, Nevada. It develops, owns, and operates casinos and related hotel, food, and entertainment properties in the United States. Resorts is a limited liability company formed under the laws of Delaware and is also active in the casino gaming industry. Approximately three years ago, the parties entered into negotiations for Ameristar to purchase the Casino, located outside Chicago, Illinois, just across the state line in Indiana.

The Purchase Agreement

On April 3, 2007, Ameristar and Resorts executed a purchase agreement (the "Purchase Agreement") whereby Ameristar purchased Resorts' membership interest in the limited

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liability company that owned and operated the Casino for $ 675 million. The relevant provisions of the Purchase Agreement are discussed below.

Representations and Warranties

In the Purchase Agreement, Resorts made a number of representations and warranties relating to the Casino's liability to pay property taxes on the improvements to the land leased from the City of East Chicago.[280] Those provisions were necessary because commercial property taxes in Indiana are paid the year after those property taxes are assessed. For example, property taxes for 2006 are paid in 2007. Therefore, property taxes assessed during Resorts' ownership of the Casino would come due after Ameristar acquired the Casino.

First, Resorts undertook to provide Ameristar with an audited financial statement for the year ended December 31, 2006. In Section 2.4 of the Purchase Agreement, Resorts represented and warranted that the financial statements "[were] prepared in accordance with GAAP applied on a consistent basis . . . and fairly represented in all material respects . . . the consolidated financial positions of" the Casino. The financial statements that Resorts delivered in compliance with this undertaking reflected a property tax accrual for the year 2006 approximately 6% higher than the actual amount paid in 2005. That 6% increase was actually an estimate because there had been a delay in receiving the Assessment for 2006, and the amount of the 2006 increase was as yet unknown when Resorts closed its 2006 books in April of 2007. When the agreement was being negotiated, Resorts explained that the 6% estimated accrual was based on Resorts' expectation of a normal inflationary increase in the property tax.

Second, Resorts gave representations and warranties in the Purchase Agreement about the adequacy of the reserves it had taken for taxes. Specifically, Section 2.6(b) of the Purchase Agreement states that:

> [Resorts] has adequately reserved in the Financial Information according to GAAP for all material Taxes payable by, or in respect of, [Resorts] that have accrued through the date thereof but that were not then due and payable, except for Taxes that are both (i) being contested in good faith and (ii) disclosed in reasonable detail in Section 2.6(b) of the Seller Disclosure Letter.

Resorts made a further representation in Section 2.6(b) about taxes incurred in later periods: "No tax has been incurred by [the Casino] since the date of the Financial Information [i.e., December 31, 2006] other than in the Ordinary Course of Business thereof, in amounts consistent with amounts incurred in prior periods."

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[280] The Purchase Agreement provided generally that the representations, warranties, and covenants would survive the closing. Schiltz Aff. Ex. A § 7.1 (Purchase Agreement (Apr. 3, 2007)) (the "Purchase Agreement").

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Covenants

The Purchase Agreement also contains several affirmative covenants that are relevant to this action. First, the parties mutually agreed in Section 4.2 of the agreement to notify one another promptly of any fact that would render any representation or warranty materially untrue:

> [Resorts] shall promptly notify [Ameristar], and [Ameristar] shall promptly notify [Resorts] in writing of, and will use commercially reasonable efforts to cure before the Closing Date, any event, transaction or circumstance, as soon as practical after it becomes known to such party, that causes or will cause any covenant or agreement of [Resorts] or of [Ameristar] under the Agreement to be breached in any material respect or that renders or will render untrue in any material respect any representation or warranty of [Resorts] or [Ameristar] contained in this agreement.

In other words, Section 4.2 required Resorts to notify Ameristar of a material breach of a representation, such as the representations found in Section 2.6(b). Based on the facts supplied by Ameristar, it is reasonable to infer that failure to notify Ameristar of the 248% increase in the Casino's assessed value, which allegedly would have amounted to an annual property tax liability of $ 18 million for an asset only producing $ 30 million a year in net income, meets Section 4.2's materiality requirement.

Second, the parties agreed in Section 4.12 to notify one another of any circumstance that would reasonably be expected to result in a failure of a closing condition:

> From the date of this Agreement until the Closing, each party hereto shall promptly notify all of the other parties here in writing regarding any . . . fact circumstance, event or action which will result in, or would reasonably be expected to result in, the failure of such party to timely satisfy any of the closing conditions specified in Article V hereof of this Agreement, as applicable.

And, third, the parties mutually agreed to cooperate with respect to the Casino's tax obligations:

> [Resorts and Ameristar] shall reasonably cooperate . . . as and to the extent reasonably requested by the other party . . . with respect to any audit, litigation, ruling request or other proceeding or dispute with respect to Taxes relating to [the Casino] (provided that the reasonable out-of-pocket costs incurred by the non-requesting party shall be reimbursed by the requesting party).

Therefore, each party's duty to cooperate with the other in respect to a tax proceeding was triggered when one party affirmatively requested the cooperation of the other party.

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Closing Conditions

The Purchase Agreement did not obligate Ameristar to close the deal unless Resorts certified at the time of the closing that: (1) all of Resorts' representations and warranties remained materially true; and (2) Resorts had complied in all material respects with all of its obligations under the Purchase Agreement. To wit, Section 5.2 of the Purchase Agreement provided as follows:

> The obligation of [Ameristar] to effect the Closing is subject to the satisfaction of each of the following conditions on or prior to the Closing date . . . .
>
> (a) Representations and Warranties. The representations and warranties of [Resorts] contained in this Agreement shall be true and correct (without giving effect to any limitation as to "materiality" or "Material Adverse Effect" set forth therein) at and as of the Closing as if made at and as of such time . . . except where the failure of such representations and warranties to be true and correct would not, individually or in the aggregate, result in a Material Adverse Effect. … [Ameristar] shall have received a certificate signed on behalf of [Resorts] by an executive officer of [Resorts] to such effect.

The Purchase Agreement defines "Material Adverse Effect" as, in relevant part, "changes, events or effects that are materially adverse to the business, condition (financial or otherwise), properties, assets or results of operations of [the Casino], taken as a whole …" Under the plaintiff-friendly Rule 12(b)(6)standard, it seems required for me to infer that the property tax liability arising from a 248% increase in the Casino's assessed value would have been a Material Adverse Effect under the terms of the Purchase Agreement. As mentioned before, if the Casino's property tax liability had increased in line with the increase in its assessed value, the Casino's annual property tax bill would have risen to $ 18 million annually.

As mentioned above, Section 4.12 required Resorts to notify Ameristar if an event occurred which would result in -- or would reasonably be expected to result in -- a failure of the Section 5.2 closing condition. Therefore, both Sections 4.2 and 4.12 ultimately had similar effects: Section 4.2 required Resorts to notify Ameristar if an event occurred that would render a representation materially untrue; and Section 4.12 required Resorts to notify Ameristar if an event would reasonably lead to a material failure of a closing condition, such as the requirement that Resorts' representations and warranties remained true.

Indemnification and Remedies

Finally, the parties agreed to a plan of post-closing indemnification for breaches of the Purchase Agreement. Resorts agreed that, after the closing, it would indemnify Ameristar as follows:

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> [F]rom and against any and all costs, losses, Liabilities, obligations, damages, claims, demands and expenses (whether or not arising out of third-party claims), including interest, penalties, reasonable attorneys' fees and all amounts paid in investigation, defense or settlement of any of the foregoing (herein, "Damages"), incurred in connection with, arising out of or resulting from:
>
> (i) any breach of any representation or warranty made by [Resorts] in this Agreement, or in any certificate, instrument or agreement provided for in this Agreement, in either case without regard to any reference to materiality or Material Adverse Effect; and
>
> (ii) any breach of any covenant or agreement made, or to be performed by [Resorts] in this Agreement or in any certificate, instrument or agreement provided for in this Agreement.

The parties agreed that indemnity claims would be subject to an aggregate threshold amount of $ 6.75 million and a cap amount of $ 50.625 million, and that the indemnity provisions would constitute the exclusive remedy for most breaches, subject to the following relevant exceptions:

> Except as specifically set forth in Section[] 4.18 . . . after the Closing, the indemnities provided in this Article VII shall constitute the sole and exclusive remedy of any Indemnified Party for Damages arising out of, resulting from or incurred in connection with any claims regarding matters arising under or otherwise relating to this Agreement; provided, however, that this exclusive remedy for Damages does not preclude a party from bringing an action for specific performance or other equitable remedy to require a party to perform obligations under this Agreement . . . . Notwithstanding anything to the contrary in this Section 7.8, in the event of a fraud or any willful breach of the representations, warranties, covenants or agreements contained herein by [Ameristar] or [Resorts], any Indemnified shall have all remedies available at law or in equity with respect thereto.

In short, the indemnity regime, including its threshold and cap, is not the exclusive contractual remedy as to: (1) claims regarding the tax cooperation covenant in Section 4.18; (2) actions for specific performance or other equitable remedies; or (3) actions involving fraud or willful breach of representations, warranties or covenants.

After The Purchase Agreement Was Executed, But Before The Deal Was Closed, Resorts Received Notice Of A Dramatic Increase In The Casino's Assessed Property Value

On July 16, 2007, over three months after the parties had signed the Purchase Agreement but before the closing, Resorts received notice from the Lake County, Indiana, North Township Assessor (the "Assessor") stating that the assessed value of the Casino's

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improvements for 2006 would be $ 367,132,300 -- a 248% increase over the $ 105,377,900 assessed value for the year 2005. Despite the fact that this huge increase in the assessed value of the Casino would, if not overturned in the tax regulatory process, invariably lead to a higher property tax bill for the owner of the Casino, Resorts did not correspondingly increase the 2006 tax accrual in its July 2007 monthly financial statements delivered to Ameristar before the closing, and also did not disclose the increased assessed value in any other format to Ameristar before the closing. That is, neither Resorts' seller disclosure letter nor its closing certificate mentioned the Assessment. Instead, the complaint alleges that, sometime after July 16, 2007, an unidentified representative of Resorts made a selective disclosure to Ameristar, indicating only that the Assessment had been received, and that Resorts intended to make a written request for a preliminary conference with the Assessor in order to begin an appeal of the Assessment. Resorts did not provide Ameristar with a copy of the Assessment, and therefore did not disclose the magnitude of the increase. For its part, Ameristar, upon receiving notification that the Assessment was received and that Resorts intended to appeal the Assessment, did not inquire further as to the amount of the increase.

After The Deal Closes, Ameristar Discovers The Magnitude Of The Assessment Increase

The transactions contemplated by the Purchase Agreement closed on September 18, 2007. A day later, Resorts' outside tax consultants, rather than Resorts itself, revealed the magnitude of the Assessment to Ameristar. Ameristar asserts that this revelation took it entirely by surprise. After learning of the increase, Ameristar unilaterally chose to continue the appeal of the Assessment that Resorts had initiated. There is no indication in the complaint that Resorts made any request that Ameristar pursue the property tax appeal.

On January 7, 2008, Ameristar sent Resorts an indemnity claim under the process outlined in Article VII of the Purchase Agreement. The claim demanded the full amount of indemnity up to the cap and specifically asserted claims of fraud, equitable fraud, and willful breach of contract. On April 10, 2008, when efforts to resolve the dispute out of court failed, Ameristar filed its original complaint in this court, which sought specific performance, damages, and indemnification based on theories of fraud, equitable fraud, and breach of contract by Resorts under the Purchase Agreement.

After that complaint was filed, the property tax appeal was resolved through a settlement between the Casino, the Assessor, and the Lake County Treasurer. The settlement was limited to the years 2006 and 2007, years in which Resorts, as the owner of the Casino, was primarily responsible for the payment of property taxes. The settlement decreased the property tax liability from 248% to 26%. In particular, the appeal decreased the property tax liability for the 2006 tax year by $ 11,509,302.30 and the property tax liability for the 2007 tax year by $ 16,239,057.42. Prosecuting that appeal cost Ameristar $ 3,869,796.92 in legal fees and consultant costs. Although the tax settlement materially reduced the amount of property taxes Resorts was required to pay for the period before

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closing, Resorts refused to reimburse Ameristar for the fees and costs it sought.

In light of Resorts' refusal to compensate Ameristar for prosecuting the appeal, Ameristar filed its amended complaint on August 12, 2009. The amended complaint continues to seek declaratory relief and rescissory relief as to the transaction on theories of fraud (Count I), equitable fraud (Count II), willful breach of contract (Count III), and contractual indemnity (Count IV). The amended complaint also adds a count for reimbursement of Ameristar's costs in prosecuting the tax appeal -- that is, for enforcement of Section 4.18 of the Purchase Agreement (Count V). And the amended complaint adds claims for restitutionary relief under principles of unjust enrichment (Count VI) and quantum meruit (Count VII).

Notably, because the property tax appeal resulted in a large reduction to the Casino's property tax liability, the amended complaint eliminates the claim in the original complaint that the Assessment resulted in a Material Adverse Effect. Nevertheless, Ameristar continues to allege that the Assessment was an event that, at the time it occurred, was reasonably likely to have a Material Adverse Effect. That is, Ameristar still alleges, as discussed below, that Resorts' failure to disclose the magnitude of the increased Assessment breached both the representations and warranties and the covenants it made in the Purchase Agreement.

Resorts has moved to dismiss those claims under Court of Chancery Rule 12(b)(6). The issues raised in Resorts' motion are addressed in detail below.

LEGAL ANALYSIS

Standard of Review

A motion to dismiss under Rule 12(b)(6) will be denied "unless it can be determined with reasonable certainty that the plaintiff could not prevail on any set of facts reasonably inferable" from the pleadings. Accordingly, the Court must accept as true all well-pled facts and afford plaintiffs "the benefit of all reasonable inferences." Nevertheless, a complaint "must plead enough facts to plausibly suggest that the plaintiff will ultimately be entitled to the relief sought.

A NUMBER OF AMERISTAR'S CLAIMS MUST BE DISMISSED UNDER RULE 12(B)(6)

As outlined above, Ameristar's amended complaint alleges a number of inter-related claims against Resorts. At oral argument, it became clear that the common assertion underlying most of Ameristar's claims is that Resorts breached its representations in Section 2.6(b) of the Purchase Agreement. Obviously, that alleged breach is central to Ameristar's breach of contract claim (Count III). But Ameristar also argues that Resorts' alleged misrepresentations under Section 2.6(b) form the basis for its fraud and equitable fraud claims (Counts I and II). And, because willful breach of the representations and warranties in the Purchase Agreement negates application of the limitation of damages

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under Section 7.6, Section 2.6(b) is also central to Ameristar's indemnity claim (Count IV). Therefore, I first determine whether Ameristar has adequately stated its claim that Resorts breached its representations in Section 2.6(b).

Ameristar Has Stated A Claim That Resorts Breached The Representations It Made In Section 2.6(b) Of The Purchase Agreement

Ameristar's complaint alleges that Resorts breached its representations in Section 2.6(b) by not revising its accrual for the 2006 taxes after receiving the Assessment. Ameristar also claims that Resorts breached Sections 4.2 and 4.12 by not notifying Ameristar that its representations in Section 2.6(b) were no longer true, and that the breach of Section 2.6(b) caused the closing conditions set forth in Section 5.2 to fail. Therefore, the predicate issue to all of Ameristar's breach of contract claims is whether Resorts' decision to not revise its accrual for the 2006 taxes rendered the representations Resorts made in Section 2.6(b) untrue. If the integrity of those representations in Section 2.6(b) are still intact, then the relevant covenants and closing conditions are not triggered.

Section 2.6(b) includes two important representations, which are italicized in the full text of the provision below:

> [Resorts and the Casino] have timely paid all Taxes that have become due and payable, and have adequately reserved in the Financial Information according to GAAP for all material Taxes payable by, or in respect of, [Resorts and the Casino] that have accrued through the date thereof but that were not then due and payable, except for Taxes that are both (i) being contested in good faith and (ii) disclosed in reasonable detail in Section 2.6(b) of the Seller Disclosure Letter. No Tax has been incurred by [Resorts or the Casino] since the date of the Financial Information other than in the Ordinary Course of Business thereof, in amounts consistent with amounts incurred in prior periods. Other than Transfer Taxes described in Section 4.9, the transactions contemplated hereby will not result in a Tax Liability to [Resorts or the Casino].

That is, in Section 2.6(b), Resorts first represented that it had properly followed GAAP when reserving for taxes in the "Financial Information." Section 2.4 of the Purchase Agreement defines "Financial Information" as follows:

> On or prior to April 12, 2007, Seller shall deliver to Buyer, a true and complete copy of the Casino's audited consolidated balance sheet as of December 31, 2006 and consolidated income and cash flow statements for the twelve (12) months ended December 31, 2006 (collectively, the "Financial Information"). . . . The Financial Information was prepared in accordance with GAAP applied on a consistent basis throughout the periods involved . . . and fairly represented in all material respects . . . the consolidated financial position of the [Casino] as of such date.

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And, Resorts' second representation in Section 2.6(b) is that the Casino has incurred no taxes since December 31, 2006 other than in the ordinary course and consistent with past experience.

Thus, the two representations Resorts made in Section 2.6(b) work in tandem: the first representation covers reserves taken for 2006 taxes known by the time the Casino's audited 2006 financial statements were closed, and the second representation covers any extraordinary taxes that were "incurred" after the Casino's books for the twelve-month period ending December 31, 2006 were closed. This arrangement appears to be in part a protection for Ameristar from any surprises created by a system where the Casino's property taxes were payable in arrears, and where the Casino might receive an unexpected property tax bill or assessment after its 2006 books were finalized but before the deal's closing.

In regard to the first representation in Section 2.6(b), Ameristar's complaint has not stated a claim because it has presented no facts supporting an inference that the representation meant anything other than that the historical Financial Information was accurate. The definition of Financial Information in Section 2.4 is clear: the consolidated financials, which were prepared according to GAAP, covered the twelve months ending on December 31, 2006. Section 2.6(b) is also clear: Resorts represented that all taxes payable by the Casino had been adequately reserved in the Financial Information according to GAAP at the time the Casino's books were closed. In April 2007, when the audited financials were prepared, the extraordinarily high Assessment had not yet been received. Therefore, Resorts could not have anticipated it, which is why it reserved for an estimated 6% increase in the Casino's property tax liability.

To overcome Section 2.6(b)'s plain language, Ameristar must argue that GAAP required Resorts to take action regarding the reserve taken in the Financial Information -- for example, to take a catch-up reserve, and to notify Ameristar of the new reserve -- when it received the Assessment in July 2007. But, Ameristar's complaint does not make that allegation, and is devoid of any particular facts regarding GAAP's requirements in this regard. Detail on GAAP's requirements is also entirely absent from Ameristar's answering brief. And, given the opportunity at oral argument to explain why GAAP required Resorts to take action, Ameristar could not reference any applicable accounting rules. Without any basis to infer that the Financial Information was tainted by GAAP violations, I cannot conclude that Ameristar has stated a claim that Resorts breached its representation in the first sentence of Section 2.6(b).

But, Ameristar has adequately alleged that Resorts breached its representation in the last sentence of Section 2.6(b) that no extraordinary taxes had been incurred since December 31, 2006. Resorts' first argument in this regard is that Ameristar did not plead that the property tax based on the Assessment was "incurred" before the deal closed in September 2007. But, Resorts does not develop this argument beyond asserting that Ameristar's complaint did not allege "the tax based on the [Assessment] had been billed or otherwise 'incurred,' or even that the amount of that tax or the applicable tax rate had been determined by the responsible taxing authorities." The meaning of "incur" in this context

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is not readily apparent. For example, different editions of Black's Law Dictionary define the verb "to incur" as "[t]o suffer or bring on oneself (a liability or expense)," and "[t]o become liable or subject to." Given the size of the Assessment, at the pleading stage, I must infer that a large increase in the Casino's property tax liability was imminent unless the assessment was reversed, even if the exact amount of the increase was unknown at the time. I am also not prepared to assume on a motion to dismiss that it was common practice in East Chicago, Indiana for the local authorities to issue high initial property assessments and then turn around and settle appeals of those assessments at a drastically reduced amount. Therefore, it is reasonable to conclude that receiving the Assessment, which tripled the Casino's assessed value, was that point in time where the Casino "suffered" or "became subject to" the increased property tax liability, especially when that Assessment, if not reversed through an appeal, would establish the property tax for the year 2006 due in 2007. Of course, additional information might reveal that the Casino did not "incur" the property tax liability until some later time when the property tax bill became more concrete. But Resorts has not focused serious attention on this issue, and under Rule 12(b)(6), I must draw reasonable inferences in Ameristar's favor.

Resorts' second argument in this regard is that Ameristar has failed to state a claim because the increased Assessment of the Casino's value may not have necessarily led to a corresponding increase in property tax liability. In Resorts' view, it is "patently erroneous" that an increase in the value of the property necessarily leads to an increase in property tax liability. For support, Resorts cites the following language from an Indiana Supreme Court opinion:

> In broad brush, the amount of property taxes owed for each individual property is set by allocating the total amount of property taxes to be raised in a taxing district among all pieces of property in proportion to their assessed valuations. . . . If all assessed valuations go up or down by the same percentage as the result of a reassessment, even if there is a large change in the dollar amount of the assessed valuation on each property, there is no change in the tax burden or any individual property. In simplified terms, if the assessed valuation of every property doubles, it would have no effect on the tax bills of any of them. *If, however, some assessed valuations go up or down more than others, as is always the case in the real world, some taxes go up and some go down.*

Because it is hypothetically possible that an increased valuation may not lead to an increased property tax liability (if, for example, the values of all the properties in the tax district increased in lock-step), Resorts argues that Section 2.6(b) of the Purchase Agreement was not breached because it was not yet absolutely certain that the Assessment would increase the Casino's tax exposure.

It may be true, as a matter of deductive logic abstracted from the real world, that a 248% increase in a property's value need not lead to an increase in the property's tax liability. But, this court must decide real world cases under certain procedural guidelines. Those guidelines include the requirement that all reasonable inferences be drawn in the plaintiff's favor on a motion to dismiss. Given that standard, the plausible inference I

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must make is that such a large increase in a property's assessed value would likely, if sustained, lead to a correspondingly large hike in its property tax liability. That is especially the case for a casino property, whose property taxes likely provide one of the largest revenue streams for the local government. In other words, the local tax authority is unlikely to let an increased assessment for the Casino go by without taking the opportunity to levy higher taxes. Indeed, the Indiana Supreme Court language Resorts cites in its brief concedes that increased assessments lead to increased property tax liabilities: because "some assessed valuations go up or down more than others, as is always the case in the real world, some taxes go up and some go down." Resorts' own behavior reflects that reality: it initiated an appeal of the increased Assessment, illustrating that it too presumed that the Assessment would lead to a greater property tax burden. Furthermore, Resorts' counsel conceded at oral argument that half of the actual 26% increase in the Casino's property tax liability could be directly attributed to the ultimate increase in the Casino's assessed property value that resulted from the conclusion of the appeal process. Therefore, it is reasonable to infer in accordance with the Rule 12(b)(6) standard that such a causal connection between the Casino's property valuation and its property tax liability exists.

Thus, Ameristar has adequately stated a claim in Count III that Resorts breached its obligations under the Purchase Agreement.

Ameristar Has Stated A Claim For Fraud But Not For Equitable Fraud

Under Delaware common law, the elements of fraud are as follows: "(1) a false representation, usually one of fact, made by the defendant; (2) the defendant's knowledge or belief that the representation was false, or was made with reckless indifference to the truth; (3) an intent to induce the plaintiff to act or to refrain from acting; (4) the plaintiff's action or inaction taken in justifiable reliance upon the representation; and (5) damage to the plaintiff as a result of such reliance."[281] For a claim of equitable fraud, however, "there is no requirement that the defendant have known or believed its statement to be false or to have made the statement in reckless disregard of the truth." Thus, to state a case for equitable fraud, a plaintiff must satisfy all the elements of common-law fraud with the exception that the plaintiff need not demonstrate that the misstatement or omission was made knowingly or recklessly. Court of Chancery Rule 9(b) requires that the plaintiff claiming fraud allege with particularity "the time, place, and contents of the false representation, the identity of the person(s) making the representation, and what he intended to obtain thereby. Essentially, to satisfy that requirement, the plaintiff must allege circumstances sufficient to fairly apprise the defendant of the basis for the claim."[282]

Ameristar Has Adequately Pled A Fraud Claim Against Resorts

Under Delaware law, a fraud claim can be based on representations found in a contract or

[281] *Zirn v. VLI Corp.*, 681 A.2d 1050, 1060-61 (Del. 1996) (citations omitted).
[282] *Abry Partners V, L.P. v. F & W Acquisition LLC*, 891 A.2d 1032, 1050 (Del. Ch. 2006) (citations omitted).

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on material statements or omissions outside of the contract. Here, Ameristar has alleged that the representations Resorts made in the Purchase Agreement were false. In particular, Ameristar has alleged that Resorts' representation in Section 2.6(b) of the Purchase Agreement -- that it had incurred no taxes since its 2006 books closed -- was incorrect, and that the closing certificate Resorts delivered to Ameristar as required under Section 5.2 of the Purchase Agreement did not indicate that the representations Resorts had made regarding taxes were no longer true.

Resorts raises a couple of arguments in response, both of which must be rejected. First, Resorts argues that it did not have the necessary scienter to commit fraud because, at the time the Assessment was received up until the transaction closed, it was uncertain whether the Assessment would lead to a greater property tax liability because the appeal process had not yet run its course. But, as discussed above, it is reasonable to infer from the facts Ameristar has pled that: (1) a massive increase in the assessed value of the Casino would lead to a corresponding increase in its property tax liability; (2) Resorts, a sophisticated operator well-familiar with property tax regimes due to its holdings throughout the country, understood that the Assessment would lead to an increased property tax liability; and (3) Resorts did not disclose the full truth about the Assessment for fear that Ameristar would not proceed with closing the deal if it was told about the magnitude of the increase in the Casino's assessed value. Therefore, the complaint has adequately pled facts upon which one can infer that Resorts had the requisite intent to commit fraud.

Second, Resorts argues that Ameristar could not justifiably rely upon Resorts' representations because Ameristar could have discovered the true magnitude of the Assessment by simply asking Resorts about it. Resorts argues that the disclosure that it made to Ameristar put Ameristar on inquiry notice, and therefore Ameristar can have no claim upon Resorts for fraud because it chose to ignore the obvious. Further development of the record may unearth the details of what Resorts communicated and what Ameristar learned from that communication, but at this stage in the proceeding, when I am constrained to make factual inferences in Ameristar's favor, I cannot conclude that Ameristar was put on adequate inquiry notice of a disturbingly large increase in the Casino's assessed value and, therefore, could not justifiably rely upon Resorts' representations. Ameristar's complaint indicates that Ameristar believed that Resorts' disclosure that it was meeting with the Assessor was immaterial because requesting a meeting with the Assessor was a routine measure taken in order to preserve the right to contest an assessment.

Ameristar Has Not Stated an Equitable Fraud Claim Against Resorts

Although Ameristar has adequately pled a common law fraud claim against Resorts, it has not stated an equitable claim. "[E]quitable fraud can only be applied in those cases in which one of the two fundamental sources of equity jurisdiction exist: (1) an equitable right founded upon a special relationship over which equity takes jurisdiction, or (2) where equity affords its special remedies, e.g., 'rescission, or cancellation; where it is

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sought to reform a contract . . . or to have a constructive trust decreed.'"[283] Here, there is no allegation that Resorts owed Ameristar any fiduciary duties, or that there was another relationship from which equitable duties sprung. Furthermore, Ameristar has requested no equitable remedies. Therefore, Ameristar has not stated an equitable fraud claim.

Ameristar Has Stated A Claim That Resorts Must Indemnify Ameristar Under Section 7.6 Of The Purchase Agreement

Section 7.6(a) of the Purchase Agreement provides that no party will be obliged to indemnify the other party for claims for damages less than $ 6,750,000. Resorts argues that this provision precludes Ameristar's request for indemnification for the costs it incurred in prosecuting the property tax appeal because those costs only amount to $ 3,869,796.92. But, Section 7.6's threshold requirement does not apply if a party "willfully breached" the Purchase Agreement:

> [I]n the event of a fraud or any willful breach of the representations, warranties, covenants or agreements contained herein by [Ameristar] or [Resorts], any Indemnified shall have all remedies available at law or in equity with respect thereto.

As discussed above, Ameristar has pled sufficient facts to support a claim that Resorts willfully breached the representations it made in the Purchase Agreement by intentionally failing to disclose that its representation in Section 2.6(b) was no longer true. Ameristar has also pled a viable fraud claim. For both reasons, Ameristar has adequately alleged that the threshold in Section 7.6 does not apply, and its indemnity claim survives.

Ameristar Has Not Stated A Claim For Specific Performance Of Section 4.18 Of The Purchase Agreement

Ameristar's complaint alleges that Section 4.18 of the Purchase Agreement requires Resorts to reimburse Ameristar for the expenses of appealing the Assessment. Section 4.18 of the Purchase Agreement provides in pertinent part that Resorts and their respective affiliates:

> [S]hall reasonably cooperate . . . as and to the extent reasonably requested by the other party . . . with respect to any audit, litigation, ruling request or other proceeding or dispute with respect to Taxes relating to the Company or the Company Subsidiary (provided that the reasonable out-of-pocket costs incurred by the non-requesting party shall be reimbursed by the requesting party).

But, because the complaint did not allege any facts that Resorts affirmatively requested

[283] *U.S. WEST, Inc. v. Time Warner, Inc.*, 1996 Del. Ch. LEXIS 55, 1996 WL 307445, at *26 (Del. Ch. June 6, 1996); *see also NACCO Indus., Inc. v. Applica Inc.,* A.2d , 2009 Del. Ch. LEXIS 217, 2009 WL 4981577, at *29 (Del. Ch. 2009) ("NACCO is a sophisticated party, none of the defendants occupied a special relationship towards NACCO, and nothing about the case suggests any other equity that has traditionally moved this Court to relax the pleading requirements for fraud.").

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that plaintiffs undertake the property tax appeal, there is no basis for Ameristar's claim for specific performance of Section 4.18. * * *

Ameristar Has Not Stated Claims For Unjust Enrichment And Quantum Meruit * * *

As an alternative to its claim for specific performance under Section 4.18, Ameristar attempts to recover the costs of prosecuting the property tax appeal -- that is the $ 3,869,796.92 of attorneys' and property tax consultants' fees allegedly incurred in appealing the Assessment -- through claims for unjust enrichment (Count VI) and quantum meruit (Count VII). But, those claims must be rejected because there is an enforceable contract governing the subject of the parties' dispute.

Under Delaware law, "[c]ourts generally dismiss claims for quantum meruit on the pleadings when it is clear from the face of the complaint that there exists an express contract that clearly controls." 73 And, "[w]hen the complaint alleges an express, enforceable contract that controls the parties' relationship, . . . a claim for unjust enrichment will be dismissed." 74 The logic behind those rules is simple: if a contract covers the subject matter, the defendant's conduct either violates the contract or not. If the defendant did not violate the contract governing the subject of the dispute, then the plaintiff cannot attempt to hold the defendant responsible by softer doctrines, and thereby obtain a better bargain than he got during the contract negotiations.

Therefore, because the Purchase Agreement governs the subject of the parties' dispute, Ameristar's claims for unjust enrichment and quantum meruit must be dismissed.

CONCLUSION

For the reasons stated above, Resorts' motion is GRANTED in part and DENIED in part, and Ameristar's claims for equitable fraud, specific performance, unjust enrichment, and quantum meruit are dismissed. IT IS SO ORDERED.

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B. Page 789, New Sec. 15.14.A. Rejected Acquiror's (1) Contract Action Against Target for Violation of No Shop, and (2) Fraud and Tortious Interference Action against Successful Acquiror—NACCO

Page 789, New Sec. 15.14.A. Add before Sec. 15.15. the following:

New Sec. 15.14.A. **Rejected Acquiror's (1) Contract Action Against Target for Violation of No Shop, and (2) Fraud and Tortious Interference Action against Successful Acquiror—*NACCO***

NACCO Industries, Inc. v. Applica Incorporated
Chancery Court of Chancery of Delaware, 2009
2009 Del. Ch. LEXIS 217

LASTER, Vice Chancellor.

In 2006, Applica Incorporated embarked on a sale process. Applica initially entered into a merger agreement with NACCO Industries, Inc. Later, Applica terminated its agreement with NACCO and agreed to be acquired by affiliates of Harbert Management Corporation. A bidding contest ensued, which NACCO lost. In this action, NACCO seeks damages and other unspecified relief arising out of its defeated acquisition attempt. NACCO has asserted claims for breach of contract (Count I), breach of the implied covenant of good faith and fair dealing (Count II), tortious interference with contract (Count III), fraud (Count IV), equitable fraud (Count V), aiding and abetting a breach of fiduciary duty (Count VI), and civil conspiracy (Count VII). Applying Rule 12(b)(6)'s plaintiff-friendly standard, I deny the motion to dismiss Counts I, III, IV and VII. I dismiss Counts II, V, and VI.

FACTUAL BACKGROUND

I assume the following facts to be true for purposes of the motion to dismiss. The facts are drawn solely from the allegations of the Second Amended Complaint (the "Complaint") and from publicly filed documents that it incorporates by reference.

The Parties

Defendant Harbert Management Corporation is an investment manager that oversees a hedge fund complex. The Complaint names as defendants the Harbert-affiliated entities that were involved in the Applica transaction. Many of the funds operate under the "Harbinger" name, and I refer to the Harbert-affiliated defendants collectively as "Harbinger." The Complaint previously named as individual defendants three Harbinger principals, all of whom were dismissed for lack of personal jurisdiction.

Defendant Applica is a Florida corporation headquartered in Miramar, Florida. Applica

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markets, distributes, and sells small household appliances. Applica is now a portfolio company of Harbinger. Prior to being taken private by Harbinger, Applica's common stock traded on the New York Stock Exchange.

Plaintiff NACCO is a Delaware corporation with its principal place of business in Mayfield Heights, Ohio. NACCO is a holding company whose shares trade on the New York Stock Exchange. NACCO owns plaintiff HB-PS Holding Company, Inc. ("Hamilton Beach"), a Delaware corporation with its principal place of business in Glen Allen, Virginia. Hamilton Beach is a designer, marketer, and distributor of small electric household appliances and commercial products for restaurants, hotels, and bars.

NACCO And Applica Enter Into A Merger Agreement.

In early 2005, NACCO approached Applica about a strategic transaction with Hamilton Beach. The parties signed a non-disclosure agreement, exchanged confidential information, and began discussions. Applica broke off talks, inviting NACCO to re-approach in early 2006.

Applica proved more receptive in 2006. In January, Applica's board authorized merger discussions with NACCO. On February 16, Applica and NACCO updated their non-disclosure agreement, and NACCO agreed to a standstill provision that limited its ability to act unilaterally to acquire Applica. When NACCO found itself in a bidding contest for Applica some seven months later, the consequences of agreeing to the standstill would prove critical, because NACCO ended up competing against Harbinger, which was not similarly restricted and had used its freedom and the cover of allegedly false Schedule 13 disclosures to accumulate a large block of Applica stock.

On February 28, 2006, Applica announced publicly that it was exploring strategic alternatives. In March, Applica began making outgoing calls to potential strategic partners.

On May 2, 2006, Applica's board of directors decided to pursue NACCO's merger proposal. During the week of May 24, Applica conducted due diligence on Hamilton Beach's operations. On June 6, NACCO sent Applica a draft merger agreement. On July 23, the parties executed a merger agreement (the "Hamilton Beach Merger Agreement"). In the contemplated transaction, NACCO would spin off Hamilton Beach, which would acquire Applica in a stock-for-stock merger. Following the transaction, NACCO's stockholders would own 75% and Applica's stockholders 25% of the resulting entity. In advance of the spin-off, Hamilton Beach would pay a $ 110 million cash dividend to NACCO. The parties announced the Hamilton Beach Merger Agreement on July 24.

Harbinger Enters The Fray.

On September 14, 2006, Harbinger announced a bid to acquire all of the Applica shares it did not yet own at $ 6.00 per share. Although Harbinger had been on the scene for some time, this announcement heralded a change in Harbinger's public role.

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Harbinger began purchasing Applica stock on February 24, 2006, at the direction of Harbinger principal Phillip Falcone, who instructed one of Harbinger's brokers to "START ACCUMULATING [APPLICA] QUIETLY. SIZE." That same day, Harbinger purchased 191, 350 shares. On the next trading day, February 27, Falcone told the same broker, "I CAN USE MORE [APPLICA] TODAY." Within two days, Harbinger acquired another 518, 285 shares. On February 28, Applica announced publicly that it was exploring strategic alternatives.

NACCO alleges that Harbinger's propitious timing resulted from Applica's management tipping Harbinger advisor David Maura. At the time, Applica and NACCO were bound by a non-disclosure agreement, which barred Applica from disclosing to any third party that "discussions relating to a possible Transaction are taking place, or . . . any other facts with respect to such discussions." According to NACCO, this was the first in a series of actions taken by Applica management to aid Harbinger. NACCO alleges that Applica senior executives knew their jobs were at risk in a strategic deal with Hamilton Beach, which already had a management team, and that Applica's insiders therefore favored Harbinger as a financial buyer who was likely to retain them.

On March 13, 2006, Harbinger filed a Schedule 13G disclosing its ownership of 8.9% of Applica's outstanding common stock. Schedule 13G only can be used by filers who acquire shares strictly for investment purposes. In the filing, Harbinger certified that the shares "were not acquired and are not held for the purposes of or with the effect of changing or influencing the control of [Applica]" and were "not held in connection with or as a participant in any transaction having such purpose or effect."

NACCO contends that in reality, Harbinger planned to influence the outcome of Applica's process for exploring strategic alternatives. At least as early as March 31, 2006, Maura pitched Falcone on the idea of combining Applica with Salton, Inc., a competing small electronic appliance distributor. Falcone responded, "I like it. Take control of that and buy [Salton] and [Applica]." On April 4, Falcone reminded Maura to focus on the opportunity.

Harbinger filed an amended Schedule 13G on April 4, 2006, disclosing additional purchases of Applica stock. The Complaint alleges that Applica CFO Terry Polistina and Applica Chairman Harry Schulman assisted Harbinger in obtaining large blocks of stock and increasing its position.

On April 26, 2006, Maura advised Falcone that he had modeled Salton and Applica "as one company" and recommended that Harbinger "take our [Applica] position up to 30%." He continued: "I am hearing the bids are in the $ 4+ range -- we sont [sic] make much money buying additional shares at $ 3.5 - $ 3.76 -- but we can use a bigger position to keep the bidders honest and if we see enough value in the [Applica]/[Salton] combo -- we can bid for [Applica] outright ourselves." He noted it was "cheaper to build the position now -- rather than in Jun [sic] when there is a $ 4 bid on the table." The next day, he wrote Falcone that "[t]he biggest risk to this strategy is if we buy Salton preferred and

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get out bid by a strategic for [Applica].”

By May 14, 2006, Harbinger had acquired 24.7% of Applica’s outstanding shares. Harbinger filed a Schedule 13D disclosing its position and stating as follows:

> The Shares held by the Reporting Persons were acquired for, and are being held for, investment purposes only. The acquisitions of the Shares were made in the ordinary course of the Reporting Persons’ business or investment activities, as the case may be.
>
> The Reporting Persons have no plan or proposal which relates to, or would result in, any of the actions enumerated in Item 4 of the instructions to Schedule 13D.

On May 22, Maura wrote to Falcone that he was expecting a merger announcement from Applica “in the next 2-3 weeks.” At the time, NACCO was conducting due diligence on Applica. On June 6, after purchasing additional shares that brought its holdings up to 30.8% of the outstanding stock, Harbinger filed an amended Schedule 13D, in which it made the same disclosure.

Also in May 2006, Harbinger moved on Salton. According to the Complaint, by June 2, Harbinger had acquired $ 100 million of the company’s preferred stock and established a position in excess of $ 100 million in its debt. On June 22, Maura e-mailed Falcone: “I think we pay cash for [Applica] -- take it private -- then bid [REDACTED] for Salton -- then the world [would] be knocking on our door . . . and we can take the new company public in 24-36 months for a massive gain.” Maura described for Falcone the proposed structure of the Hamilton Beach merger, which was not yet public. In e-mails on June 24, Maura and Falcone discussed the details of a Salton bid for Applica. Maura outlined his plan and wrote, “In the process we completely replace both boards with a new board of people we know and who get the joke.” Also in June, Harbinger retained a financial advisor to evaluate gaining “full/complete control of Applica.”

In the midst of these internal exchanges, on June 21, 2006, Harbinger filed another Schedule 13D, in which it disclosed that it had increased its position to 32% of Applica’s outstanding shares. The Schedule 13D stated: “The Reporting Persons have acquired their Shares of the Issuer for investment.” Harbinger thus dropped the word “only” from its disclosure. Harbinger added a disclosure that “[t]he Reporting Persons evaluate their investment in the Shares on a continual basis including, without limitation, for possible synergies with their other current investments.” Harbinger “reserve[d] the right to be in contact with members of [Applica’s] management, the members of [Applica’s] Board of Directors, other significant shareholders and others regarding alternatives that [Applica] could employ to maximize shareholder value.” NACCO alleges that these disclosures were false not only because Harbinger already planned to influence or control Applica, but also because Harbinger already had been in covert contact with members of Applica’s management who were tipping Harbinger about the deal process and because Harbinger had zeroed in on and was pursuing the specific alternative of an Applica-Salton combination.

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In July 2006, Maura advised Harbinger not to enter into a confidentiality agreement with Applica because Maura did not think Harbinger "would learn more than we already know." By declining to sign the confidentiality agreement, Harbinger also avoided the standstill restriction that bound NACCO. Later that month, Maura's information again proved to be excellent. On Friday, July 21, Maura knew that Applica "has a deal" and that "it will be announced shortly." That same day, the Applica board approved the Hamilton Beach Merger Agreement. On Monday, July 24, the deal was announced.

On the same day that the Hamilton Beach merger was announced, Applica management contacted Harbinger through intermediaries and signaled that an all-cash offer for Applica would likely be successful. Harbinger responded by moving forward with plans for a Salton-Applica combination. Two days after the announcement of the Hamilton Beach Merger Agreement, Maura told a former Salton board member that Harbinger and Salton were going to bid for Applica. That same day, the Salton board approved a bid to be financed by Harbinger. The Salton board resolved that Applica be contacted and notified of the bid. Harbinger and Salton agreed that if Applica did not respond positively, Salton would tell Applica's lawyers that it was a breach of fiduciary duty for Applica's directors not to consider the Salton/Applica deal. Harbinger and Salton agreed that if Applica remained unresponsive, they would try other means, including a tender offer. NACCO believes, consistent with these plans, that a Salton representative contacted Applica on July 26, 2006.

At the time these communications were taking place, Applica was bound by a no-shop provision in the Hamilton Beach Merger Agreement and was obligated to give NACCO prompt notice of "any inquiry or proposal relating to an [Applica] Competing Transaction." The term "[Applica] Competing Transaction" broadly included "any merger, consolidation, share exchange, business combination or other transaction or series of transactions involving [Applica] that is conditioned on the termination of this Agreement or could reasonably be expected to preclude or materially delay the completion of the Merger." Applica did not disclose to NACCO either the outgoing communication from Applica management or the incoming call from Salton.

Nor did Harbinger revise its Schedule 13D disclosures. Thus, during the time that it was increasing its position in Applica to a nearly 40% stake, establishing effective control over Salton, receiving an outgoing communication from Applica management, and causing Salton to make a competing proposal to Applica, Harbinger continued to maintain that it was holding Applica shares "for investment purposes."

But just as Harbinger and Salton put their plans into motion, they hit a snag. Harbinger learned that its acquisition of Applica shares had triggered the Florida Control Shares Act (the "Florida Act") and that under the statute, Harbinger lost the right to vote its shares. Harbinger naturally sought to remedy this issue. On July 31, 2006, Maura contacted a senior Applica officer, expressed dissatisfaction with the Hamilton Beach Merger Agreement, and asked whether Applica intended to apply the Florida Act to Harbinger. The Applica officer assured Maura that Applica did not intend to rely on the Florida Act

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and that Harbinger would be able to vote its shares. On August 2, Harbinger asked Applica to seek a shareholder vote that would restore Harbinger's voting rights under the Florida Act. When Applica advised NACCO of the request, Applica assured NACCO that Harbinger planned on voting for the Hamilton Beach Merger Agreement.

Harbinger continued to increase its position in Applica, and on August 3, August 8, and August 11, 2006, Harbinger filed additional Schedule 13D forms disclosing its increased holdings. In its August 3 filing, Harbinger disclosed Maura's July 31 call to the "Applica senior officer" but stated that it was the Applica officer who raised the Florida Act and Applica's plan not to invoke it against Harbinger. Harbinger did not disclose that one subject of the call was Harbinger's dissatisfaction with the Hamilton Beach deal.

On August 17, 2006, Harbinger filed another Schedule 13D disclosing that its position now amounted to 39.24% of Applica's outstanding stock. Harbinger attached as an exhibit to its Schedule 13D an August 14 demand for books and records in which Harbinger requested stockholder lists as of May 10 and August 4 and information about representations Applica made in the Hamilton Beach Merger Agreement relating to whether the Florida Act applied.

In all of its August 2006 Schedule 13D filings, Harbinger continued to state that it was holding its shares for investment purposes and not with any plan or intention to influence or control Applica. None of the filings disclosed the July communication by Applica management or the Salton response. None of the filings disclosed that in Maura's calls to Applica, he had expressed Harbinger's dissatisfaction with the Hamilton Beach Merger Agreement. NACCO asserts that in reliance on Harbinger's Schedule 13D filings, Applica's reassurances that Harbinger would support the deal, and Harbinger's lack of any prior deal jump attempts, NACCO believed that Harbinger would not make a competing bid or seek to influence the outcome of the merger vote.

On September 14, 2006, Harbinger topped the Hamilton Beach Merger by offering to acquire all of the outstanding shares of Applica that Harbinger did not already own for $ 6.00 per share. In conjunction with its bid, Harbinger filed a Schedule 13D/A amending the disclosure in its prior Schedule 13 forms. The amended disclosure stated that rather than acquiring its shares for "investment purposes," Harbinger "acquired [its] Shares of [Applica] in order to acquire control of [Applica]." NACCO points to this amendment as an admission by Harbinger that its prior statements of intent were false.

Approximately one month later, on October 19, 2006, Harbinger amended its statement of intent once more. Harbinger now stated that as of September 14, its investment intent had changed, and as of that point it "now propose[d] to acquir[e] all of [Applica's shares]."

Applica Jilts NACCO For Harbinger.

The Hamilton Beach Merger Agreement contained a no-shop provision limiting Applica's ability to explore competing transactions. If Applica received an unsolicited

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bona fide written offer that the Applica board determined was reasonably likely to constitute a "Superior Proposal," as defined in the Hamilton Beach Merger Agreement, then Applica could provide information to and enter into discussions with the offeror. On September 14, 2006, Applica advised NACCO that it had received Harbinger's offer. On September 15, Applica informed NACCO that Harbinger's $ 6.00 per share cash bid was reasonably likely to constitute a "Superior Proposal," such that Applica was initiating discussions with Harbinger. On September 26, Applica informed NACCO that it had entered into a confidentiality agreement with Harbinger.

On October 10, 2006, Applica notified NACCO that it was terminating the Hamilton Beach Merger Agreement and would enter into a merger agreement with Harbinger. Under the Hamilton Beach Merger Agreement, Applica was permitted to terminate the agreement to accept a "Superior Proposal."

On October 11, 2006, NACCO disputed Applica's ability to terminate the Hamilton Beach Merger Agreement, asserting that Applica had breached the no-shop provision and failed to notify NACCO promptly of developments involving Harbinger. On October 12 and 13, Applica and NACCO each reiterated their positions. On October 17, NACCO asserted that it had been misled by Harbinger and the statements in Harbinger's Schedule 13 filings.

In an effort to cure any violation of the prompt notice provision, Applica did not take any further action until October 19, 2006. On that date, Applica again informed NACCO that the Hamilton Merger Agreement was terminated. Applica paid NACCO the $ 4 million termination fee and $ 2 million in expense reimbursement that the Hamilton Beach Merger Agreement called for in the event the agreement was validly terminated to accept a topping bid. Applica then entered into a merger agreement with Harbinger (the "Harbinger Merger Agreement").

On November 2, 2006, Applica filed a preliminary proxy statement to solicit proxies in favor of a merger with Harbinger (the "Harbinger Proxy Statement"). The "Background of the Merger" section contained disclosures markedly different from what Harbinger had disclosed in its Schedule 13D filings. For example, the Harbinger Proxy Statement disclosed that "[i]n mid-July, a representative of Harbinger . . . contacted [Applica's] financial advisor concerning the exploration of a possible strategic transaction." None of Harbinger's Schedule 13D filings disclosed that contact. The Harbinger Proxy Statement also disclosed that when Maura called the Applica senior officer on July 31, Maura "expressed dissatisfaction with the terms of the NACCO merger." Harbinger's Schedule 13D's had not disclosed this but rather portrayed the call as concerning only whether Harbinger could vote its shares in light of the Florida Act. According to the Harbinger Proxy Statement, Harbinger's expressed its dissatisfaction sufficiently strongly for the Applica board to discuss it on August 2.

NACCO Files Suit.

On November 13, 2006, NACCO filed this action against Applica and Harbinger seeking,

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among other things, a decree of specific performance enforcing the Hamilton Beach Merger Agreement and an order enjoining the Harbinger merger. NACCO sought expedited discovery and a trial, but was informed that the Court's calendar could not accommodate a full trial prior to the anticipated closing of the Harbinger merger. NACCO then moved for a preliminary injunction. After a preliminary exchange of documents, NACCO withdrew its injunction application on December 1.

Two weeks later, on December 18, 2006, NACCO filed an action in the United States District Court for the Northern District of Ohio seeking injunctive relief against the Harbinger merger based on allegedly false statements in Harbinger's Section 13 filings and in the Harbinger Proxy Statement. On December 20, the district court denied NACCO's applications for a temporary restraining order, preliminary injunction, and expedited discovery. The district court held that on the preliminary record before it, NACCO had failed to present a sufficiently strong likelihood of success on the merits. In a passage understandably embraced by the defendants, the district court noted, "[c]ontrary to Plaintiffs' position, the Court does not perceive any falsity in Harbinger's filings when they are properly viewed alongside unfolding events." NACCO Indus., Inc. v. Applica, Inc., 2006 U.S. Dist. LEXIS 91940, 2006 WL 3762090, at *7 (N.D. Ohio Dec. 20, 2006). On January 10, 2007, NACCO dismissed this federal action without prejudice.

A Bidding Contest Ensues.

Between December 15, 2006, and January 17, 2007, NACCO and Harbinger bid against each other for Applica. On December 15, NACCO launched a tender offer for Applica at $ 6.50 per share. Harbinger matched. On December 21, NACCO raised its bid to $ 7.00. Harbinger matched. Incremental bidding continued, with NACCO ultimately offering $ 8.05 per share on January 16, 2007.

On January 17, 2007, Harbinger raised its bid to $ 8.25 per share. In consideration for the increased bid, Applica nearly doubled Harbinger's termination fee--from $ 4 million to $ 7 million--and increased Harbinger's expense reimbursement from $ 2 million to $ 3.3 million.

NACCO points out that throughout the bidding, Harbinger had the benefit of owning a nearly 40% block that it had acquired for much lower prices at a time when NACCO was limited by a standstill agreement. Harbinger thus effectively was bidding for 60% of Applica, while NACCO was bidding for the whole thing. Put differently, every time NACCO put a dollar on the table, Harbinger could match with 60 cents. NACCO claims Harbinger only enjoyed this advantage because of its fraudulent Section 13 disclosures.

On January 24, 2007, Applica's stockholders approved the Harbinger Merger Agreement. NACCO terminated its offer.

Harbinger Causes Applica To Merge With Salton.

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Shortly after Applica's stockholders approved the Harbinger merger, Applica and Salton entered into a merger agreement. Harbinger was the driving force behind the deal. On December 28, 2007, the Salton-Applica transaction closed. Harbinger owned 92% of the combined company.

This Action Continues.

After the bidding contest ended, this action resumed. In October 2007, NACCO amended its complaint. The individual defendants disputed whether they were subject to personal jurisdiction, and NACCO sought jurisdictional discovery. In February 2008, NACCO moved to file a second amended complaint. Notwithstanding the liberal standard for amendment under Rule 15(a), the defendants opposed that motion. Vice Chancellor Lamb granted plaintiffs leave to amend in a letter opinion dated May 7, 2008.

Meanwhile, the individual defendants were opposing NACCO's efforts to conduct jurisdictional discovery, and NACCO was forced to move to compel. During argument after full briefing, Vice Chancellor Lamb assisted the parties in working out a stipulation that could be used in lieu of jurisdictional discovery. That stipulation was finally entered in December 2008.

It then came time for the defendants to brief their motions to dismiss the second amended complaint. The motions were argued in May 2008. Vice Chancellor Lamb ruled that this Court could not exercise personal jurisdiction over the individual defendants, who were dismissed from the case.

As I discuss below, NACCO's fraud claim rests on statements in federal securities filings mandated by the Securities Exchange Act of 1934 (the "Exchange Act"). In their briefing, the parties did not meaningfully discuss whether the Exchange Act's grant of exclusive jurisdiction to the federal courts prevented this Court from entertaining NACCO's fraud claim. As a court of limited jurisdiction, this Court has an independent obligation to inquire into the basis for invoking its powers. Vice Chancellor Lamb raised the issue during argument on the motion to dismiss, and the parties undertook to provide supplemental briefing.

LEGAL ANALYSIS

A Rule 12(b)(6) motion will be denied "unless it appears with reasonable certainty that the plaintiff would not be entitled to relief under any reasonable set of facts" supported by the complaint. Bonham v. HBW Holdings, Inc., 2005 Del. Ch. LEXIS 210, 2005 WL 3589419, at *6 (Del. Ch. Dec. 23, 2005). Applying this plaintiff-friendly standard, I deny the motion to dismiss Counts I, III, IV and VII. I dismiss Counts II, V, and VI.

Count I States A Claim For Breach Of Contract.

The Hamilton Beach Merger Agreement became effective as of July 23, 2006. From that point on, Applica was bound by Section 6.12 of the agreement, entitled "No Solicitation."

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Count I of the Complaint asserts that Applica breached Section 6.12.

I find it helpful to break Section 6.12 into subparts. Under Sections 6.12(a) and (b), Applica had the obligation to stop all discussions about any competing transaction. Framed in customary language, these sections stated:

> (a) [Applica] will immediately cease, terminate and discontinue any discussions or negotiations with any Person conducted before the date of this Agreement with respect to any [Applica] Competing Transaction . . . .
>
> (b) Prior to the Effective Time, [Applica] will not, and will cause its Affiliates and representatives not to, directly or indirectly solicit, initiate or encourage any inquiries or proposals from, discuss or negotiate with, or provide any non-public information to, any Person (other than [NACCO], [Hamilton Beach] and their respective representatives) relating to any merger, consolidation, share exchange, business combination or other transaction or series of transactions involving [Applica] that is conditioned on the termination of this Agreement or could reasonably be expected to preclude or materially delay the completion of the Merger (an "[Applica] Competing Transaction").
> I will refer to these subsections as the "No-Shop Clause."

Section 6.12(d) created an exception to the No-Shop Clause. In similarly customary language, Section 6.12(d) permitted Applica "to engage in any discussions or negotiations with, or provide any information to, any Person" if Applica "received an unsolicited bona fide written offer regarding an [Applica] Competing Transaction from a third party (which has not been withdrawn) and its board of directors has determined in good faith that there is a reasonable likelihood that such [Applica] Competing Transaction would constitute [an Applica] Superior Proposal." Section 6.12(e) defined "Applica Superior Proposal" as, in substance, an Applica Competing Transaction "which the board of directors of [Applica] concludes, after consultation with its financial advisors and following the receipt of the advice of its outside counsel, would, if consummated, result in a transaction that is more favorable to the [Applica] Shareholders than the Transactions." I will refer to this aspect of Section 6.12(d) as the "Superior Proposal Clause."

In addition to the No-Shop and Superior Proposal Clauses, Sections 6.12(c) and (d) required Applica to keep NACCO informed of any inquiry or proposal relating to an Applica Competing Transaction. Section 6.12(c) provided:

> [Applica] will promptly (and in any event within 24 hours) notify [NACCO] of its or any of its officers', directors' or representatives' receipt of any inquiry or proposal relating to, an [Applica] Competing Transaction, including the identity of the Person submitting such inquiry or proposal and the terms thereof.

In language following the Superior Proposal Clause, Section 6.12(d) provided that "[Applica] will use its commercially reasonable efforts to keep [NACCO] informed

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promptly of the status and terms of any such proposal or offer and the status and terms of any such discussions or negotiations and will promptly provide [NACCO] with any such written proposal or offer." I will refer to these aspects of Section 6.12 as the "Prompt Notice Clause."

The Period From July 23 Until September 14, 2006.

In asserting its breach of contract claim, NACCO first focuses on the period of time from July 23, 2006, when the Hamilton Beach Merger Agreement became effective, until September 14, when Applica advised NACCO that it had received Harbinger's $ 6.00 per share proposal. I find that the Complaint contains allegations sufficient to support a claim for breach of the Hamilton Beach Merger Agreement during this period under the plaintiff-friendly Rule 12(b)(6) standard.

The Complaint alleges that "[o]n July 24, 2006, the morning after the stock-for-stock Hamilton Beach Merger Agreement was signed, Applica caused Harbinger to be informed that Harbinger would likely succeed with an all-cash offer for Applica." The Complaint thus alleges that an indirect, outgoing call was made by Applica management in violation of the No-Shop Clause.

The Complaint further alleges that on July 26, 2006, a Salton representative contacted Applica about a Salton-Applica transaction.

These allegations are sufficient to plead a claim for breach of the No-Shop and Prompt Notice Clauses. In reaching this conclusion, I focus on the breadth of both clauses and the related definition of Applica Competing Transaction. The No-Shop Clause barred Applica from taking any action to "directly or indirectly solicit, initiate or encourage any inquiries or proposals from, discuss or negotiate with, or provide any non-public information to, any Person (other than [NACCO], [Hamilton Beach] and their respective representatives)" regarding an Applica Competing Transaction. It was thus not limited to soliciting a competing bid (which the Complaint sufficiently alleges took place), but also extended to engaging in discussions or negotiations relating to an Applica Competing Transaction. The Prompt Notice Provision likewise was not limited to a competing bid or firm offer, but extended to any "inquiry or proposal" relating to an Applica Competing Transaction. The definition of "Applica Competing Transaction" encompassed "any merger, consolidation, share exchange, business combination or other transaction or series of transactions involving [Applica] that is [1] conditioned on the termination of this Agreement or [2] could reasonably be expected to preclude or materially delay the completion of the Merger." Hamilton Beach Merger Agreement § 6.12(b) (emphasis added). The second half of this definition thus encompassed any "transaction or series of transactions that . . . could reasonably be expected to preclude or materially delay the completion of the Merger."

The No-Shop Clause and Prompt Notice Provision thus covered the outgoing communication by Applica management and the incoming call from Salton. They also covered the discussions regarding Harbinger's dissatisfaction with the Hamilton Beach

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Merger Agreement and its request for a waiver of the vote-stripping effect of the Florida Act, which related to a "transaction or series of transactions that . . . could reasonably be expected to preclude or materially delay the completion of the Merger."

In denying the motion to dismiss Count I with respect to this period, I am also influenced by the Complaint as a whole, which alleges that throughout the deal timeline, Harbinger representatives received timely and accurate tips and assistance from Applica insiders.

The Period From September 14 Until October 10, 2006.

As a second basis for its breach of contract claim, NACCO focuses on the time period starting on September 14, 2006, when Applica advised NACCO that it had received Harbinger's $ 6.00 per share proposal. On that date, Applica exercised its right under the Superior Proposal Clause to enter into discussions with Harbinger. NACCO alleges that from that point on, NACCO breached its obligations under the Prompt Notice Clause to "use its commercially reasonable efforts to keep [NACCO] informed promptly of the status and terms of [Harbinger's proposal] and the status and terms of any such discussions or negotiations."

According to the Complaint, the sum total of Applica's communications to NACCO during this period consisted of: (i) informing NACCO on September 14, 2006, of Harbinger's competing proposal, which Harbinger announced publicly; (ii) advising NACCO on September 22 that Applica had entered into a confidentiality agreement with Harbinger, which also was publicly disclosed; and (iii) notifying NACCO on October 10 that Applica was terminating the Hamilton Beach Merger Agreement. Applica claims it was not "commercially reasonable" to disclose anything else about the Harbinger discussions. In other words, according to Applica, NACCO bargained for nothing more than the right to receive the same information that Applica made publicly available to its stockholders. For purposes of its motion to dismiss, Applica argues that this level of notice was commercially reasonable as a matter of law.

I disagree and conclude that the Complaint states a claim for breach of the Prompt Notice Clause during the twenty-seven day period from September 14 until October 10, 2006. According to the Complaint, Applica made no effort to keep NACCO informed about the status of its discussions. Applica said nothing to NACCO about its negotiation of a confidentiality agreement with Harbinger beginning on September 14 and extending "over the next few days." It was not until after the close of business on September 21 that NACCO heard from Applica, and then only to be told that a confidentiality agreement had been signed. This fact was in any event disclosed in an SEC filing.

The Complaint Adequately Pleads Damages.

Defendants argue aggressively that despite having pled breaches of the Hamilton Beach Merger Agreement, NACCO has not sufficiently pled damages and thus its contract claims should be dismissed. The crux of the "no damages" argument is that NACCO subsequently engaged in a bidding war for Applica and lost. Having been defeated in the

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marketplace, the defendants claim that NACCO should not have a remedy in court.

If embraced as grounds for a pleadings-stage dismissal, the defendants' theory would have serious and adverse ramifications for merger and acquisitions practice and for our capital markets. Parties bargain for provisions in acquisition agreements because those provisions mean something. Bidders in particular secure rights under acquisition agreements to protect themselves against being used as a stalking horse and as consideration for making target-specific investments of time and resources in particular acquisitions. Target entities secure important rights as well. It is critical to our law that those bargained-for rights be enforced, both through equitable remedies such as injunctive relief and specific performance, and, in the appropriate case, through monetary remedies including awards of damages.

I am comfortable inferring at the pleading stage that if NACCO succeeds in establishing a breach of the Hamilton Beach Merger Agreement, it will be able to establish harm sufficient to invoke this Court's remedial powers. NACCO is entitled to make its case that it should receive its full expectancy damages for breach of the Hamilton Beach Merger Agreement. If it cannot obtain expectancy damages, then NACCO is entitled to prove an alternative damages measure, such as its reliance interest.

In terms of any reliance-based recovery, NACCO will have to contend with its receipt of a bargained-for $ 4 million termination fee and $ 2 million in expense reimbursement. But as is customary in merger agreements, Applica's right to terminate the Hamilton Beach Merger Agreement under Section 8.1(h) and pay the fees without further liability depended on Applica complying with its obligations under Section 6.12, including the No-Shop and Prompt Notice Clauses. And Section 8.2 of the Hamilton Beach Merger Agreement excludes from the limitation on liability any termination resulting "from the willful and material breach by a party of any of its representations, warranties or covenants in this Agreement." It is far from clear at this stage that NACCO is bound contractually or factually to the termination fee and expense reimbursement as a measure of recovery.

Without question, the damages inquiry will present difficult legal and factual issues. But it is premature to address those now or to expect NACCO to have quantified its damages claims at the pleading stage. It is certainly a reasonable inference that NACCO has been damaged.

For all these reasons, I conclude that Count I pleads a claim for breach of Hamilton Beach Merger Agreement.

Count II Fails To State A Claim For Breach Of The Implied Covenant Of Good Faith And Fair Dealing.

In Count II, NACCO asserts a claim for breach of the implied covenant of good faith and fair dealing. Although part of every contract governed by Delaware law, the implied covenant does not apply when "the subject at issue is expressly covered by the contract."

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Dave Greytak Enters., Inc. v. Mazda Motors of Am., Inc., 622 A.2d 14, 23 (Del. Ch. 1992). The Hamilton Beach Merger Agreement is a detailed contract containing specific provisions governing the issues that NACCO has raised. The express terms of the Hamilton Beach Merger Agreement, including the No-Shop Clause and the Prompt Notice Clause, establish the scope of NACCO's rights. These specific provisions, bargained for and crafted by sophisticated parties, leave no room for the implied covenant. Count II is dismissed.

Count IV States A Claim For Fraud.

I now jump to Count IV, in which NACCO asserts a claim for common law fraud against Harbinger. I do so because my analysis of Count IV influences my ruling on Count III, which asserts a claim for tortious interference with contract. I conclude that I have jurisdiction to consider NACCO's fraud claim and that a claim has been adequately pled.

Jurisdiction

The fraud claim turns exclusively on statements that Harbinger made in its Section 13 filings between March 8 and August 17, 2006. The source of Harbinger's statements raises the jurisdictional issue of whether a Delaware court can provide a common law fraud remedy for false statements in an Exchange Act filing. The Delaware Supreme Court has held that such a remedy exists. Moreover, the ability of this Court to enforce such a remedy where a Delaware entity has been accused of fraud serves important Delaware interests.

The jurisdictional provisions of the Exchange Act provide the initial structure for the analysis. Section 27 of the Exchange Act provides: "The district courts of the United States . . . shall have exclusive jurisdiction of violations of [the Exchange Act] or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by [the Exchange Act] or the rules and regulations thereunder." 15 U.S.C. § 78aa. At the same time, Section 28(a) of the Exchange Act provides that "[T]he rights and remedies provided by [the Exchange Act] shall be in addition to any and all other rights and remedies that may exist at law or in equity . . . ." 15 U.S.C. § 78bb.

The Delaware Supreme Court analyzed the implications of Sections 27 and 28 of the Exchange Act for state law claims in Rossdeutscher v. Viacom, Inc., 768 A.2d 8 (Del. 2001). The plaintiffs in that case sued on behalf of a class of holders of contingent value rights ("CVRs") whose value depended upon the price of the common stock of Viacom, Inc. The plaintiffs alleged that during the valuation period for the CVRs, Viacom made false statements regarding its financial condition to artificially inflate its stock price, resulting in a lower payout on the CVRs. More than one year after discovery of the violations, the plaintiffs sued for breach of contract, asserting that Viacom's conduct violated the implied covenant of good faith and fair dealing in the CVR agreements. The Delaware Superior Court dismissed the claims, holding that the contract claims were federal securities claims in disguise, and, under the federal securities laws, the claims had

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to be filed within one year after discovery of the violations. See id. at 10-16.

The Delaware Supreme Court reversed. Citing Section 28 of the Exchange Act, the Supreme Court held that "the federal statutory remedies of the Act over which the federal courts have exclusive jurisdiction are intended to coexist with claims based on state law and not preempt them." Id. at 17 (footnote omitted). The Delaware Supreme Court noted that the language of Section 28 was "not limited to state securities statutes or common law fraud actions" and therefore implied that "the express intention of Congress was that the federal securities law would not dilute any remedies allowed by the states, either in law or equity." Id. Citing securities laws treatises, the Delaware Supreme Court observed that commentators consistently regarded state common law fraud claims as existing in parallel with the anti-fraud provisions of the Exchange Act. Id. at 18. Based on these authorities, the Delaware Supreme Court held that a common law claim for breach of the implied covenant of good faith and fair dealing similarly could proceed independent of the Exchange Act. Id. The Delaware Supreme Court therefore reversed the Delaware Superior Court's ruling that the federal statute of limitations applied and remanded the case to proceed on the state law theory.

Although it might be possible to construe Rossdeutcher narrowly as addressing the statute of limitations for a breach of contract claim, a responsible reading of Rossdeutcher must recognize the intellectual foundation of the decision. The Delaware Supreme Court started from the premise that a claim for common law fraud based on false statements in federal securities filings could be litigated independently in state court. The Delaware Supreme Court then expanded that basic rule to include a common law claim for breach of the implied covenant of good faith and fair dealing. I therefore view Rossdeutcher as controlling on the question of whether a state law claim for common law fraud can proceed in this court, even though the statements giving rise to the claim appeared in filings made pursuant to the Exchange Act. Under Rossdeutcher, it can.

But NACCO's real beef is that the information in Harbinger's Schedule 13G and 13D filings was false and misleading, regardless of whether or not the information was required to be included under federal law. This issue can be adjudicated by this Court as a question of fact, separate and independent from what the line items of Schedule 13G and Schedule 13D require. In making this determination, I will be ruling on questions of Delaware law, not federal law. This does not mean that I am precluded from considering federal precedent on matters such as whether a particular disclosure is false or misleading. As Grable and other decisions recognize, it is perfectly appropriate to consider federal standards and case law as guideposts and as persuasive authority. This does not convert a Delaware state law claim into a federal claim.

Nor do I believe, as Harbinger contends, that the disclosures called for by Schedule 13G and 13D are so inherently technical that I must necessarily cross the line into construing federal law in resolving questions of fact. In its Schedule 13D filings Harbinger made affirmative statements of fact that were true, false, or materially misleading because they were incomplete. I do not have to consider federal law to evaluate the truth, falsity, or misleading nature of the factual statements. Prior to September 14, 2006, Harbinger also

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disclosed that it had "no plan or proposal which relates to, or would result in, any of the actions enumerated in Item 4 of the instructions to Schedule 13D." Item 4 provides as follows:

> State the purpose of purposes of the acquisition of securities of the issuer. Describe any plans or proposals which the reporting persons may have which relate to or would result in:
>
> (a) The acquisition by any person of additional securities of the issuer, or the disposition of securities of the issuer,
>
> (b) An extraordinary corporate transaction, such as a merger . . . involving the issuer or any of its subsidiaries,
>
> * * *
>
> (g) . . . other actions which may impede the acquisition of control by any person . . . .

These disclosure requirements appear sufficiently straightforward such that I will not have any difficulty determining as a factual matter whether at the time Harbinger was making its pre-September 14 disclosures Harbinger in fact had a "plan or proposal which relates to, or would result in" one of the matters enumerated in Item 4. I have a similar view of my ability to evaluate the truth or falsity of Harbinger's Schedule 13G certifications.

Consistent with the Delaware Supreme Court's holding in Rossdeutcher, the ability of a Delaware court to hear a common law fraud claim based on statements made by a Delaware chartered entity in Exchange Act filings serves important Delaware interests. Four of the Harbinger defendants accused of fraud are Delaware entities. Although the federal government has an obvious interest in enforcing the disclosure scheme established by the Exchange Act, Delaware has a powerful interest of its own in preventing the entities that it charters from being used as vehicles for fraud. Delaware's legitimacy as a chartering jurisdiction depends on it. The fate of some jurisdictions during the competition for corporate charters at the turn of the twentieth century provides a cautionary tale:

> The policy of West Virginia [at the time] was to offer the loosest, most liberal law of any state in the union. It was anticipated that such a law would attract a certain number of crooks and swindlers, and the West Virginia bar seemed to take a somewhat nonjudgmental attitude toward that possibility. The new policy was a resounding failure [and] West Virginia did quite poorly for a state actively seeking incorporations.
> Charles M. Yablon, The Historical Race Competition for Corporate Charters and the Rise and Decline of New Jersey: 1880-1910, 32 J. Corp. L. 323, 365 (2007) (footnote omitted). South Dakota similarly failed to attract incorporations after it

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> "acquired a reputation as home of wildcat mining stocks and other shady schemes." Id. at 366. In citing these historical examples, I intimate no criticism of either jurisdiction today.

If a Delaware entity engages in fraud or is used as part of a fraudulent scheme, that entity should expect that it can be held to account in the Delaware courts. I therefore hold that NACCO's fraud claim can go forward in this Court.

Falsity

To plead a fraud claim, NACCO must allege a fraudulent misrepresentation. Court of Chancery Rule 9(b) requires that fraud be pled with particularity. This standard requires that the plaintiff alleges "the circumstances of the fraud with detail sufficient to apprise the defendant of the basis for the claim." Abry Partners V, L.P. v. F & W Acquisition LLC, 891 A.2d 1032, 1050 (Del. Ch. 2006). A defendant's state of mind, including its knowledge and intent, need not be pled with particularity but "may be averred generally." Anglo Am. Sec. Fund, L.P. v. S.R. Global Int'l Fund, L.P., 829 A.2d 143, 158 (Del. Ch. 2003); see Ct. Ch. R. 9(b). The pleading requirement also takes into account whether "the facts lie more in the knowledge of the opposing party than of the pleading party." H-M Wexford LLC v. Encorp, Inc., 832 A.2d 129, 146 (Del. Ch. 2003).

Based on the allegations of the Complaint, NACCO has pled sufficiently that Harbinger's statements regarding its investment intent in its Schedule 13G and 13D filings were false or misleading. In reaching this conclusion, I recognize that my federal colleague considered a similar issue in the context of NACCO's applications for a temporary restraining order, preliminary injunction, and expedited discovery, and wrote that "the Court does not perceive any falsity in Harbinger's filing when they are properly viewed alongside unfolding events." NACCO Indus., Inc. v. Applica Inc., 2006 U.S. Dist. LEXIS 91940, 2006 WL 3762090, at *7 (N.D. Ohio Dec. 20, 2006). That ruling was made in a different procedural posture and on a different record. The district court was asked on a highly expedited basis to consider applications for equitable relief. The district judge did so solely on a paper record consisting of NACCO's complaint, which did not contain references to e-mails and other documents from the Delaware action because the defendants stood on their confidentiality designations.

The district court's determination, made in the context of weighing the likelihood of success for purposes of an injunction application, was necessarily tentative and preliminary. It would not have been binding on the district court in a further proceeding, and it is not binding on me. I, by contrast, am tasked with judging the sufficiency of the Complaint under Rules 9(b) and 12(b)(6). Those rules mandate different standards than were applied by the district court, and I must grant all reasonable inferences to the plaintiff. Given the differences in procedural posture, it is understandable that the district court and I could reach different conclusions. For purposes of the motion to dismiss, I believe that NACCO has sufficiently alleged facts supporting a reasonable inference that Harbinger's statements were false or materially incomplete.

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Reliance And Materiality

Making a false statement is not a strict liability offense. To plead a claim of fraud, the defendant must have had "the intent to induce the plaintiff to act or refrain from acting," and the plaintiff must in fact have acted or not acted "in justifiable reliance on the representation." * * *

I am frankly troubled by the reliance inquiry. Even based on the unusual and extreme facts pled in the Complaint, I view it as a close call.

The relevant parties for purposes of the fraud claim are NACCO, the original acquirer, and Harbinger, the second bidder. The Complaint alleges that NACCO read Harbinger's Schedule 13 disclosures and relied on them in making decisions about how to proceed. This is exactly what happens in an M&A scenario. NACCO was entitled to treat Harbinger's disclosures as true and accurate, as the law required them to be. In another matter involving Harbinger, Vice Chancellor Lamb held that a target corporation was entitled to rely on Harbinger's filing of a Schedule 13G, indicating that its ownership of the target's stock was for investment purposes only, in concluding that Harbinger was acting as a passive investor. Openwave Sys. v. Harbinger Capital, 924 A.2d 228, 243 (Del. Ch. 2007). So too may NACCO.

I find it equally reasonable to infer that Harbinger drafted its securities filings carefully and intentionally, knowing that NACCO and other market participants would review them and rely on what Harbinger said it was doing. The Complaint's allegations of tipping imply that Harbinger knew a good deal about Applica's process, including about NACCO's involvement. For example in June, Maura described for Falcone the proposed structure of the Hamilton Beach merger, a month before the deal was signed up and announced. Although it is not clear how early Harbinger knew specifically about NACCO, it was NACCO's re-approach to Applica in early 2006 that led to Applica announcing a process to explore strategic alternatives, and the Complaint alleges that Harbinger was tipped about those events. I therefore find it reasonable to infer at the pleadings stage that Harbinger drafted its securities filings with NACCO in mind. * * *

It is thus reasonable to my mind at the pleadings stage that NACCO relied on Harbinger's disclosures in deciding what to do and what not to do, and that Harbinger's false disclosures were material to NACCO. This is a case-specific ruling. It is critical that the Complaint has alleged a reasonable basis for me to infer that Harbinger intentionally made false disclosures about its investment intent in a context where Harbinger expected NACCO to review and rely on them and where NACCO reasonably did so.

Causally-Related Damages

To be actionable, a false statement must cause harm. H-M Wexford LLC, 832 A.2d at 144-45. The necessary causal connection has two dimensions. First, the false statement must be a factual cause of the harm in the sense that the harm would not have occurred but for the false statement. Second, the false statement must be a legal cause of the harm,

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meaning that the false statement must be a sufficiently significant cause of the harm to impose liability. Restatement (Second) of Torts § 548A, cmt. a-b; see 37 Am. Jur. 2d Fraud and Deceit § 281 (discussing requirements of but-for and proximate cause). The second limitation recognizes that the harm flowing from an event in the but-for sense at some point becomes too attenuated to give rise to liability. Our law will not award damages for a kingdom when the wrong concerns a two-penny nail.

As with the element of reliance, I view the question of causally related damages as a close one, and NACCO's theory has potential difficulties. But at the motion to dismiss stage, largely for the reasons discussed in my analysis of the reliance argument, I believe that NACCO has sufficiently pled that it suffered harm causally connected to Harbinger's false disclosures. I recognize that it is not necessarily true that NACCO would have consummated the Hamilton Beach Merger Agreement but for Harbinger's fraud. Harbinger might have outbid NACCO anyway, or Applica's stockholders might have voted down the Hamilton Beach Merger Agreement. But our law does not require that a fraud victim plead what "necessarily" would have happened. Carlton Invs. v. TLC Beatrice Int'l Holdings, Inc., 1996 Del. Ch. LEXIS 47, 1996 WL 189435, at *6 (Del. Ch. Apr. 16, 1996) (Allen, C.) (emphasis in original). A plausible theory is sufficient at the pleadings stage. Id. * * *

Although the question is close, I hold at the pleadings stage under the extreme facts pled that NACCO can seek damages for the loss of the Hamilton Beach merger under a fraud theory. I may well conclude after trial that Harbinger did not engage in fraud, that NACCO did not establish a but-for connection between Harbinger's fraud and the loss of the Hamilton Beach transaction, or that the line of dots connecting the two is too attenuated for Harbinger's fraud to be a legal cause of the loss. But given the allegations of the Complaint, I will not make those determinations on a motion to dismiss. Count IV will proceed.

Equitable Fraud

I reach a different conclusion regarding Count V, in which NACCO asserts a claim for equitable fraud. NACCO is a sophisticated party, none of the defendants occupied a special relationship towards NACCO, and nothing about the case suggests any other equity that has traditionally moved this Court to relax the pleading requirements for fraud. Equitable fraud is not appropriately invoked in this case. See U.S. West, Inc. v. Time Warner, Inc., 1996 Del. Ch. LEXIS 55, 1996 WL 307445, at *26 (Del. Ch. June 6, 1996) (Allen, C.). Therefore, I dismiss Count V.

Count III States A Claim For Tortious Interference With Contract.

Having addressed the fraud claims, I now return to Count III, where NACCO asserts a claim for tortious interference with contract against Harbinger. I decline to dismiss Court III.

"The tort of interference with contractual relations is intended to protect a promisee's

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economic interest in the performance of a contract by making actionable ‘improper’ intentional interference with the promisor’s performance.” Shearin v. E.F. Hutton Group, Inc., 652 A.2d 578, 589 (Del. Ch. 1994) (Allen, C.). As traditionally framed, a claim for tortious interference with contract requires “(1) a contract, (2) about which defendant knew and (3) an intentional act that is a significant factor in causing the breach of such contract (4) without justification (5) which causes injury.” Irwin & Leighton, Inc. v. W.M. Anderson Co., 532 A.2d 983, 992 (Del. Ch. 1987) (Allen, C.). There can be no meaningful dispute about the existence of the Hamilton Beach Merger Agreement or Harbinger’s knowledge of it. Based on my analysis of Count I, NACCO has pled a claim for breach of contract and has alleged injury flowing from the breach. The issues are therefore elements (3) and (4).

This Court has held that a plaintiff pled a claim for tortious interference with a covenant not to compete when the defendants set out to form a competing business and intentionally solicited the assistance and involvement of an individual whom they knew was bound by the covenant. See TriState Courier & Carriage, Inc. v. Berryman, 2004 Del. Ch. LEXIS 43, 2004 WL 835886, at *12 (Del. Ch. Apr. 15, 2004). Vice Chancellor Noble accepted for pleading purposes that the defendants’ solicitations were a substantial factor in causing a breach of the covenant. Id. Here, as discussed in my analysis of Count I, the Complaint adequately alleges that Harbinger knew about the No-Shop Clause and Prompt Notice Clause, but nevertheless engaged in contacts and communications that violated those clauses. As in TriState, this is sufficient for pleading purposes.

I also believe that the detailed allegations of fraudulent statements that I discussed in analyzing Count IV provide a sufficient basis for a claim of tortious interference. In denying a motion to dismiss a counterclaim for tortious interference with prospective business relations, a tort that is conceptually similar to tortious interference with contract, Vice Chancellor Strine ruled that the element of wrongfulness was met where the alleged interferer made false and misleading statements of fact about the counter-claimant. Agilent Technologies, Inc. v. Kirkland, 2009 Del. Ch. LEXIS 11, 2009 WL 119865, at *8 (Del. Ch. Jan. 20, 2009). As he noted, “claims for unfair competition and tortious interference must necessarily be balanced against a party’s legitimate right to compete,” but misrepresentations of fact “are not legitimate vehicles of competition.” Id.

The fact pattern alleged in the Complaint differs from Agilent, but similar principles are involved. As in Agilent, the Complaint alleges sufficiently that Harbinger did not limit itself to “legitimate vehicles of competition” when seeking to acquire Applica. Harbinger instead made false statements to hide its intent and get the drop on NACCO.

For purposes of the tortious interference analysis, I also take into account Harbinger’s success in acquiring a nearly 40% stock position, facilitated at least in part through its false disclosures. Vice Chancellor Strine held a defendant liable for tortious interference where the defendant obtained an unfair advantage by using confidential information it had obtained from other defendants in violation of contractual agreements with the plaintiff. Cura Fin. Servs. v. Elec. Payment Exch., Inc., 2001 Del. Ch. LEXIS 132, 2001 WL 1334188, at *18 (Del. Ch. Oct. 22, 2001). Harbinger similarly obtained an unfair

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advantage over NACCO by accumulating a large stock position based on false disclosures. Because of Harbinger's actions, NACCO did not receive the full benefit of the contractual protections that NACCO bargained for, including the superior proposal mechanism for filtering Applica's access to topping bids. NACCO instead faced a competing bidder with a significant leg up thanks to its improper activities.

At this stage of the case, I believe that NACCO's allegations are adequate to support the contention that Harbinger acted wrongfully in a manner that was a substantial factor in Applica's breaches of the Hamilton Beach Merger Agreement. Harbinger intentionally engaged in improper actions that interfered with NACCO's rightful expectations of performance. I therefore decline to dismiss Count III.

Counts VI Has Been Abandoned.

Count VI of the Complaint asserts a claim for aiding and abetting a breach of fiduciary duty. In response to the defendants' motion to dismiss and opening brief, NACCO chose not to defend this claim, consented to its dismissal, and did not mention it further. I dismiss it.

Count VII States A Claim For Civil Conspiracy For Fraud Against Applica.

Count VII of the Complaint asserts a claim for civil conspiracy. To successfully plead a claim for civil conspiracy under Delaware law, a plaintiff must allege "(1) [a] confederation or combination of two or more persons; (2) [a]n unlawful act done in furtherance of the conspiracy; and (3) [a]ctual damage." Nicolet, Inc. v. Nutt, 525 A.2d 146, 149-50 (Del. 1987). Each conspirator "is jointly and severally liable for the acts of co-conspirators committed in furtherance of the conspiracy." Id. at 150.

NACCO first claims that Harbinger conspired with Applica to breach the Harbinger Merger Agreement. Although the elements of a claim for civil conspiracy are flexible, it is essential that there be an underlying wrongful act, such as a tort or a statutory violation. Empire Fin. Servs. v. Bank of New York (Delaware), 900 A.2d 92, 97 (Del. 2006). A breach of contract is not an underlying wrong that can give rise to a civil conspiracy claim. Kuroda v. SPJS Holdings, L.L.C., 971 A.2d 872, 892 (Del. Ch. 2009). NACCO therefore cannot state a claim for civil conspiracy by alleging that Applica and Harbinger conspired to breach the Hamilton Beach Merger Agreement.

NACCO fares no better to the extent it means to suggest that Harbinger has engaged in tortious interference with contract, and that Applica can be held liable under a theory of civil conspiracy for that tort. Delaware upholds the freedom of contract and enforces as a matter of fundamental public policy the voluntary agreements of sophisticated parties. See, e.g., Abry Partners, 891 A.2d at 1061 (describing policy and discussing authorities). Delaware also recognizes the concept of efficient breach. Allied Capital Corp. v. GC-Sun Holdings, L.P., 910 A.2d 1020, 1039 (Del. Ch. 2006). Delaware law generally elevates contract law over tort to allow parties to order their affairs and bargain for specific results, to the point where Delaware law enforces contractual provisions that eliminate

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the possibility of any tort liability short of actual fraud based on explicit written contractual representations. Abry Partners, 891 A.2d at 1061-64. A claim of conspiracy to commit tortious interference against a party to the contract would undercut these principles and replace the predictability of the parties' agreement with a far less certain, after-the-fact, judicially-fashioned tort remedy. Recognizing such a round-about claim would circumvent the limitations on tort liability that are a fundamental aspect of Delaware law.

Thus, to the extent Count VII asserts that Applica and Harbinger conspired to breach the Hamilton Beach Merger Agreement, I dismiss the claim. Likewise, to the extent Count VII attempts to sue Applica in tort for a civil conspiracy to engage in tortious interference, I dismiss the claim.

NACCO last asserts that Applica conspired with Harbinger and therefore should be liable civilly for Harbinger's fraud. The claim of fraud readily meets the requirement for an underlying wrong. The Complaint alleges sufficiently that Applica management sought to advance Harbinger's bid by tipping Harbinger about non-public events in the deal timeline, assisting Harbinger in accumulating blocks of Applica stock to facilitate Harbinger's ability to influence the outcome of the Hamilton Beach merger or make a competing bid, making an outgoing communication to Harbinger after the Hamilton Beach Merger Agreement was announced to solicit an all-cash bid, and delaying providing information to NACCO at Harbinger's request and even providing false information to NACCO to further Harbinger's agenda. This is sufficient to state a claim for civil conspiracy based on the fraud.

CONCLUSION

This is a pleadings-stage decision. It determines only whether NACCO can proceed with its claims. Whether NACCO ultimately prevails and obtains a remedy will depend on the evidence presented, any defenses, and the ultimate equities of the case.

The parties shall confer on a scheduling order that will bring this matter to trial within twelve months. If the parties have any difficulty reaching agreement, I will be happy to assist.

The defendants' motion to dismiss is thus GRANTED IN PART and DENIED IN PART. IT IS SO ORDERED.

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XI. CHAPTER 16, PROXY CONTESTS

A. Page 807, Sec. 16.8. SEC's Proposal to Shareholder Access to the Proxy Mechanism

Page 807, Sec. 16.8.	Replace the current Sec. 16.8 with the following:
New Sec. 16.8.	**SEC's Proposal to Shareholder Access to the Proxy Mechanism**

SEC Proposed Rule, Facilitating Shareholder Director Nominations
SEC Release No. 34-60089 (June 10, 2009)

PROPOSED CHANGES TO THE PROXY RULES

Introduction

We are proposing amendments to the proxy rules to require companies to include disclosures about shareholder nominees for director in the companies' proxy materials, under certain circumstances, so long as the shareholders are not seeking to change the control of the issuer or to gain more than a limited number of seats on the board. These proposed amendments build on the Commission's 2003 and 2007 proposals. They also reflect our experience with, and continued consideration of, the issue of shareholder involvement in the proxy process, the interaction between the proxy rules and state law, and the extensive comment that we have received over the past six years on these topics. As stated previously, due to dispersed ownership, director elections are largely conducted by proxy rather than in person and, as a result, impediments that the federal proxy rules create to shareholders nominating directors through the proxy process translate into the inability of shareholders to effectively exercise their rights to nominate and to elect those directors. We believe the proposed rule changes will provide shareholders with a greater voice and an avenue to exercise the rights they have to effect change on the boards of the companies in which they invest that they no longer can exercise effectively through attending a shareholder meeting in person.

The Commission's proposals would provide shareholders with two ways to more fully exercise their rights to nominate directors. First, we are proposing a new proxy rule (Exchange Act Rule 14a-11) that would, under certain circumstances, require companies to include shareholder nominees for director in the companies' proxy materials. This requirement would apply unless state law or a company's governing documents prohibits shareholders from nominating directors. In this regard, state law or a company's governing documents may provide for nomination or disclosure rights in addition to those provided pursuant to Rule 14a-11 (e.g., a company could choose to provide a right for shareholders to have their nominees disclosed in the company's proxy materials regardless of share ownership – in that instance, the company's provision would apply for certain shareholders who would not otherwise have their nominees included in the company's proxy materials pursuant to Rule 14a-11). Second, we are proposing an amendment to Exchange Act Rule 14a-8(i)(8), the election exclusion, to preclude

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companies from relying on Rule 14a-8(i)(8) to exclude from their proxy materials shareholder proposals by qualifying shareholders that would amend, or that request an amendment to, a company's governing documents regarding nomination procedures or disclosures related to shareholder nominations, provided the proposal does not conflict with proposed Rule 14a-11.

B. Page 810, New Sec. 16.10.C. Allegation of Third Party Vote Buying in Delaware—Kurz

Page 810, New Sec. 16.10.C. New Sec. 6.10.C. — Add before Sec. 16.11 the following: **Allegation of Third Party Vote Buying in Delaware—*Kurz***

Crown Emak Partners, LLC, v. Kurz
Supreme Court of Delaware, 2010
992 A.2d 377

OPINION

HOLLAND, Justice:

This is a consolidated appeal from a final judgment entered by the Court of Chancery pursuant to Rule 54(b). This proceeding involves competing requests for relief under section 225 of the Delaware General Corporation Law (the "DGCL"). At issue is which of two competing factions lawfully controls the board of directors (the "Board") of EMAK Worldwide, Inc. ("EMAK").

Prior to December 18, 2009, the Board had six directors and one vacancy. On December 18, one director resigned, creating a second vacancy. The plaintiffs-appellees contend that on December 20 and 21, Take Back EMAK, LLC ("TBE") delivered sufficient consents (the "TBE Consents") to remove two additional directors without cause, and fill three of the resulting vacancies with Philip Kleweno, Michael Konig, and Lloyd Sems. Incumbent director Donald A. Kurz ("Kurz") is a member of TBE. If valid, the TBE Consents would establish a new Board majority.

The defendants-appellants contend that on December 18, 2009, Crown EMAK Partners, LLC ("Crown") delivered sufficient consents (the "Crown Consents") to amend EMAK's bylaws (the "Bylaw Amendments") in two important ways. First, the Crown Consents purportedly amended Section 3.1 of the Bylaws ("New Section 3.1") to reduce the size of the Board to three directors. Because Crown has the right to appoint two directors under the terms of EMAK's Series AA Preferred Stock, a by-law reducing the Board to three, if valid, would give Crown a Board majority. Second, the Crown Consents purportedly added a new Section 3.1.1 to the Bylaws ("New Section 3.1.1") providing that if the number of sitting directors exceeds three, then the EMAK CEO will call a special

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meeting of stockholders to elect the third director, who will take office as the singular successor to his multiple predecessors. The defendants contend that the Bylaw amendments are valid and that the next step is for the EMAK CEO to call a special meeting under New Section 3.1.1.

The Court of Chancery concluded that the TBE Consents validly effected corporate action and that, therefore, the lawful Board consists of incumbent directors Kurz, Jeffrey Deutschman, and Jason Ackerman, and newly elected directors Kleweno, Konig, and Sems. Consequently, one vacancy remains. The Court of Chancery also concluded that the bylaw amendments adopted through the Crown Consents conflict with the DGCL and are void. Therefore, the court held, the Crown Consents were ineffective either to reduce the size of the Board or to require the calling of a special meeting.

The appellants raise three claims in this appeal. First, the appellants submit that the Court of Chancery erred in concluding that Kurz did not engage in impermissible vote buying. In the alternative, they contend Kurz's purported purchase of the outcome determinative shares from Peter Boutros ("Boutros") was an improper transfer under the plain language of a Restricted Stock Grant Agreement between EMAK and Boutros.

We hold that Kurz did not engage in improper vote buying, but that his purchase of shares from Boutros was an improper transfer that was prohibited by a restricted stock agreement between Boutros and EMAK. Because the Boutros shares could not be voted, that deprived the Kurz faction of the votes required to elect their nominees.

***Factual Background * * ***

Boutros Purchase Agreement

With the December 21, 2009, deadline looming, TBE and its principals were working feverishly to round up the final consents. On Thursday, December 17, Sems emailed Kurz: "We need to buy someone[s'] shares this weekend."

One person whose vote remained undecided was Boutros, a former employee and current consultant of EMAK who lived in Australia. Boutros owned 175,000 shares of restricted stock, all entitled to vote. Both sides sought Boutros's support. On Thursday, December 17, 2009, Boutros told Kurz that he would support Crown. Kurz responded that he would contact Boutros that weekend and encouraged Boutros to reconsider before the December 21 deadline.

As of Friday, December 18, 2009, D.F. King, TBE's proxy solicitor, showed TBE having consents for approximately 48.4% of the common shares. To prevail, TBE needed another 116,325 votes.

Between Friday, December 18 and Sunday, December 20, 2009, Kurz had a series of telephone calls with Boutros. On Sunday, Kurz had additional calls with Boutros's

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counsel. The result was a Purchase Agreement dated as of December 20, 2009 (the "Purchase Agreement"), in which Boutros sold to Kurz:

> (a) all shares of common stock of EMAK Worldwide, Inc., a Delaware corporation (the "Company") that Seller owns and is entitled or permitted to sell, transfer or assign as of the date hereof (the "Shares"), and (b) all rights to receive all other shares of the Company that the Seller is or may hereafter be entitled or permitted to sell, transfer or assign, for a total purchase price of U.S. $ 225,000.00 (the "Purchase Price"), with the Purchase Price to be paid by wire transfer to an account designated by Seller upon full execution of this Agreement.

Boutros originally asked for $ 2.25 per share. Kurz felt that was too high and bargained Boutros down. Kurz believed he obtained the economic and voting rights (albeit not legal title) to 150,000 shares, resulting in a price of $ 1.50 per share. At the time, EMAK's stock was trading on the pink sheets for around $ 0.95 per share.

The description of what Boutros sold and Kurz bought reflects their efforts to contract around transfer restrictions. A Restricted Stock Grant Agreement dated March 3, 2008, governed 150,000 of Boutros's shares. Section 2 of that Agreement provided: "Prior to [March 3, 2011], [Boutros] shall not be entitled to transfer, sell, pledge, hypothecate or assign any shares of Restricted Stock." Under Section 3 of that agreement, if Boutros was still employed by EMAK on March 3, 2011, then the transfer restrictions would lapse. If Boutros was terminated without cause before March 3, 2011, then the restrictions would lapse upon termination. If Boutros was terminated for cause or resigned before March 3, 2011, then he would forfeit the shares. The cover letter from EMAK that conveyed the grant stated: "The stock will vest equally (one-third per year) over a three year period." The Court of Chancery found that it was odd to use the term "vest," because under Section 2, the transfer restrictions and forfeiture provisions seemingly applied to all 150,000 shares until March 3, 2011.

Boutros' remaining 25,000 shares were governed by a Resale Restriction Agreement dated November 6, 2009. That latter agreement contains a different form of transfer restriction, which provides: "[Boutros] agrees not to sell, contract to sell, grant any option to purchase, transfer the economic risk of ownership in, make any short sale of, pledge or otherwise transfer or dispose of any Shares (or any interest in any Shares) until the Shares have been released from the foregoing restrictions [on or before November 7, 2010]."

The parties dispute what was actually transferred. Of the shares governed by the Restricted Stock Grant Agreement, the plaintiffs-appellees contended Boutros could transfer 50,000 shares immediately, another 50,000 on March 3, 2010, and the final 50,000 on March 3, 2011. The defendants-appellants contended Kurz got nothing and 150,000 shares if Boutros still holds them on March 3, 2011. For purposes of its opinion, the Court of Chancery assumed the latter to be true.

Section 2 of the Purchase Agreement was critical to Kurz. It provides:

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> **Proxies**. As a material part of the consideration for this Agreement, and an express condition precedent to the effectiveness hereof, Seller agrees to execute and deliver to Buyer by facsimile transmittal on the date hereof, time being of the essence, with originals to follow immediately by express delivery, (a) this Agreement, (b) an Irrevocable Proxy, (c) the Revocation, and (d) the White Consent Card solicited by Take Back EMAK, LLC, each in the form attached hereto.

With Boutros' votes in hand, Kurz believed TBE had the consents it needed to prevail.

Late in the evening on December 20, 2009, Kurz's counsel sent by email to EMAK's general counsel an initial Broadridge omnibus consent dated November 23, 2009, reflecting voting instructions received through that date (the "Initial Broadridge Omnibus Consent"). Kurz's counsel also sent written consent cards for record holders and a certification attesting to the soliciting parties' good faith belief that they had received valid and unrevoked consents sufficient to take corporate action. The defendants-appellants question whether Kurz, TBE, and the other soliciting parties could have held that good faith belief on December 20. The Court of Chancery found that the certification was properly given, based on the consents TBE had in hand and the information TBE had from its proxy solicitor about how the street name vote came in.

On the morning of December 21, 2009, the same documents were hand-delivered to EMAK's registered office in Delaware. That morning, TBE ordered a supplemental omnibus consent from Broadridge dated December 21, 2009 (the "Supplemental Broadridge Omnibus Consent"), showing additional votes, net of revocations, since November 23. The Supplemental Broadridge Omnibus Consent was hand-delivered to EMAK's registered office later that day. TBE also delivered additional consent cards from registered holders to EMAK's registered office.

ANALYSIS

Improper Vote Buying Concern

Shareholder voting differs from voting in public elections, in that the shares on which the shareholders' vote depends can be bought and sold. Vote buying in the context of corporate elections and other shareholder actions has been and continues to be an important issue. Several commentators have addressed the corporate voting process and techniques by which shareholder voting rights can be manipulated.[284]
The Court of Chancery characterized vote buying that does not involve the use of corporate resources as "third party vote buying." Here, although Kurz is a director of EMAK, he used his own resources to acquire Boutros's shares. Accordingly, Kurz's

[284] See, e.g., Henry T. C. Hu & Bernard Black, Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms, 61 Bus. Law. 1011 (2006) (hereinafter Empty Voting); Henry T. C. Hu & Bernard Black, Equity and Debt Decoupling and Empty Voting II: Importance and Extensions, 156 U. Pa. L. Rev. 625 (2008); Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance And Corporate Control, 155 U. Pa. L. Rev. 1021 (2007).

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actions as a third party do not involve the problem of insiders using corporate resources to "buy" votes.[285]

Vote buying has been described as disenfranchising when it delivers the swing votes.[286] In this case, the Court of Chancery opined that third party vote buying merits judicial review if it is disenfranchising, *i.e.*, if it actually affects the outcome of the vote. Applying those principles to this case, the Court of Chancery concluded that the Purchase Agreement between Kurz and Boutros was potentially disenfranchising and "should be subjected to a vote buying analysis," because the "Purchase Agreement provided TBE with the votes they [sic] needed to prevail and disenfranchised what would have been a silent majority against the TBE Consent Solicitation." Therefore, it determined that the Purchase Agreement should be scrutinized closely.

The Court of Chancery noted a 1983 scholarly analysis of shareholder voting which concluded "[i]t is not possible to separate the voting right from the equity interest" and that "[s]omeone who wants to buy a vote must buy the stock too."[287] The Court of Chancery also recognized, however, that over the last twenty-five years" [i]nnovations in technology and finance have made it easier to separate voting from the financial claims of shares." Today, "the market permits providers to slice and dice the shareholder's interest in a variety of ways, and investors are willing to buy these separate interests."

According to a recent scholarly study of corporate voting by Professors Robert Thompson and Paul Edelman, a disconnect between voting rights and the economic interests of shares "compromises the ability of voting to perform its assigned role." They concluded that "[a] decisionmaking system that relies on votes to determine the decision of the group necessarily requires that the voters' interest be aligned with the collective interest. [Therefore, i]t remains important to require an alignment between share voting and the financial interest of the shares."

No Improper Vote Buying

For many years, Delaware decisions have expressed consistent concerns about transactions that create a misalignment between the voting interest and the economic interest of shares. As then Vice-Chancellor (now Chief Justice) Steele explained, "[g]enerally speaking, courts closely scrutinize vote-buying because a shareholder who divorces property interest from voting interest [ ] fails to serve the 'community of interest' among all shareholders, since the 'bought' shareholder votes may not reflect rational, economic self-interest arguably common to all shareholders."[288] Again, in this

[285] See Portnoy v. Cryo-Cell Int'l, Inc., 940 A.2d 43, 73-74 (Del. Ch. 2008); Hewlett v. Hewlett-Packard Co., 2002 Del. Ch. LEXIS 44, 2002 WL 549137, at *4-7 (Del. Ch. Apr. 8, 2002); Kass v. E. Air Lines, Inc., 1986 Del. Ch. LEXIS 486, 1986 WL 13008, at *2-4 (Del. Ch. Nov. 14, 1986); Schreiber v. Carney, 447 A.2d 17, 22-23 (Del. Ch. 1982).

[286] Hewlett v. Hewlett-Packard Co., 2002 Del. Ch. LEXIS 44, 2002 WL 549137, at *5.

[287] Frank H. Easterbrook & Daniel R. Fischel, Voting in Corporate Law, 26 J. L. & Econ. 395, 410(1983).

[288] In re IXC Commc's, Inc. S'holders Litig., 1999 Del. Ch. LEXIS 210, 1999 WL 1009174, at *8 (Del. Ch. Oct. 27, 1999); see also Haft v. Haft, 671 A.2d 413, 421 (Del. Ch. 1995) ("A powerful argument can be advanced that generally the congruence of the right to vote and the residual rights of ownership will tend

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case, the Court of Chancery recognized that "[w]hat legitimizes the stockholder vote as a decision-making mechanism is the premise that stockholders with economic ownership are expressing their collective view as to whether a particular course of action serves the corporate goal of stockholder wealth maximization."[289]

Accordingly, the Court of Chancery held that "[p]olicing third-party vote buying does not rest on the outdated notion that every stockholder owes every other stockholder a duty to use its best judgment while voting. It flows instead from the legitimating conditions necessary for meaningful stockholder voting. . . ." The Court of Chancery concluded that:

> Because transactions in which economic interests are fully aligned with voting rights do not raise concern, Delaware law does not restrict a soliciting party from buying shares and getting a proxy to bolster the solicitation's chance of success. Delaware law presumes that in the sale of the underlying stock, the seller sells and assigns all of its rights, title and interest, "including its right to grant a consent or a revocation with respect to a past record date. . . ." *Commonwealth Assocs. v. Providence Health Care*, 641 A.2d at 158. Delaware law further presumes that "upon request the seller will, in good faith, take such ministerial steps as are necessary (*e.g*., granting proxies) to effectuate the transfer." *Id*. Such transactions are common. John C. Wilcox, John J. Purcell III, & Hye-Won Choi, *"Street Name" Registration & The Proxy Solicitation Process*, at 10-26 in Amy Goodman, et al., *A Practical Guide to SEC Proxy and Compensation Rules* (4th Ed. 2007 & 2008 Supp.) ("[O]ver the course of a proxy contest, it is not uncommon for contestants to attempt to increase their voting power by purchasing additional shares . . . ."); Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 Vand. L. Rev. 129, 130 (2009) ("A corporate voter who has intense feelings about the matter to be determined can influence, if not control, the outcome by purchasing shares.").

Guided by these principles, the Court of Chancery scrutinized the Purchase Agreement as follows:

> I find no evidence of fraud in the transaction. The record indicates that Boutros was fully informed about the ongoing consent solicitations. Both factions had made multiple attempts to get him to commit to their side. Although there is no direct evidence establishing that Boutros knew his shares were the swing shares, I conclude that he must have been cognizant of this fact. He cut his deal with Kurz over the weekend before the Monday on which the TBE Consent Solicitation ended. At a time when EMAK's stock was trading on the pink sheets for less than

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towards efficient wealth production."); Commonwealth Assocs. v. Providence Health Care, 641 A.2d 155, 157 (Del. Ch. 1993) (noting law's historic concern about "the sale of votes unconnected to the sale of stock" in part because "such sales misalign the interests of voters and the interests of the residual corporate risk bearers").

[289] *HN5* A Delaware public policy of guarding against the decoupling of economic ownership from voting power can be seen in the 2009 amendment to section 213(a), which now authorizes a board to set one record date for purposes of giving notice of a meeting of stockholders and a second, later record date for determining which stockholders can vote at the meeting. Del. Code Ann. tit. 8, § 213(a) (West Supp. 2010).

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> a dollar, Boutros asked for $ 2.25 per share and received $ 1.50 per share. Boutros was advised by counsel and bargained to obtain specific terms for the deal, including an absence of representations and warranties and contractual indemnification from Kurz. These are the hallmarks of a transaction in which Boutros understood what he was selling, the circumstances under which he was selling it, and what he was getting in return.

This brings me to the *alignment of interests*. Although Kurz did not take title to the 150,000 shares that Boutros owned, and although I assume the Restricted Stock Grant Agreement prohibits Boutros from transferring title to Kurz until March 3, 2011, Boutros nevertheless transferred to Kurz, and *Kurz now bears, 100% of the economic risk* from the 150,000 shares. If the value of EMAK's shares drops further, then Kurz will suffer. If EMAK goes bankrupt and its shares become worthless, then Kurz will have a paper souvenir. Conversely, if EMAK turns itself around and prospers, then Kurz will benefit. Kurz has already paid Boutros. Kurz's only interest lies in how EMAK performs.

Because Kurz now holds the economic interest in the shares, Delaware law presumes that he should and will exercise the right to vote. Commonwealth Assocs. v. Providence Health Care, 641 A.2d at 158; *see Len v. Fuller*, 1997 Del. Ch. LEXIS 78, 1997 WL 305833, at *5 (Del. Ch. May 30, 1997) (barring record holder from voting shares by written consent after corporation exercised option to acquire shares); *Freeman v. Fabiniak*, 1985 Del. Ch. LEXIS 486, 1985 WL 11583, at *7 (Del. Ch. Aug. 15, 1985) ("[I]t would be inequitable to allow a holder of record who holds mere legal title to stock to act by consent in a manner contrary to the wishes of the true owner."). The proxy Boutros granted to Kurz under the Purchase Agreement comports with what our law expects. *See generally* John C. Wilcox, John J. Purcell III, & Hye-Won Choi, *"Street Name" Registration & The Proxy Solicitation Process* at 10-27 in Amy Goodman, et al., *A Practical Guide to SEC Proxy and Compensation Rules* 10-3 (4th ed. 2007 & 2008 Supp.) (explaining that a purchaser typically obtains an irrevocable proxy when shares are acquired from a registered holder).

We hold that the Court of Chancery correctly concluded that there was no improper vote buying, because the economic interests and the voting interests of the shares remained aligned since both sets of interests were transferred from Boutros to Kurz by the Purchase Agreement.

Restricted Stock Grant Agreement Violated

The defendants-appellants next argue that, even if the Purchase Agreement did not constitute improper vote buying, Kurz should not be allowed to vote the Boutros shares, because by entering into the Purchase Agreement, Boutros breached the transfer restrictions in the Restricted Stock Grant Agreement. The Restricted Stock Grant Agreement provided that "[p]rior to [March 3, 2011], [Boutros] shall not be entitled to transfer, sell, pledge, hypothecate or assign any shares of Restricted Stock." The Court of Chancery assumed that the restrictions are operative and binding.

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The factual findings made by the Court of Chancery are important. On Thursday, December 17, 2009, Kurz was told "we need to *buy* someone's shares this weekend." As of Friday, TBE had consents for approximately 48.4% of the common shares and needed another 116,325 votes to prevail. Boutros owned 175,000 shares of restricted stock, all of which were all entitled to vote. Kurz was provided with copies of both of Boutros' stock restriction agreements on Sunday, December 20, 2009, before entering into the Purchase Agreement.

Kurz read the agreements and parsed the restrictions. He focused on the language in the Resale Restriction Agreement that extended beyond any sale to encompass any "contract to sell," any "option to purchase," and any transfer of the "economic risk of ownership." He noted that the Restricted Stock Grant Agreement did not contain similar language and appeared to restrict only an actual sale, transfer, pledge, hypothecation, or assignment. Kurz concluded that he could contract with Boutros to buy however many shares Boutros could sell at the time, and to obtain in the future however many shares Boutros eventually could transfer, if and when Boutros became able to transfer them.

The Court of Chancery held that Kurz and Boutros had successfully contracted around the sale and transfer restrictions, because the Restricted Stock Grant Agreement does not prohibit Boutros from agreeing to take those actions *at a future date*. The record supports the Court of Chancery's conclusion that Kurz did not engage in illegal vote buying because that court found that, along with the votes, Kurz simultaneously purchased and immediately received the *full economic* interests associated with the Boutros shares. That finding, however, leads inexorably to the conclusion that the Purchase Agreement violated the Restricted Stock Grant Agreement. The Court of Chancery's determination that there was no actual sale or transfer is not supported by the record, the language and purpose of the Restricted Stock Grant Agreement, or the court's own findings.

In their comprehensive analysis of new vote buying and its corporate governance implications, Professors Henry Hu and Bernard Black have examined modern vote buying techniques. In doing so they defined three terms that are relevant to our review of what was *actually transferred immediately* by the Purchase Agreement between Kurz and Boutros.

> "[F]ormal voting rights" [--] the *legal* right to vote shares under company law (as supplemented by SEC and stock exchange rules governing voting of shares held in street name), including the legal power to instruct someone else how to vote.
>
> "[E]conomic ownership" [--] the economic returns associated with shares. This ownership can be achieved directly by holding shares, or indirectly by holding a "coupled asset," which conveys returns that relate directly to the returns on the shares. Economic ownership can either be positive -- the same direction as the return on shares -- or negative -- the opposite direction from the return on shares.

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> "Full ownership" consist[s] of voting ownership plus direct economic ownership.[290]

Professors Hu and Black also noted:

> Our system of record ownership already decouples economic ownership from formal voting rights. The record owner is typically at least two persons removed from the economic owner of the shares. Shares held in "street name" are generally held "of record" by Depository Trust Company or another securities depository, which holds the shares on behalf of another intermediary (such as a broker-dealer or bank), which holds the shares for economic owners. Our legal system has responded by partly recoupling voting and economic ownership. Depositories pass voting rights to their bank and broker clients, who must request voting instructions from economic owners. If the customer does not provide instructions, New York Stock Exchange (NYSE) Rule 452 allows a bank or broker to vote on routine matters, but not on a contested matter or on a merger or similar transaction which may substantially affect the value of the shares.[291]

Professors Hu and Black concluded that the foregoing rules on when record owners can vote provide precedent for an effort to reconnect voting rights to economic ownership, when technology has severed them.

Those observations helpfully aid our analysis of the Purchase Agreement. Kurz paid Boutros for the immediate receipt of all economic interest in the shares. The Restricted Stock Grant Agreement, however, required the continued decoupling of the formal voting rights, by requiring that Boutros remain as the record owner until 2011. Nevertheless, Kurz was able to connect the economic rights he purchased from Boutros with the formal voting rights that Boutros would otherwise retain by requiring Boutros to execute an Irrevocable Proxy.

Therefore, unlike other beneficial owners, Kurz could vote the shares on any future corporate matter without ever again contacting the record owner, Boutros, for another proxy. By reconnecting the voting rights to the economic ownership via the Irrevocable Proxy, the Purchase Agreement *immediately* conferred upon Kurz the functional equivalent of "full ownership," in consideration for the $ 225,000 he paid to Boutros. There was nothing for Boutros to transfer to Kurz in the future, other than the bare legal title.

The Court of Chancery found that "Kurz believed he obtained the economic and voting rights (albeit not legal title) to 150,000 shares" for a price of $ 1.50 per share. Kurz testified that when he entered into the Purchase Agreement, the financial results and forecasts he received suggested he was *overpaying Boutros for his shares*. In rejecting the

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[290] Henry T. C. Hu & Bernard Black, Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms, 61 Bus. Law. 1011, 1022 (2006).
[291] Id. at 1058 (internal citations omitted).

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defendants' insider trading arguments,[292] the Court of Chancery concluded that Kurz's testimony was credible and that "Kurz *bought Boutros' shares* because TBE needed another 116,325 votes to win."

The purpose of the Restricted Stock Grant Agreement was to "provid[e] employees and consultants of [EMAK] with a proprietary interest in pursuing the long-term growth, profitability and financial success of the Corporation." That is consistent with the purpose of restricted stock agreements generally. The structure of the Restricted Stock Agreement, providing that Restricted Stock will fully vest in Boutros only after three years of continued employment beyond the grant date, is also consistent with this purpose.

The Court of Chancery found that "although Kurz did not take title to the 150,000 shares that Boutros owned, and although I assume the Restricted Stock Grant Agreement prohibits Boutros from transferring title to Kurz until March 3, 2011, Boutros nevertheless transferred to Kurz, and Kurz now bears, 100% of the economic risk from the 150,000 shares." Boutros' immediate divestiture of all voting and economic rights in his shares frustrates the purpose of the Restricted Stock Grant Agreement, because bare legal title, alone and without more, does not give Boutros a stake in the corporation's future.

The Restricted Stock Agreement prohibits any "transfer, [sale], pledge or hypothecat[ion]" of Boutros' restricted EMAK shares. The Court of Chancery found that the "odd framing of what Boutros sold and Kurz bought reflects their efforts to contract around those transfer restrictions."[293] The Boutros/Kurz Purchase Agreement recites that Boutros agrees to "sell" all shares "that he owns and is permitted to sell, transfer or assign…." By its very terms, the Restricted Stock Grant Agreement prohibits what the Boutros/Kurz Purchase Agreement purports to do, *i.e.*, sell, transfer or assign his shares. Therefore, we hold that the Purchase Agreement did not operate as a legally valid sale or transfer of Boutros' shares, and that Kurz was not entitled to vote those shares. * * *

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[292] In this appeal, it is unnecessary to address either the defendants' insider trading theory or Kurz's violation of EMAK's insider trading policy. Although the Court of Chancery characterized those arguments as theoretical and highly technical, in our view, an actual finding of insider trading violations requires an appropriate remedy.

[293] The record clearly reflects Boutros' concern about whether the Purchase Agreement successfully circumvented the prohibitions in the Restricted Stock Grant Agreement. The Court of Chancery found: "Boutros asked for $ 2.25 per share and received $ 1.50 per share. Boutros was advised by counsel and bargained to obtain specific terms for the deal, including an absence of representations and warranties and contractual indemnification from Kurz. These are the hallmarks of a transaction in which Boutros understood what he was selling, the circumstances under which he was selling it, and what he was getting in return."

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XII. CHAPTER 18, REGULATION OF OPEN MARKET PURCHASES

A. Page 852, New Sec. 18.8. When Can a 13G Be Filed, the Ordinary Course of Business Rule—Perry

Page 852, New Sec. 18.8.	Add before the References:
New Sec. 18.8.	**When Can a 13G Be Filed, the Ordinary Course of Business Rule—*Perry***

In the Matter of Perry Corp.
Securities Exchange Act of 1934 Release No. 60351, July 21, 2009

[PART I]

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(e) of the Investment Advisers Act of 1940 ("Advisers Act") against Perry Corp. ("Respondent" or "Perry").

[PART II]

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934 and Section 203(e) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order as to Perry Corp. ("Order"), as set forth below.

[PART III]

On the basis of this Order and Respondent's Offer, the Commission finds that:

<u>Summary</u>

1. This matter concerns Perry's failure to file a required disclosure statement pursuant to Section 13(d) of the Exchange Act within ten days of acquiring beneficial ownership

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of more than five percent of the shares of Mylan Laboratories Inc. (now Mylan Inc.) ("Mylan").

2. At the time of Perry's purchases of Mylan shares, Mylan had announced a proposed acquisition, subject to shareholder approval, of King Pharmaceuticals, Inc. ("King"). Perry entered into an investment strategy known as "merger arbitrage," in which Perry would profit from consummation of the merger. The amount of the potential profit depended, at the time the arbitrage position was taken, on the spread in value between the shares of the acquirer and the target company. The spread, in turn, depended on how the market viewed the likelihood that the merger would be consummated. As the likelihood of consummation increased, the spread narrowed and the opportunity for profit diminished.

3. In order to increase the likelihood of consummation, Perry purchased Mylan shares in order to vote the shares in favor of the merger. At the same time, in order to avoid the economic risk of owning Mylan shares, Perry entered into a series of swap transactions designed to hedge fully its financial exposure from owning the Mylan shares. The swap transactions provided that the swap counterparty would reimburse Perry for any decrease in the market price of Mylan shares between the time of Perry's purchase and the time Perry's position was unwound, which had the effect of insulating Perry from movements in the Mylan share price. As a result, Perry acquired the voting rights to nearly ten percent of Mylan's outstanding shares without any economic risk of share ownership. Perry's ability to acquire the voting rights to Mylan shares without disclosure enhanced its ability to profit potentially from its merger arbitrage position.

4. In general, Section 13(d) of the Exchange Act requires any person who has acquired beneficial ownership of more than five percent of a voting class of equity securities registered under Section 12 of the Exchange Act to report such acquisition within ten days. When it exceeded the five percent threshold in September 2004, Perry determined not to file a beneficial ownership disclosure statement after receiving advice from outside counsel that it could defer filing pursuant to Rule 13d-1(b). However, Perry was not entitled to defer filing pursuant to Rule 13d-1(b) because Perry's acquisition of Mylan securities was not "in the ordinary course" of its business. Qualified institutional investors can defer their Section 13(d) reporting obligations in reliance on Exchange Act Section 13(g) and Rule 13d-1(b) thereunder only when they acquire securities as part of their ordinary market making or passive investment activities. When institutional investors, such as Perry, acquire ownership of securities for the purpose of influencing the direction or management of an issuer or affecting or influencing the outcome of a transaction – such as acquiring shares for the primary purpose of voting those shares in a contemplated merger – the acquisition is not made and the shares are not held in the "ordinary course" of business for purposes of relying on Rule 13d-1(b). By failing to make a timely filing, Perry violated Section 13(d) of the Exchange Act and Rule 13d-1 thereunder.

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Respondent

5. **Perry**, a New York corporation headquartered in New York, New York, is a registered investment adviser that provides investment advice and asset management services to five private investment funds. Perry has been registered with the Commission as an investment adviser since April 2000. Perry operates its investment advisory business in the United States principally through Perry Capital, LLC ("Perry Capital"). As of March 30, 2009, Perry had approximately $8.8 billion under management.

The Mylan/King Merger

6. On July 26, 2004, Mylan, one of the nation's largest manufacturers of generic pharmaceutical products, announced an agreement to acquire King, an established brand-name pharmaceutical company. The agreement provided that King shareholders would receive 0.9 shares of Mylan common stock for each outstanding share of King stock, which represented a 61% premium for King shareholders as of the date of the announcement. Pursuant to the terms of the agreement, consummation of the merger was subject to the approval of both Mylan and King shareholders.

7. Perry had invested in King intermittently from October 2001, and beginning in March 2004 had built a significant position in King. As of the close of business on July 23, 2004, Perry had accumulated a total of 4,337,900 shares of King, at an average cost of $15.08 per share. Because King's share price declined between March and July 2004, Perry sustained a paper loss of $20,413,440. On the day of the merger announcement, King's stock price went up almost 25% and Perry could have sold its King shares then and recouped a portion of its trading losses.

8. Following the merger announcement, Perry engaged in "merger arbitrage." Perry tried to maximize its potential profits by converting its King position into a "risk-arbitrage spread" position through the short-sale of a corresponding number of Mylan shares. An arbitrage spread opportunity is created when, as a result of a merger announcement, the securities of the acquiring company (the "acquirer") trade at a higher adjusted price than the shares of the company it seeks to purchase (the "target"). The adjusted price refers to the stock price of the acquirer adjusted for how many shares of the acquirer the target's shares will convert to in the stock-for-stock merger. This pre-completion spread between the adjusted price of the acquirer's shares and the price of the target's shares reflects market uncertainty about deal consummation, *i.e.*, whether the premium offered to the target company will be realized. Thus, the pre-completion spread widens if there are indications that the merger will not be completed. Conversely, the pre-completion spread narrows as confidence grows that the merger will be completed. A transaction designed to take advantage of an arbitrage spread opportunity, called a risk-arbitrage spread trade, is established by acquiring shares of the target and selling short a corresponding number of shares of the acquirer. When the merger is completed, the shares of the target become shares of the acquirer, and these shares can be used by the investor to cover

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its short-sales of the acquirer's stock. Through these risk-arbitrage spread trades, investors can profit from the pre-merger spread that resulted from the risk that the transaction would not be completed. If the merger is not completed, no profit is realized from the risk-arbitrage spread transaction and a loss may result.

9. In the five days immediately following the merger announcement, Perry sold short 3,839,500 shares of Mylan (and adjusted its King position) in order to establish a risk-arbitrage spread position, the profitability of which was contingent upon successful completion of the merger. If the merger had been completed at that time, Perry's existing risk-arbitrage spread position – the shares of King it currently held and corresponding Mylan short-sales – would have resulted in a gain to Perry of approximately $14.4 million, off-setting much of its paper loss on King. Perry also continued to increase its King position, such that as of the close of business on August 13, 2004, Perry held 5,152,600 shares of King, representing 2.1% of King's outstanding shares.

Opposition to the Mylan-King Merger

10. On August 18, 2004, a prominent activist investor (the "Activist Investor") and certain entities he controlled (the "Activist Investor Group") received Hart-Scott-Rodino clearance from the Federal Trade Commission to purchase between $100 million and $500 million worth of Mylan shares, representing between 2.4% and 11.9% of Mylan's outstanding common stock. On September 7, 2004, the Activist Investor Group filed a Schedule 13D with the Commission, disclosing that it had acquired 6.8% of Mylan's stock and that it opposed the Mylan-King merger and intended to solicit proxies against it.

11. The Activist Investor Group's Schedule 13D filing signaled that winning Mylan shareholder approval of the merger would be difficult and the market reacted swiftly. Between September 7, when the Activist Investor Group filed its Schedule 13D, and September 17, 2004, when it amended its Schedule 13D to disclose that it held 8.9% of Mylan's stock, the risk-arbitrage spread widened by 59%, from $3.26 to $5.19. The risk-arbitrage spread reflected market uncertainty as to whether the merger would succeed in the face of the Activist Investor's opposition, particularly given that there was no indication that any other large Mylan shareholder supported the merger. If the Activist Investor succeeded in blocking the merger, Perry would lose its anticipated profit from its risk-arbitrage spread trades.

Perry's Acquisition of Voting Rights to Mylan Stock

12. Following the Activist Investor Group's initial Schedule 13D filing, Perry began exploring various ways of acquiring Mylan voting rights without economic risk and without public disclosure. Perry wanted to obtain Mylan stock in order to vote in favor of the merger, and thereby counter the Activist Investor's votes, but did not want to take on the economic risk of owning Mylan shares. In addition, because Perry wanted to profit from a wider risk arbitrage spread, Perry did not want the market to be aware that Perry was building a position to vote in favor of the merger. Had the

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market known that Perry was acquiring Mylan shares sufficient to offset the Activist Investor Group's position, the spread would have narrowed to reflect the increased likelihood that the merger would be completed, thereby reducing Perry's potential profits on its spread trades. As a result, Perry researched possible mechanisms through which it could purchase or transfer Mylan stock in transactions which would not be reflected publicly in the market, and obtained pricing on various derivative products which could eliminate or come close to eliminating Perry's economic exposure to the Mylan stock. Perry had never before engaged in a similar strategy to acquire voting rights to a security in order to vote those shares in a merger, without having any economic interest in the shares.

13. On September 8, 2004, a Perry employee contacted a brokerage house specializing in derivative products to inquire about various ways that Perry might be able to purchase Mylan shares while simultaneously obtaining a derivative product to offset the economic risk of owning the stock. The Perry employee also inquired whether there was any way Perry could purchase the Mylan shares without the purchase being publicly reported:

    If we traded like a million shares or two million shares of Mylan … would it print, or would we have to see it hit the tape? … [C]ould you print on like a consolidated tape at like 6:30 at night tonight or something, so that way it never really hits our tape.[294] You know what I mean, like, there's exchanges in the Caymans, there's exchanges in London. … Ask your [brokerage trader] what is the most discreet way to print this … and call me back.[295]

14. Thereafter, on September 10, a second Perry employee had several telephone calls with Perry's contact at an investment bank. During the calls, the Perry employee first asked who would see trades printed on the consolidated tape, and the bank representative expressed his understanding that trades done after 6:30 p.m. were reported only to the relevant exchange and not to the market as a whole. The Perry employee then asked: "So if we wanted to cross stock with you guys and have it print on a consolidated tape after 6:30, is that something that you guys would be willing to do for us?" The bank representative responded, "You mean you're doing it in a swap?" The Perry employee explained that Perry wanted to do it as a cross, which the bank representative rejected as not a "real trade." The Perry employee then asked, "So we could do it in swaps, you're saying. We could do it in swaps?" The bank representative responded that he thought they could. Minutes later, the Perry employee instructed the bank to begin looking into transactions whereby Perry would acquire Mylan shares in 500,000 to 1 million share lots, every few days, after 6:30

[294] This conversation demonstrates Perry's understanding of then-existing trade reporting requirements. During the relevant period, over-the-counter ("OTC") trades made between 6:30 p.m. and midnight were reported to an NASD facility on the next trading day and marked "as of." Trades reported in this way were not disseminated to the public. By contrast, trades that took place during regular business hours involved trade reports that were immediately publicly disseminated.

[295] A "print" is an industry term for trade reporting.

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p.m. to avoid public disclosure while eliminating Perry's risk through "swap" agreements with the bank.

15. Starting on September 8, 2004, Perry acquired 26.6 million shares, or 9.89% of Mylan's shares, to vote in favor of the Mylan-King merger and to counter the Activist Investor's opposition. Perry purchased 5.6 million of these Mylan shares in regular open-market transactions.[296] Perry acquired the remaining 21 million shares from, and engaged in a complex series of "swap" transactions with, two banks (collectively, the "Banks") that gave Perry voting rights to Mylan shares while eliminating Perry's economic risk of holding the shares.

16. The Banks borrowed and short-sold to Perry 21 million shares of Mylan stock, in blocks of 1 million to 2 million shares, which Perry purchased in foreign markets or after hours on the OTC market. Perry took several steps to ensure that the transactions would be hidden from the market. First, because the Banks were borrowing the shares, the transfer of the shares from the investors who owned them to the Banks did not hit the tape. Second, and more important, Perry instructed the Banks to conduct the Mylan short-sales in foreign markets or as OTC trades after hours so those trades also would not be disseminated to the public. By structuring the transactions this way, these trades were not reported by any volume-reporting or other public dissemination services, even though on many days Perry's share purchases eclipsed the total volume of all Mylan shares reported to have been purchased through all reporting exchanges. Thus other market participants were unaware that Perry was obtaining a very large voting interest in Mylan that could be used to counter the Activist Investor's opposition to the merger.

17. At the same time as it was acquiring its long position in Mylan through short sales by the Banks, Perry was executing "swap" agreements with the Banks tied to the underlying Mylan shares Perry was purchasing from the Banks. The "swaps" were governed by ISDA (International Swap Dealers Association) Master Agreements, with the specific terms of each transaction set forth in a "confirmation." These "swaps" were synthetic transactions tied to the price of the underlying security. Essentially, the parties to a "swap" transaction agree to pay one another the difference between the price of the underlying security at origination and termination, with one party being obligated to make payments if the price goes up, and the other obligated

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[296] From September 8 through September 10, 2004, the days in which it was exploring alternative mechanisms, Perry purchased 2,883,900 shares of Mylan through the New York Stock Exchange, all of which shares were offset by short sales Perry already had in Mylan, but did not cover its short position using these Mylan long purchases. Perry purchased another 2,742,400 shares in standard market transactions from September 23 through October 13, 2004, again offsetting these shares with Mylan shares it sold short as part of its risk-arbitrage position. Although an investor typically would "cover" a short position and close out the short (and stop paying financing fees to the bank through whom it was executing the short), Perry kept both positions open — long Mylan and short Mylan — thereby paying financing fees to its prime brokers for its existing short position while retaining the right to vote the shares purchased to cover the short. Payment of these unnecessary financing costs, which totaled $5.7 million, was consistent with Perry's purpose in purchasing the Mylan shares solely for voting rights, further demonstrating the lack of any independent economic rationale for Perry's acquisition of Mylan stock.

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to make payments if the price goes down. In this case, the "swap" transactions had the effect of insulating both parties from movements in the price of the underlying stock, Mylan. Because the Banks were borrowing the shares that they sold short to Perry, the Banks would be at risk if the price of Mylan stock was up at the time the Banks needed to cover their short positions. At the same time, Perry – which was long the 21 million shares – would be at risk if the price of Mylan stock was down at the time Perry wished to unwind its position. The "swaps" guaranteed both parties against these potential losses: through the "swap" Perry agreed to reimburse the Banks for the difference between the price at which the Banks short-sold the Mylan shares to Perry and the market price at the time the transaction was unwound, if the market price at that time was higher, and the Banks agreed to reimburse Perry for the difference between the price Perry paid for the stock and the market price at the time the transaction was unwound, if the market price at that time was lower. The "swap" agreements effectively eliminated any economic risk Perry had from owning Mylan shares. As a result of the "swap" transactions, neither Perry nor the Banks were at risk of any movement in the price of Mylan stock.

18. By entering into these "swap" transactions, Perry was able to acquire the voting rights to nearly ten percent of Mylan's stock without having any economic risk and no real economic stake in the company. Moreover, Perry was able to do this without making a significant financial outlay. Perry financed its purchase of Mylan stock through an extension of its existing margin line of credit at its prime broker. For each purchase of Mylan stock, in the three days between trade date and settlement date, Perry drew upon its margin account to have enough cash deposited into its cash account to satisfy payment for the long position. The funds were then transferred to the Banks by the settlement date. In total, Perry paid less than $7.2 million to its prime broker to finance the purchase of 26.6 million Mylan shares, worth approximately $492 million. Perry also earned interest on its short positions and on the collateral it gave to the Banks for the "swaps." As a result, accounting for all of Perry's costs and also the interest it earned on its various positions, Perry paid only $5.76 million to acquire voting rights to almost ten percent of Mylan's shares.[297]

19. While Perry was engaging in its Mylan strategy of essentially buying votes, it was simultaneously adding to its risk-arbitrage spread position by purchasing additional King shares and continuing to short Mylan shares. As of November 11, 2004, the day on which Perry held its largest King position, Perry stood to capture an additional $21.8 million gain on the further risk-arbitrage spread trades it had made since September 7.[298] If the merger had been consummated that day, Perry's July 26, 2004

[297] The Banks profited from this transaction through commissions earned and financing fees charged for establishing the swap positions. The Banks also benefited by virtue of holding a total of $448,074,500 in funds obtained from Perry while the position was open, in what can be described as an extremely low interest loan from Perry to the Banks. The Banks received $389,630,000 for the 21 million shares of Mylan the Banks short-sold to Perry, as well as $58,444,500 in collateral that Perry posted for the swaps. Although Perry earned the nominal federal funds rate from the Banks on its collateral payment, the Banks were free to earn more on the total amount of $448,074,500.

[298] By the close of business on September 7, 2004, Perry held 5,146,800 shares of King, which it had converted into risk-arbitrage spread positions by short-selling Mylan stock, and stood to earn at least

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$20.4 million paper loss on its 4,337,900 share King position would have turned into a net profit of $21.3 million on its 8,594,700 share King risk-arbitrage spread position – a $41.7 million swing. Had the market known that Perry was acquiring voting rights in Mylan shares sufficient to offset the Activist Investor's Mylan position, the spread between the price of King and the price of Mylan would have been narrower. Because the market was unaware of Perry's position and conduct, however, Perry was able to not only protect its existing potential arbitrage-spread gain, but also further profit by engaging in additional risk-arbitrage spread trades at artificially wide spreads.

Perry's Failure to File Required Reports

20. On September 20, 2004, Perry was approaching the five percent ownership threshold triggering reporting obligations pursuant to Section 13(d) of the Exchange Act and Rule 13d-1 thereunder. To determine whether it was required to file a Schedule 13D disclosing its Mylan position, Perry sought advice from outside counsel at two different law firms. First, Perry personnel contacted outside counsel from the law firm that routinely handled Perry's public filings, including its Section 13 filings ("Lawyer A"). Lawyer A advised Perry that, ordinarily in a merger situation, his initial reaction and general bias was that Perry should file a Schedule 13D.

21. Perry personnel then contacted another lawyer, who had previously provided advice to Perry on various mergers and acquisition matters ("Lawyer B") – including advice in August 2004 concerning the Activist Investor's acquisition of Mylan shares. Without informing Lawyer B that Perry previously had consulted with Lawyer A, Perry asked Lawyer B, who had not previously handled any of Perry's Section 13 filings, for his legal advice concerning Perry's Schedule 13D filing obligations. After discussing the matter with Perry, Lawyer B advised by email that Perry could defer filing "assuming the purchase of Mylan shares is [in the] ordinary course":

> I think you're ok filing a 13G if you are acquiring the securities in the ordinary course of business and not with a view toward, or as part of a plan having the purpose or effect of, changing or influencing control of Mylan. My understanding of the deal is that it is a reverse triangular merger, with a subsidiary of Mylan merging into King, and that there will be no change in the Mylan board as a result of the merger. So, assuming the purchase of Mylan shares is ordinary course for Perry (and I'm not sure why it would not be), I think you can file a 13G if a filing is necessary.

22. Perry personnel then informed Lawyer A that Lawyer B had opined that Perry did not have to file a Schedule 13D because it was acquiring an interest in the acquirer, not the target company. After discussing the issue, Lawyer A agreed that, in general, Perry's ownership in an acquiring company would not amount to "influencing control" under Rule 13d-1(b)(1)(i) of the Exchange Act and therefore would not automatically trigger a Schedule 13D filing obligation.

$19.97 million on this position if the merger were to be consummated, reducing Perry's pre-merger announcement paper loss on its King position from $20.4 million to $443,000.

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23. In opining upon Perry's reporting obligations, neither attorney specifically considered whether Perry's vote-buying strategy was in the ordinary course of Perry's business. Perry's counsel did not ask questions or follow up with Perry concerning whether Perry's strategy was in the ordinary course of Perry's business. Nor did Perry conduct any internal assessment or follow up with counsel for legal advice on this issue. By the close of business on September 24, 2004, Perry had acquired 16.2 million shares of Mylan, representing more than five percent of Mylan shares. Pursuant to Section 13(d), Perry was required to disclose its acquisition within ten days, that is, by October 3, 2004.

Perry's Untimely Schedule 13D Filing

24. On November 19, 2004, the Activist Investor announced that he intended to make a $20 per share tender offer for Mylan. Shortly thereafter, at the end of the day on November 22, 2004, a news article was published that speculated that Perry and other hedge funds had taken positions in Mylan to vote in favor of the merger and capture the significant risk arbitrage spread, without having any economic interest in the company or exposure to Mylan's stock price.

25. On November 23, 2004, Perry consulted with counsel at a third law firm ("Lawyer C"), who opined that Perry should file a Schedule 13D in light of the Activist Investor's tender offer. Lawyer C opined that because of the tender offer, Perry now could be said to hold its Mylan shares with the purpose or effect of changing or influencing the control of Mylan. On November 29, 2004, Perry filed a Schedule 13D disclosing its Mylan position, more than two months after Perry had acquired more than five percent of Mylan shares.[299]

26. The Mylan/King merger was not completed for reasons unrelated to the above-described trading. On December 8, 2004, King announced that it would have to restate earnings for 2002, 2003 and the first six months of 2004. On February 27, 2005, Mylan and King announced that they had mutually agreed to terminate the proposed merger because they were "not able to agree upon terms for a revised transaction."

Violations

27. Section 13(d) of the Exchange Act and Rule 13d-1 thereunder generally require any person who has acquired beneficial ownership of more than five percent of a voting class of equity securities registered under Section 12 of the Exchange Act to report such acquisition on Schedule 13D within ten days after such acquisition. However, as an alternative, the rules allow the use of short-form disclosure statements with differing timing requirements under certain conditions. Rule 13d-1(c) provides that,

[299] On November 12, 2004, Perry filed a Schedule 13F disclosing among its holdings in 216 different companies that it owned over 16.9 million shares of Mylan as of September 30, 2004. Filing a required Schedule 13F does not relieve persons from their obligations with respect to filing Schedule 13D, which requires the disclosure of more detailed information than a Schedule 13F.

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in lieu of filing a Schedule 13D, any person may file a short-form statement on Schedule 13G within ten days after the triggering acquisition (a "10-Day 13G"), so long as that person "has not acquired the securities with any purpose, or with the effect of, changing or influencing the control of the issuer, or in connection with or as a participant in any transaction having that purpose or effect," and is not directly or indirectly the beneficial owner of twenty percent or more of the class of securities. In addition, Rule 13d-1(b) provides that, in lieu of filing a Schedule 13D, certain qualified institutional investors may file a short-form statement on Schedule 13G within 45 days after the end of the calendar year in which they made the triggering acquisition (a "45-Day 13G"), so long as the institutional investor acquired the securities "in the ordinary course of his business and not with the purpose nor with the effect of changing or influencing the control of the issuer, nor in connection with or as a participant in any transaction having such purpose or effect."[300]

28. The institutional investors that can avail themselves of the more liberal timing requirements of the 45-Day 13G include broker-dealers, banks, insurance companies, investment companies, and persons registered as investment advisers. An institutional investor that does not meet the "ordinary course of business" requirement for filing a 45-Day 13G can still file a 10-Day 13G, in lieu of a Schedule 13D, so long as it meets the requirements of Rule 13d-1(c).[301]

29. The filing requirements of Section 13(d) of the Exchange Act were adopted for the twofold purposes of "(i) providing adequate disclosure and other protections to stockholders in connection with takeover attempts, such as tender offers, and corporate repurchases, and (ii) providing adequate disclosure to stockholders in connection with any substantial acquisition of securities within a relatively short period of time." Exchange Act Release No. 13291, 42 Fed. Reg. 12342, 12343 n.2 (Mar. 3, 1977); see also GAF Corp. v. Milstein, 453 F.2d 709, 717 (2d Cir. 1971) ("the purpose of section 13(d) is to alert the marketplace to every large, rapid aggregation or accumulation of securities, regardless of technique employed, which might represent a potential shift in corporate control"); SEC v. Drexel Burnham Lambert, Inc., 837 F. Supp. 587, 607 (S.D.N.Y. 1993) (citing cases).

30. "Section 13(d) is not a mere 'technical' reporting provision; it is, rather, the 'pivot' of a regulatory scheme that may represent the only way that corporations, their shareholders and others can adequately evaluate . . . the possible effects of a change in substantial shareholdings." Drexel, 837 F. Supp. at 607 (internal citations omitted);

[300] Under Rule 13d-1(b), qualified institutional investors who meet these tests need not file a 45-Day 13G unless they beneficially own more than five percent of a class of equity securities as of the end of the calendar year in which they acquired the securities. Rule 13d-1(b)(2).

[301] See, e.g., Exchange Act Release No. 34-37403, 1996 WL 374621, at *6 (July 3, 1996) ("Even where an institutional investor is unable to make the 'ordinary course of business' certification [under Rule 13d-(1)(b)(1)] it would still be permitted to file on Schedule 13G under the Passive Investor provision so long as it does not have [beneficial ownership of equal to or greater than 20% of the outstanding class or acquire or hold the securities with] a disqualifying purpose or effect.") Perry never filed a Schedule 13G pursuant to Rule 13d-1(c) and therefore was legally precluded from satisfying its beneficial ownership reporting obligation by claiming that it was a "Passive Investor" as defined in Exchange Act Release 39538, (January 12, 1998) at footnote 9.

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see also H.R.Rep. No. 1711, 90th Cong., 2d Sess., at 8 (1968), reprinted in 1968 U.S.C.C.A.N. 2811, 2818 ("The purpose of section 13(d) is to require disclosure of information by persons who have acquired a substantial interest, or increased their interest in the equity securities of a company by a substantial amount, within a relatively short period of time."); SEC v. First City Fin. Corp., Ltd., 890 F.2d 1215, 1230 (D.C. Cir. 1989) (a violator of Section 13(d) improperly benefits by purchasing stock at an artificially low price, because disclosure of a holding in excess of five percent of a company's stock suggests to the rest of the market a likely takeover and therefore may increase the price of the stock). Proof of scienter is not required to establish a violation of this reporting provision. See, e.g., SEC v. Savoy Indus., Inc., 587 F.2d 1149, 1167 (D.C. Cir. 1978).

31. Section 13(d) and Section 13(g) are broad disclosure statutes. The availability of a short-form Schedule 13G is designed to ensure adequate disclosure to the marketplace while minimizing the burden on passive investors who would otherwise be required to complete a comprehensive Schedule 13D filing. All persons other than "Exempt Investors" filing pursuant to Exchange Act Rule 13d-1(d)[302] who avail themselves of Schedule 13G must certify that they have acquired the subject securities with a passive investment purpose.[303] Qualified institutional investors can defer their initial beneficial ownership reporting obligations by relying on Rule 13d-1(b) only if they can additionally certify that they have acquired the subject securities in the "ordinary course of [their] business."

32. The "ordinary course of business" provision was first added to Section 13(d) by Congressional amendment in 1970. The purpose of the amendment was to allow the Commission to exempt broker-dealers and stock exchange specialists acquiring the specified percentage of securities in the ordinary course of trading or market making activities from the more rigorous disclosure provisions of Schedule 13D. See, e.g., H.R. Rep. No. 91-1655, 91st Cong., 2d Sess. (1970) at 4-5 ("The Committee amendment adds a new paragraph to Section 13(d) of the Act to grant clearly to the Commission authority to permit simpler reporting for persons who, although acquiring more than 5 percent of any equity security, have done so in the ordinary course of business and have not acquired the shares for the purpose of changing or influencing the control of the issuer. Acquisitions by stock exchange specialists, over-the-counter marketmakers, and investment companies might well fall within the class of persons to which this amendment addresses itself.").[304]

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[302] The types of investors who may file on Schedule 13G pursuant to Rule 13d-1(d) are described as "Exempt Investors" and are identified in footnote 8 in Exchange Act Release 39538 (January 12, 1998). "Exempt Investors" who, as of the end of a calendar year, beneficially own more than five percent of a class of equity securities are required to file Schedule 13G within 45 days after the end of the calendar year but are not required to certify that the securities were acquired either in the "ordinary course of business" or with a passive investment purpose. Rule 13d-1(d). Perry was not an Exempt Investor.

[303] See Rules 13d-1(b)(1)(i) and 13d-1(c)(1).

[304] See also, Additional Consumer Protection in Corporate Takeovers and Increasing the Securities Act Exemptions for Small Businessmen: Hearing on S. 336 and S. 3431 Before the Subcomm. on Secs. of the Senate Comm. on Banking and Currency, 91st Cong., 2d Sess. (1970) at 13, 103, 111, 113, 116 (discussing securities industry proposals to provide an exemption from the Section 13(d) disclosure provisions for broker-dealers and stock exchange specialists acquiring the specified percentage of securities in the course

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33. Here, Perry engaged in a series of transactions in order to acquire voting rights to a large block of Mylan stock for the exclusive purpose of voting the shares in a merger and influencing the outcome of the vote. Perry's acquisition of Mylan shares was not made in order to invest in, or profit from, ownership of the Mylan shares. Irrespective of whether transactions of this type are routine for an institutional investor, reliance on Rule 13d-1(b)(1)(i) based on the "ordinary course of business" provision is inappropriate when transactions of the type executed by Perry are undertaken. The exception to the ordinary 10-day disclosure requirements of Section 13(d) for qualified institutional investors is available only where such investors are acquiring securities for passive investment or ordinary market making purposes as part of their routine business operations.[305]

34. When institutional investors acquire, directly or indirectly, the beneficial ownership of securities with the purpose of influencing the management or direction of the issuer or affecting or influencing the outcome of a transaction – such as acquiring securities, or an interest in securities, for the purpose of voting those securities in favor of a merger – the acquisition of those securities cannot be said to be in the "ordinary course of [the institutional investor's] business" for purposes of relying on Rule 13d-1(b) or making the certification under Item 10 of Schedule 13G. To the extent a qualified institutional investor, such as Perry, acquired shares outside of its ordinary course of business, Section 13(d) filing obligations automatically arise. Similarly, when institutional investors rapidly accumulate securities of an acquirer after the announcement of a business combination transaction with the intent to ensure completion of a merger by the acquirer, the legislative purpose of Section 13(d) is defeated in the absence of full disclosure. When such acquisitions are made, or when such institutional investors act in concert with the management or advisors of one of the parties to the transaction to ensure completion of the merger, those institutions are ineligible to certify that the securities were acquired and are held in the "ordinary course of [the institutional investor's] business" for purposes of relying upon Exchange Act Rule 13d-1(b) to defer the filing of a beneficial ownership report.

35. Because Perry did not acquire the Mylan securities in the ordinary course of its business, it was not eligible to file a Schedule 13G and was instead required to disclose its acquisition within 10 days.

36. As a result of the conduct described above, Perry willfully[13] violated Section 13(d) of the Exchange Act and Rule 13d-1 thereunder.

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of normal market-making activities); 91 P.L. 567 (Dec. 22, 1970) (amending Section 13(d) to insert new subparagraph (5)). The "ordinary course of business" provision was incorporated in the rules allowing the use of the short-form Schedule 13G upon their adoption in 1978. Exchange Act Release No. 34-14692, 1978 WL 170898 (April 21, 1978).

[305] See, e.g., In the Matter of JWGenesis Financial, Inc., Release No. 34-43053, 2000 WL 987730 (July 19, 2000); Blunt, Ellis and Loewi, Inc., SEC No-Action Letter, 1988 WL 234209, at *1 (April 15, 1988).

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[PART IV]

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Perry's Offer.

Accordingly, pursuant to Section 21C of the Exchange Act and Section 203(e) of the Advisers Act, it is hereby ORDERED that:

A. Respondent Perry shall cease and desist from committing or causing any violations and any future violations of Section 13(d) of the Exchange Act and Rule 13d-1 thereunder.

B. Respondent Perry is censured.

C. Respondent shall, within 30 days of the entry of this Order, pay a civil money penalty in the amount of $150,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Perry as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to David Rosenfeld, Associate Regional Director, New York Regional Office, Securities and Exchange Commission, 3 World Financial Center, New York, NY 10281.

By the Commission.

Elizabeth M.
Murphy
Secretary

A willful violation of the securities laws means merely "'that the person charged with the duty knows what he is doing.'" Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting Hughes v. SEC, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "'also be aware that he is violating one of the Rules or Acts.'" Id. (quoting Gearhart & Otis, Inc.
v. SEC, 348 F.2d 798, 803 (D.C. Cir. 1965)).
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XIII. CHAPTER 23, TARGET'S DEFENSIVE TACTICS

A. Page 998, New Sec. 23.11.B. Delaware Court's View on Change of Control Provision of Debt Instrument—Amylin

Page 998, New Sec. 23.11.B. Add before Sec. 23.12 the following:
New Sec. 23.11.B. **Delaware Court's View on Change of Control Provision of Debt Instrument—*Amylin***

San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc
C.A. No. 4446-VCL
COURT OF CHANCERY OF DELAWARE
2009 Del. Ch. LEXIS 83

MEMORANDUM OPINION AND ORDER

LAMB, Vice Chancellor.

The principal issue addressed in this opinion is whether a commonplace provision found in a trust indenture governing publicly traded notes prevents the issuer's board of directors from "approving" as "continuing directors" persons nominated by stockholders in opposition to the slate nominated by the incumbent directors. Both the corporation and its stockholders take the position that it does not and that, instead, the board of directors has the power to give its approval to any nominee, whether or not nominated by the incumbent directors. The indenture trustee takes the opposite position, arguing that the incumbent directors cannot "approve" as a "continuing director" any person whose election the incumbent directors publicly oppose. The issue is consequential because if a majority of the board at any time are not "continuing directors," holders of the notes gain the right to put their notes to the corporation at face value. Because the notes are trading on a deeply discounted basis, any event threatening to trigger this provision poses a substantial economic problem for the corporation and its stockholders.

Noting that provisions of this kind can operate as improper entrenchment devices that coerce stockholders into voting only for persons approved by the incumbent board to serve as continuing directors, the court holds that the indenture provision cannot be read as narrowly as urged by the indenture trustee. Instead, construed in accordance with generally applied standards, the provision is properly understood to permit the incumbent directors to approve as a continuing director any person, whether nominated by the board or a stockholder, as long as the directors take such action in conformity with the implied covenant of good faith and fair dealing and in accordance with their normal fiduciary duties.

PART ONE

The Parties

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Plaintiff San Antonio Fire & Police Pension Fund is a public pension fund for police officers and fire fighters in the city of San Antonio, Texas. The plaintiff is, and has been at all relevant times, a record and/or beneficial owner of Amylin common stock.

Defendant Amylin Pharmaceuticals, Inc. is a publicly traded Delaware corporation with its principal place of business in San Diego, California. Amylin is a biopharmaceutical company engaged in the discovery, development, and commercialization of drug candidates for the treatment of diabetes, obesity, and other diseases.

The individual defendants are all of the directors of Amylin.

Defendant Bank of America, N.A. ("BANA") is the Administrative Agent for Amylin's senior secured credit agreement dated December 21, 2007 (the "Credit Agreement"), and is also the Collateral Agent, L/C Issuer,[306] and a lender thereunder.

Defendant The Bank of New York Mellon Trust Company, N.A. (formerly, The Bank of New York Trust Company, N.A.) is the "Trustee" under the trust indenture dated June 8, 2007 (the "Indenture") for Amylin's 3.00% convertible senior notes due 2014 (the "2007 Notes").

Facts

Because there are no issues of material fact, the following is drawn mainly from the statement of undisputed facts contained in the Joint Pretrial Stipulation and Order filed May 1, 2009.

The History Of The Debt Instruments

At a meeting on or about May 22, 2007, Amylin's board adopted resolutions authorizing certain members of the company's senior management to negotiate the terms and conditions of the 2007 Notes. The board also designated the Finance Committee of the Amylin board as the "Pricing Committee" for the 2007 Notes, and delegated full board authority to the Pricing Committee to negotiate and issue the 2007 Notes. The Pricing Committee ultimately approved the issuance of the 2007 Notes.

This lawsuit arises out of a change of control covenant in the Indenture for the 2007 Notes. Section 11.01 of the Indenture gives the noteholders the right to demand redemption of any or all of their notes at face value upon the occurrence of certain events, including a Fundamental Change, as defined in the Indenture. A "Fundamental Change" is defined in Section 1.01 of the Indenture to have occurred if, *inter alia,* "at any time the Continuing Directors do not constitute a majority of the Company's Board of Directors . . . ." The Indenture defines "Continuing Directors" as:

[306] As L/C Issuer, BANA is responsible for issuing letters of credit under the letter of credit facility included as part of the Credit Agreement.

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(i) individuals who on the Issue Date constituted the Board of Directors and (ii) any new directors whose election to the Board of Directors or whose nomination for election by the stockholders of the Company was approved by at least a majority of the directors then still in office (or a duly constituted committee thereof) either who were directors on the Issue Date or whose election or nomination for election was previously so approved.[307] At present, the Amylin board consists of 12 persons, each of whom is a Continuing Director.

The drafting history of the Indenture reveals little regarding the parties' intentions surrounding the Continuing Directors provision. On June 1, 2007, counsel for Goldman Sachs and Morgan Stanley, the lead underwriters in the offering of the 2007 Notes, circulated a first draft of the description of the notes, which included a Continuing Directors provision. Amylin's outside counsel, Cooley Godward, circulated a markup of the draft description of the notes the next day. The markup did not contain any proposed change of the Continuing Directors provision. On June 5, 2007, the underwriters' counsel sent Cooley Godward an initial draft of the Indenture. The initial draft of the Indenture contained a Continuing Directors provision substantially the same as the one contained in the draft description of the notes. The final version of the Continuing Directors provision is unchanged from that contained in the initial draft Indenture.

Before authorizing the issuance of the 2007 Notes, the Pricing Committee discussed certain terms of the notes with the company's outside counsel. During the course of that discussion, the Continuing Directors provision was neither brought to the attention of, nor discussed by, the Amylin directors.[308]

Amylin's senior secured credit facility also contains a form of continuing director provision, the history of which is useful in considering the parallel provision in the Indenture. In July 2006, almost a year before the 2007 Notes were issued, the Finance Committee authorized the officers of Amylin to enter into a senior secured debt facility of up to $ 100 million on terms and conditions as those officers determined to be necessary and appropriate. In November 2006, the Finance Committee increased its authorization for the credit facility to $ 125 million. Almost a year later, in October 2007, Amylin signed a term sheet for a $ 105 million credit facility and $ 15 million revolving line of credit. On December 21, 2007, Amylin entered into the definitive senior secured Credit Agreement with BANA, providing for a $ 125 million term credit facility and a $ 15 million revolving credit facility.

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[307] Indenture § 1.01.

[308] The Pricing Committee engaged in extensive discussions with its legal advisors, management, and underwriters with regard to the best way to structure the notes. Once the final terms had been negotiated, the Pricing Committee asked its outside counsel, whom, with input from Amylin management and internal counsel, had acted as agents for the company in the process of negotiating the terms of the Indenture with the underwriters, whether the notes were subject to any terms which counsel saw as "unusual or not customary." Bradbury Dep. Tr. 77. Amylin's outside counsel responded that there were not. The Pricing Committee then authorized the issuance and sale of the notes. Amylin's officers and its outside counsel were of the opinion at the time that the financial terms of the offering were very favorable to the company.

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The Continuing Directors provision in the Credit Agreement is more explicitly confining than the one in the Indenture. Under the Credit Agreement, the occurrence of a Change of Control constitutes an Event of Default which, if not waived, would have the effect of accelerating the debt due under the agreement. A Change of Control is defined in the Credit Agreement as including:
an event or series of events by which . . . (b) during any period of 24 consecutive months, a majority of the members of the board of directors or other equivalent governing body of the Company cease to be composed of individuals

(i) who were members of that board or equivalent governing body on the first day of such period,

(ii) whose election or nomination to that board or equivalent governing body was approved by individuals referred to in clause (i) above constituting at the time of such election or nomination at least a majority of that board or equivalent governing body, or

(iii) whose election or nomination to that board or other equivalent governing body was approved by individuals referred to in clauses (i) and (ii) above constituting at the time of such election or nomination at least a majority of that board or equivalent governing body (excluding, in the case of both clause (ii) and clause (iii), any individual whose initial nomination for, or assumption of office as, a member of that board or equivalent governing body occurs as a result of an actual or threatened solicitation of proxies or consents for the election or removal of one or more directors by any person or group other than a solicitation for the election of one or more directors by or on behalf of the board of directors).
This Change of Control definition was the subject of some negotiation between counsel for BANA and counsel for Amylin. Amylin's counsel suggested that the language of the Credit Agreement defining Change of Control be changed to conform to the definition in the Indenture. BANA's counsel rejected that suggestion, instead insisting on the form found in Bank of America's Model Syndicated Credit Agreement. It is that model clause, as set forth above, that appears in the final Credit Agreement.

The Proxy Contest

On January 28, 2009, Icahn Partners LP and affiliates ("Icahn"), an approximately 8.8% stockholder, notified Amylin of its intention to nominate a slate of five directors to Amylin's 12-person board. The next day, Eastbourne Capital Management, L.L.C., a 12.5% stockholder, notified Amylin of its intention to nominate its own five-person slate. On February 1, 2009, Eastbourne sent a letter asking the Amylin board to take action to prevent the adverse consequences that would befall the corporation if the Continuing Directors provision of the Indenture were triggered. Specifically, Eastbourne asked the board to assemble an approved slate of directors that included a significant number of the nominees from each of Eastbourne's and Icahn's slates.

On February 27, 2009, Amylin filed its annual report on Form 10-K for the year ended December 31, 2008. In its Form 10-K, Amylin highlighted the potential adverse

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consequences if the Continuing Directors provisions of its outstanding debt instruments were triggered.[309]

* * *

If a proxy contest results from one or both notices received from the Icahn Group or Eastbourne announcing their intent to each nominate five individuals for election to our Board of Directors at the 2009 annual meeting . . . our business could be adversely affected because . . . if a majority of our Board of Directors ceases to be composed of the existing directors or other individuals approved by a majority of the existing directors, we may be required to repay $ 575 million under our 2007 Notes, $ 125 million under our Term Loan and any amounts that may be outstanding under our $ 15 million revolving credit facility, and if a cross-default is triggered, $200 million under our 2004 Notes . . .
(Amylin Pharmaceuticals, Inc., Annual Report (Form 10-K), at 37, 39-40 (Feb. 27, 2009)).

Thus, if the Continuing Directors provisions of both the Credit Agreement and the 2007 Notes were triggered, and the 2004 Notes cross-defaulted as a result, the company would be required to immediately pay back as much as $ 915 million. As of December 31, 2008, Amylin had approximately $ 817 million in cash, cash equivalents, and short term investments. *Id.* at 59.

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On March 9, 2009, Eastbourne sent a letter to the Amylin board questioning the legitimacy of the Continuing Directors provisions of the Indenture and the Credit Agreement and calling upon the board to use its power to remove any obstacle to the operation of the stockholder franchise, including “approving” the dissident slates for purposes of the 2007 Notes and obtaining any necessary consents or waivers from the lenders under the Credit Agreement.

On March 17, 2009, Amylin stated publicly that the tentative date for its 2009 annual meeting was May 27, 2009.

THE LITIGATION

On March 24, 2009, the plaintiff filed its original purported class action complaint

[309] Amylin stated in its annual report:
If as a result of this potential proxy contest a majority of our Board of Directors ceases to be composed of the existing directors or other individuals approved by a majority of the existing directors, then a “change of control” under the Term Loan and a “fundamental change” under the indenture for 2007 Notes will be triggered. If triggered, the lenders under the Term Loan may terminate their commitments and accelerate our outstanding debt and the holders of our 2007 Notes may require us to repurchase the notes. We may not have the liquidity or financial resources to do so at the times required or at all.

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against Amylin and its individual directors. That complaint alleged (1) breaches of the fiduciary duties of care and loyalty by the board of Amylin in the adoption of the Credit Agreement and the Indenture, insofar as they both contained Continuing Directors provisions, (2) breaches of the fiduciary duties of care and loyalty by Amylin's board in failing to approve the dissident nominees in order to defuse the Continuing Directors provision of the Indenture, and (3) breaches of the fiduciary duties of care and loyalty in the allegedly misleading and coercive manner in which Amylin's board chose to disclose the risks presented by the Continuing Directors provisions in the company's Form 10-K. The relief requested was in the form of declaratory and injunctive relief. Specifically, the plaintiff sought declarations that the directors had breached their fiduciary duties and that the Continuing Directors provisions were unenforceable. The plaintiff also sought a mandatory injunction requiring the directors to approve the stockholder nominees. After a telephonic hearing, the court ordered expedited proceedings.[310]

On March 30, 2009, Amylin filed its preliminary proxy statement, stating its belief that the board possesses the contractual right under the Indenture to approve the stockholder nominees "at any time up to the election."[311] On April 2, 2009, Amylin released a proxy "fight letter," stating:

> While we believe that the Board has the ability to approve any nominees proposed by Icahn or Eastbourne at any time up to the election in order to nullify the debt acceleration provision, we cannot ensure that our bondholders will concur with that view. In fact, we requested confirmation of our view from the trustee of the 2014 notes and the trustee has refused to confirm our view. To protect the company and its shareholders, this issue will need to be resolved in court.[312]

Early in April, the plaintiff filed second and third amended complaints, adding BANA and the Trustee as necessary defendants. The third amended complaint also added a new count seeking a declaration that Amylin's board has the sole right and power to approve the stockholder nominees for the purpose of the Continuing Directors provision of the Indenture.

On April 7, 2009, the individual defendants and Amylin filed their answer. That answer contains a cross-claim by Amylin against the Trustee, seeking declaratory relief that the board has the right under the Indenture to approve the election of any or all of the

[310] On March 26, 2009, the plaintiff filed a motion for expedited proceedings. On March 27, 2009, the plaintiff filed an amended complaint adding a count alleging that the directors violated Section 141(a) of the Delaware General Corporation Law in adopting the Continuing Directors provision in the Credit Agreement, and that such allegedly *ultra vires* act renders the provision unenforceable as a matter of law.
[311] Amylin stated: "The Company believes that its current Board of Directors has the ability to approve any nominees proposed for election by Icahn or Eastbourne at any time up to the election and avoid the occurrence of a 'fundamental change' under the indenture for the [2007 Notes] in the event six or more of those nominees are ultimately elected. However, approval of those nominees by the current Board of Directors cannot avoid the occurrence of a 'change of control' under the credit agreement in the event six or more of them are elected." Amylin Pharmaceuticals, Inc., Preliminary Proxy Statement (Schedule 14A), at 18 (Mar. 30, 2009).
[312] Amylin Pharmaceuticals, Inc., Proxy Solicitation Materials (Form DEFA14A), Ex 99.1 at 2 (Apr. 2, 2009).

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stockholder nominees at any time up to their election. The plaintiff then moved for partial summary judgment that the Continuing Directors provision of the Credit Agreement is unenforceable as a matter of law and that the board has the right and power to approve the stockholder nominees for the purpose of the Indenture.

THE PARTIAL SETTLEMENT

On April 13, 2009, the plaintiff and Amylin announced that they had entered into a partial settlement. Under the terms of the settlement, the plaintiff agreed to amend its complaint to remove any allegations of breaches of the duty of loyalty (or allegations of lack of good faith by the board), agreed not to seek damages against Amylin or the board, and agreed to dismiss without prejudice its claim against the board relating to the allegedly coercive disclosure in the company's Form 10-K. The plaintiff also agreed to dismiss its claim against the board for breach of fiduciary duty in failing to act to approve the stockholder nominees and drop its related demand for injunctive relief. In exchange for dropping this claim, the board issued a public statement that:
the Board has determined, subject only to the entry of a final, non-appealable order prior to May 27, 2009 declaring that the Board possesses the contractual right to do so, that the Board will "approve" the Icahn Capital LP and Eastbourne Capital Management L.L.C. nominees for [the purpose of the Continuing Directors provision of the Indenture].
That same day, Amylin moved for partial summary judgment on its cross-claim against the Trustee.

On April 16, 2009, the plaintiff filed its fourth amended complaint implementing the terms of the partial settlement between the plaintiff and Amylin. On April 23, 2009, BANA filed its answering brief with respect to the plaintiff's motion for partial summary judgment and made its own cross-motion for summary judgment with respect to the claims against it.

THE CLAIMS AGAINST BANA ARE MOOTED

During the pretrial conference on May 1, 2009, counsel for Amylin, together with counsel for BANA, informed the court that the parties were close to reaching an agreement on a consent and waiver under the Credit Agreement which would moot the related claims. The court thus agreed, with the consent of the parties, to hold the claims arising out of the Credit Agreement in abeyance for the purposes of the May 4 trial. Later that day, Amylin and BANA entered into a consent and waiver agreement (the "BANA Consent Agreement") as anticipated. Under the BANA Consent Agreement, the lenders would agree to waive any event of default resulting from the 2009 Amylin director elections triggering the Continuing Directors provision of the Credit Agreement.[313] In exchange, Amylin agreed to pay a 50 basis point fee on any outstanding balance under the Credit Agreement to the lenders, should the Continuing Directors provision be

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[313] The lenders' consent is conditioned on the delivery to BANA of a copy of one of the following, providing that the election of any or all of the stockholder nominees will not result in a Fundamental Change under the Indenture: (1) a final judgment by a court of competent jurisdiction, (2) a settlement agreement approved by the court, or (3) an opinion of counsel to the Trustee.

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triggered by the 2009 director elections.[314]

The resolution with BANA did not affect the claims relating to the Indenture. Thus, on May 4, 2009, trial was held and oral arguments were heard on all outstanding motions for summary judgment regarding the Indenture, and all outstanding claims relating to the Indenture were submitted to the court for final adjudication on the record.[315]

POST-TRIAL CHANGES IN THE PROXY CONTEST

On May 6, 2009, two days after the close of the record, the court received a letter from counsel for Amylin, setting forth recent developments in the plans of the insurgent parties. On May 4, 2009, Eastbourne filed its definitive proxy statement, in which it reduced the number of candidates it was nominating to the Amylin board from five to three. On May 6, 2009, Icahn filed its definitive proxy statement, in which it reduced the number of candidates it was nominating to the Amylin board from five to two. As a consequence of these changes, no more than five stockholder-nominated directors will be elected to the 12 member Amylin board at the 2009 annual stockholder meeting. The Trustee has, in response, renewed its objection to proceeding at this point, on the basis that the issues are not ripe for determination. The plaintiff and Amylin both respond that the court should proceed because, if elected, whether or not the stockholder-nominated directors constitute Continuing Directors may have a significant effect on next year's annual stockholder meeting.

[PART II]

The Amylin board has already agreed to approve the dissident slates if this court determines that it is entitled to do so. Thus, the central issue in this case is whether or not the Amylin board has both the power and the right under the Indenture to approve the stockholder nominees.

Because the Indenture constitutes a contract between Amylin and the Trustee, determination of this question is one of contract interpretation.[316] Interpretation of the Indenture is controlled by New York law pursuant to a choice of law provision contained therein.[317] "Under New York law, as in Delaware, the construction and interpretation of an unambiguous written contract is an issue of law within the province of the court."[318]

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[314] Amylin also agreed to pay a 25 basis point fee to BANA for attempting to solicit the consent to the BANA Consent Agreement of the required percentage of the lenders under the Credit Agreement (the "Required Lenders").

[315] On May 6, 2009, BANA notified the court that the Required Lenders consented to the BANA Consent Agreement. Count II of the fourth amended complaint, which seeks a declaration of the invalidity and unenforceability of the Continuing Directors provision of the Credit Agreement, has thus been rendered moot.

[316] *See Sharon Steel Corp. v. Chase Manhattan Bank, N.A.,* 691 F.2d 1039, 1049 (2d Cir. 1982) (stating that under New York law "[i]nterpretation of indenture provisions is a matter of basic contract law").

[317] *See* Indenture § 1.12.

[318] *Law Debenture Trust Co. v. Petrohawk Energy Corp.,* 2007 Del. Ch. LEXIS 113, 2007 WL 2248150, at *5 (Del. Ch.), *aff'd mem.,* 947 A.2d 1121 (Del. 2008); *see also K. Bell & Assocs., Inc. v. Lloyd's Underwriters,* 97 F.3d 632, 637 (2d Cir. 1996).

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"Included in this initial interpretation is the threshold question of whether the terms of the contract are ambiguous."[319] "Contractual language whose meaning is otherwise plain is not ambiguous merely because the parties urge different interpretations in the litigation."[320] "Contract language is unambiguous if it has 'a definite and precise meaning, unattended by danger of misconception in the purport of the [contract] itself, and concerning which there is no reasonable basis for a difference of opinion.'" [321] "Where the [contract's] language is free from ambiguity, its meaning may be determined as a matter of law on the basis of the writing alone without resort to extrinsic evidence."[322]

"In interpreting contract language, New York contract law instructs courts ordinarily to give the words and phrases employed their plain and commonly-accepted meanings."[323] Thus:

> The parties' rights under an unambiguous contract should be fathomed from the terms expressed in the instrument itself rather than from extrinsic evidence as to terms that were not expressed or judicial views as to what terms might be preferable. In its efforts to preserve the parties' rights and the status quo, the court must be careful not to alter the terms of the agreement. The parties having agreed upon their own terms and conditions, "the courts cannot change them and must not permit them to be violated or disregarded."[324]

Moreover, when interpreting quasi-standardized contracts such as indentures, "[b]oilerplate provisions are . . . not the consequence of the relationship of particular borrowers and lenders and do not depend upon particularized intentions of the parties to an indenture." [325] Finally, "[i]ndentures are to be read strictly and to the extent they do not expressly restrict the rights of the issuer, the issuer is left with the freedom to act, subject only to the boundaries of other positive law."[326]

THE POWER TO APPROVE

The Trustee contends that, for the purpose of the Continuing Directors provision of the Indenture, that the word "approve" is synonymous with "endorse or recommend." The Trustee argues:

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[319] *Alexander & Alexander Servs. v. These Certain Underwriters at Lloyd's, London,* 136 F.3d 82, 86 (2d Cir. 1998).
[320] *First Lincoln Holdings, Inc. v. Equitable Life Assurance Soc'y,* 164 F. Supp. 2d 383, 393 (S.D.N.Y. 2001) (citing *U.S. Trust Co. of New York v. Jenner,* 168 F.3d 630, 632 (2d Cir. 1999)).
[321] *Metro. Life Ins. Co. v. RJR Nabisco, Inc.,* 906 F.2d 884, 889 (2d Cir. 1990) (quoting *Breed v. Ins. Co. of N. Am.,* 46 N.Y.2d 351, 385 N.E.2d 1280, 413 N.Y.S.2d 352, 355 (App. Div. 1978)).
[322] *Master-Built Constr. Co. v. Thorne,* 22 A.D.3d 535, 802 N.Y.S.2d 713, 714 (App. Div. 2005).
[323] *Petrohawk,* 2007 Del. Ch. LEXIS 113, 2007 WL 2248150, at *6; *accord Laba v. Carey,* 29 N.Y.2d 302, 277 N.E.2d 641, 644, 327 N.Y.S.2d 613 (N.Y. 1971).
[324] *Metro Life Ins.,* 906 F.2d at 889 (some internal citations and quotations omitted) (quoting *Whiteside v. N. Am. Accident Ins. Co.,* 200 N.Y. 320, 93 N.E. 948, 950 (N.Y, 1911)).
[325] *Sharon Steel,* 691 F.2d at 1048.
[326] *In re Loral Space & Commc'ns Inc. Consol. Litig.,* 2008 Del. Ch. LEXIS 136, 2008 WL 4293781, at *35 (Del. Ch.).

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> [t]he Board's determination not to recommend the election of any of the Dissident Nominees, to recommend its own competing slate, and that the election of the Dissident Nominees would not be in the best interests of the Company--determinations that have not changed as a result of the Partial Settlement--simply cannot be reconciled with the plain meaning of the term "approval." To the contrary, such determinations by the Board clearly indicate *disapproval.*

As the Trustee would have the court read the Indenture, then, the board could never approve a stockholder-nominated slate for the purposes of the Indenture and yet, simultaneously, run its own slate in opposition.

In contrast, cross-claim plaintiff Amylin contends, citing *Black's Law Dictionary,* that "to approve" means "to give formal sanction to; to confirm authoritatively." Thus, Amylin argues, while endorsement or recommendation may necessarily imply approval, the reverse is not true. By Amylin's reading, therefore, the board may approve a slate of nominees for the purposes of the Indenture (thus sanctioning their nomination for election) without endorsing them, and may simultaneously recommend and endorse its own slate instead.

Amylin's reading of the Indenture is the correct one. To read the provision as the Trustee suggests would mean that any election of stockholder nominees resulting from a contested election, even over insubstantial matters, would bar the board from approving the dissident slate for the purposes of the Indenture. Unlike the Credit Agreement with its two-year sliding-window lookback, under the Indenture a non-Continuing Director remains so for the life of the notes. The Trustee's reading would therefore render the Continuing Directors provision of the Indenture, as a possible entrenchment mechanism, to be far more restrictive than the parallel provision in the Credit Agreement. This would be a surprising result given the facially more restrictive language in the Credit Agreement. Read that way, the Indenture would prohibit *any* change in the majority of the board as a result of any number of contested elections, for the entire life of the notes.

A provision in an indenture with such an eviscerating effect on the stockholder franchise would raise grave concerns. In the first instance, those concerns would relate to the exercise of the board's fiduciary duties in agreeing to such a provision. The court would want, at a minimum, to see evidence that the board believed in good faith that, in accepting such a provision, it was obtaining in return extraordinarily valuable economic benefits for the corporation that would not otherwise be available to it.[327] Additionally, the court would have to closely consider the degree to which such a provision might be unenforceable as against public policy.[328]

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[327] This is arguably a lesser burden than would be applied if the record showed that the board had specifically included such a provision for the primary purpose of interfering with or frustrating the stockholder franchise. *See Blasius Indus., Inc. v. Atlas Corp.,* 564 A.2d 651, 659-60, 662 (Del. Ch. 1988).
[328] A provision so strongly in derogation of the stockholders' franchise rights would likely put the trustee and noteholders on constructive notice of the possibility of its ultimate unenforceability.

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THE RIGHT TO APPROVE

Having determined that the board has, in the abstract, the power to approve a stockholder-nominated slate and still engage in a proxy contest against that slate, the court now turns to the question of whether the Amylin board has properly exercised the *right* to do so in this case. The key question is whether approval by the board, under the given circumstances, comports with the company's implied duty of good faith and fair dealing which inheres in all contracts, including the Indenture.

This court considered the contours of that duty in a similar context in *Hills Stores Company v. Bozic.* In that case, the board of directors of Hills Stores Company entered into an employment agreement with three of its executives, which agreement included the right to a significant severance payment should there be a change in control of the board not approved by the pre-existing board for the purposes of the agreement. A dissident stockholder ultimately took control of the board in a proxy contest with promises of a rich sale transaction.[329] The Hills Stores board, over the dissident's protests, refused to approve the change in control, and the executives resigned and took their severance payments. The dissident, now in control of Hills Stores, then caused the company to sue the former directors for allegedly breaching their duty of loyalty by failing to approve the change in control.

The *Hills Stores* court, in considering whether the board was justified in not approving the change in control, recognized that the measure of whether the approval was in good faith was whether the board believed that the dissident slate posed a danger to the interests of the corporation and its stockholders. The court stated:
[T]he board's decision . . . to take a consistent approach to the issue of whether to approve the Dickstein Change in Control was a reasonable response in the circumstances presented. Because the board had determined, for many sufficient reasons, that the Dickstein Change in Control was harmful to the company, it would have exercised bad faith under the Employment Agreements if it had voted to approve the Change in Control simply so as to avoid triggering the Covered Executives' right to severance.
The underlying rule is the same here. Thus, the board may approve the stockholder nominees if the board determines in good faith that the election of one or more of the dissident nominees would not be materially adverse to the interests of the corporation or its stockholders.[330]

The application of this rule here is problematic.[331] The court has been presented with no evidence regarding the board's deliberation with respect to the decision to approve the

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[329] The board, in considering the dissident's offer the financing for which was uncommitted, had earlier determined that the dissident's offer and a change in control in his favor represented a threat to the corporation and its stockholders. *Id.* at 108.
[330] In other words, if passing control would not constitute a breach of the directors' duty of loyalty to the corporation and its stockholders. It is important to recognize here that the directors are under absolutely *no* obligation to consider the interests of the noteholders in making this determination.
[331] Because Amylin seeks a declaratory judgment as to its right to approve, it bears the burden of proof here. *See Those Certain Underwriters at Lloyd's, London v. Nat'l Installment Ins. Servs., Inc.,* 2008 Del. Ch. LEXIS 57, 2007 WL 4554453 (Del. Ch.).

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stockholder-nominated slate. No party has placed into the record any board minutes, resolutions, or other evidence that would indicate how the board came to its decision. Rather, before the court are two less than helpful sets of circumstances.
First are the negative public statements made by the board in various fight letters with respect to the dissident nominees.[332] While, if taken at face value, these statements would suggest that the board has concluded that the dissidents would be harmful to the company, such a reading would be inappropriate. Election "puffery" in the context of a fight letter is hardly the same as a determination by the board, in the exercise of its power to approve Continuing Directors, that the election of one or more of the stockholder nominees would be harmful to the corporation or the interests of its stockholders.

Second is the posture in which the board appears to have made its decision to approve. On March 9, 2009, the plaintiff asked the board to act to approve the stockholder nominees. The board did not do so until April 13, 2009, and then only in exchange for a partial settlement with the plaintiff in which the plaintiff agreed to amend its complaint to remove any allegations of breach of the duty of loyalty by the individual defendants, and not to seek money damages against them. These circumstances at least raise a question whether the board's decision to approve was made in a good faith exercise of its considered business judgment, or instead taken simply to avoid facing a suit for money damages against themselves personally.[333]

Given the underdeveloped state of the record, any judgment about the propriety of the Amylin board's decision to "approve" the insurgent nominees would appear to risk

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[332] *See, e.g.,* Amylin Pharmaceuticals, Inc., Additional Definitive Proxy Solicitation Material (Form DEFA14A), at 3 (Apr. 24, 2009). The board stated:
Over the course of our conversations with Mr. Icahn and Eastbourne, it has become abundantly clear that their goal is the sale of Amylin. We strongly believe that this agenda is not in the best interests of Amylin's shareholders. Your Board and management believe that a sale of the Company in the near-term would undervalue the return on investment we believe shareholders will realize as a result of the approval and launch of exenatide once weekly. Consistent with his history in several recent and current proxy fights, Mr. Icahn wants to employ a "cookie-cutter" approach to slashing costs, without any regard to the specific nature of Amylin's business. His one-size-fits-all methodology is exemplified by his identifying insurance and logistics as potential areas for additional savings, neither of which are significant components of Amylin's cost structure. His actions would undermine our efforts to prepare for and launch exenatide once weekly.
Mr. Icahn and Eastbourne show a serious lack of understanding of Amylin's business and the value-enhancing opportunities that the Company has created in the marketplace. The Company's future opportunity is tied directly to the FDA approval for and successful launch of exenatide once weekly. Their desire to disrupt the Company's operations and focus in the middle of the FDA process could potentially derail the launch preparations for exenatide once weekly. This demonstrates that both Mr. Icahn and Eastbourne fail to appreciate the sensitivities and potential shareholder value that we expect will result from the successful execution of this process.
At the upcoming annual meeting, you have a clear choice: vote for your Board's plan, which is close to achieving its strategic objectives to build value for all shareholders, or take your chances with the Icahn and Eastbourne platform, which demonstrates a disregard for the fundamental drivers of our business. Neither Mr. Icahn nor Eastbourne has offered any constructive ideas as to how they would lead Amylin differently.
[333] The court by no means concludes that this is, in fact, what motivated the board's decision. But absent any facts about the board's decision-making process, the court cannot rule it out.

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prejudicing the rights of one of the parties to this case. Alternately, the court can treat the issue as unripe and leave it to be determined at such later time as the record can be more fully developed. In light of the fact that the dissident parties have reduced the size of their respective slates so that even if both slates are elected a majority of the board will remain Continuing Directors, regardless of the board's approval or lack thereof of the stockholder nominees, the latter course is preferable. If the dissident nominees are successful in fostering a sale of the company, the issue of Continuing Directors may become irrelevant long before next year's annual stockholder meeting. Alternately, the plaintiff or Amylin is free after the 2009 annual meeting to replead its case that the stockholder nominees, if they are in fact elected, are Continuing Directors by virtue of Amylin's "approval," whatever form that approval may ultimately take.[334] At that point, the relevant facts will be frozen, and the parties will have ample time for fact discovery to develop a complete record for the court to consider, in light of today's ruling. The court recognizes the potential diseconomy of requiring the parties to re-litigate the issue at a later time. However, the risk of prejudice to either the Amylin stockholders or the noteholders of an improvident decision made in a factual vacuum, at a time when there is no urgent need for decision, outweighs the potential costs of future litigation.

[PART III]

In addition to its claims sounding in contract, the plaintiff alleges that the board of Amylin breached its duty of care in the adoption of the Indenture for the 2007 Notes, insofar as the Indenture contained the Continuing Directors provisions. The plaintiff bases its claim largely on the fact that the Pricing Committee never discovered during its approval process that the proposed Indenture contained a Continuing Directors provision.[335]

The duty of care requires that:

> in making business decisions, directors must consider all material information reasonably available, and that the directors' process is actionable only if grossly negligent . . . . [T]he standard for judging the informational component of the directors' decisionmaking does not mean that the Board must be informed of *every* fact. The Board is responsible for considering only *material* facts that are

[334] Because there is no chance that a default or acceleration obligation will result from any choice the stockholders might make in the 2009 Amylin director elections, there is no reason to suspect that the Continuing Directors provisions should have a significant influence on the outcome of the election, even without a ruling by the court that the stockholder nominees are Continuing Directors.

[335] Moreover, the plaintiff points out, Amylin's CEO and its CFO both admit that they had no idea of the existence of the Continuing Directors provisions until they read about them on February 2, 2009. This may, on the surface, seem compelling for its "shock value." But because the CFO is not a director, and there is nothing in the record to indicate whether the CEO, who is a director, was a member of the Pricing Committee, this information does little if anything to support the plaintiff's claim.

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> reasonably available, not those that are immaterial or out of the Board's reasonable reach.[336]

Thus, the question is squarely framed: was the board of Amylin (or its delegate, the Pricing Committee) grossly negligent in failing to learn of the existence of the Continuing Directors provisions?

The answer must be no. The board [337] retained highly-qualified counsel. It sought advice from Amylin's management and investment bankers as to the terms of the agreement. It asked its counsel if there was anything "unusual or not customary" in the terms of the Notes, and it was told there was not. Only then did the board approve the issuance of the Notes under the Indenture. This is not the sort of conduct generally imagined when considering the concept of gross negligence, typically defined as a substantial deviation from the standard of care.

The plaintiff argues that the board's questioning if there was anything "unusual or not customary" in the Indenture was insufficient. But the way in which the board inquired into the material terms of the Indenture cannot be equated with gross negligence in failing to inform itself.[338]Certainly, no one suggests that the directors' duty of care required them to review, discuss, and comprehend every word of the 98-page Indenture.

This case does highlight the troubling reality that corporations and their counsel routinely negotiate contract terms that may, in some circumstances, impinge on the free exercise of the stockholder franchise. In the context of the negotiation of a debt instrument, this is particularly troubling, for two reasons. First, as a matter of course, there are few events which have the potential to be more catastrophic for a corporation than the triggering of an event of default under one of its debt agreements. Second, the board, when negotiating with rights that belong first and foremost to the stockholders (i.e., the stockholder franchise), must be especially solicitous to its duties both to the corporation and to its stockholders. This is never more true than when negotiating with debtholders, whose interests at times may be directly adverse to those of the stockholders. Outside counsel advising a board in such circumstances should be especially mindful of the board's continuing duties to the stockholders to protect their interests. Specifically, terms which may affect the stockholders' range of discretion in exercising the franchise should, even if considered customary, be highlighted to the board. In this way, the board will be able to exercise its fully informed business judgment.

[PART IV]

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[336] *Brehm v. Eisner,* 746 A.2d 244, 259 (Del. 2000) (citing *Aronson v. Lewis,* 473 A.2d 805, 812 (Del. 1984)).
[337] For the purposes of the discussion of the due care claim, references to the board encompass acts taken by the Pricing Committee on behalf of the board.
[338] The fact that a term is customary is not proof that it is, in fact, either permissible or justifiable under the specific circumstances faced by the board. *See La. Muni. Police Employees' Retirement Sys. v. Crawford,* 918 A.2d 1172, 1181 n.10 (Del. Ch. 2007).

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For the reasons set forth above, as to Count I (alleged breach of the duty of care by the defendant directors), judgment is entered for the defendants. Count II, seeking a declaration of the invalidity and unenforceability of the Continuing Directors provision of the Credit Agreement, has been rendered moot by the parties and is DISMISSED. Count III, seeking a declaration that the board of Amylin is entitled to approve the dissident nominees for the purposes of the Indenture, together with Amylin's substantially similar cross-claim against the Trustee are GRANTED to the extent described in this opinion, and are otherwise held to be unripe for adjudication at this time and therefore DISMISSED WITHOUT PREJUDICE. IT IS SO ORDERED.

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XIV. CHAPTER 26, INTERNATIONAL ACQUISITIONS

A. Page 1145, New Sec. 26.30.B.3. China's 2007 Anti-Monopoly Law

Page 1145, New Sec. 26.30.B.3. Replace the current Sec. 26.30.B.3 with the following:

New Sec. 26.30.B.3. **China's 2007 Anti-Monopoly Law**

Anti-monopoly Law of the People's Republic of China
Adopted at the 29th meeting of the Standing Committee of the 10th National People's Congress of the People's Republic of China on August 30, 2007.

GENERAL PROVISIONS

Article 1 This Law is enacted for the purpose of preventing and restraining monopolistic conducts, protecting fair competition in the market, enhancing economic efficiency, safeguarding the interests of consumers and social public interest, promoting the healthy development of the socialist market economy.

Article 2 This Law shall be applicable to monopolistic conducts in economic activities within the People's Republic of China.
This Law shall apply to the conducts outside the territory of the People's Republic of China if they eliminate or have restrictive effect on competition on the domestic market of the PRC.

Article 3 For the purposes of this Law, "monopolistic conducts" are defined as the following:

(1) monopolistic agreements among business operators;
(2) abuse of dominant market positions by business operators; and
(3) concentration of business operators that eliminates or restricts competition or might be eliminating or restricting competition.

Article 4 The State constitutes and carries out competition rules which accord with the socialist market economy, perfects macro-control, and advances a unified, open, competitive and orderly market system.

Article 5 Business operators may, through fair competition, voluntary alliance, concentrate themselves according to law, expand the scope of business operations, and enhance competitiveness.

Article 6 Any business with a dominant position may not abuse that dominant position to eliminate, or restrict competition.

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Article 7 With respect to the industries controlled by the State-owned economy and concerning the lifeline of national economy and national security or the industries implementing exclusive operation and sales according to law, the state protects the lawful business operations conducted by the business operators therein. The state also lawfully regulates and controls their business operations and the prices of their commodities and services so as to safeguard the interests of consumers and promote technical progresses.

The business operators as mentioned above shall lawfully operate, be honest and faithful, be strictly self-disciplined, accept social supervision, shall not damage the interests of consumers by virtue of their dominant or exclusive positions.

Article 8 No administrative organ or organization empowered by a law or administrative regulation to administer public affairs may abuse its administrative powers to eliminate or restrict competition.

Article 9 The State Council shall establish the Anti-monopoly Commission, which is in charge of organizing, coordinating, guiding anti-monopoly work, performs the following functions:

(1) studying and drafting related competition policies;
(2) organizing the investigation and assessment of overall competition situations in the market, and issuing assessment reports;
(3) constituting and issuing anti-monopoly guidelines;
(4) coordinating anti-monopoly administrative law enforcement; and
(5) other functions as assigned by the State Council.

The State Council shall stipulate composition and working rules of the Anti-monopoly Commission.

Article 10 The anti-monopoly authority designated by the State Council (hereinafter referred to as the Anti-monopoly Authority under the State Council) shall be in charge of anti-monopoly law enforcement in accordance with this Law.
The Anti-monopoly Authority under the State Council) may, when needed, authorize the corresponding authorities in the people’s governments of the provinces, autonomous regions and municipalities directly under the Central Government to take charge of anti-monopoly law enforcement in accordance with this Law.

Article 11 A trade association shall intensify industrial self-discipline, guide business operators to lawfully compete, safeguard the competition order in the market.

Article 12 For the purposes of this Law,
“business operator” refers to a natural person, legal person, or any other organization that is in the engagement of commodities production or operation or service provision, and “relevant market” refers to the commodity scope or territorial scope within which the business operators compete against each other during a certain period of time for specific commodities or services (hereinafter generally referred to as “commodities”).

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MONOPOLY AGREEMENT

Article 13 Any of the following monopoly agreements among the competing business operators shall be prohibited:

(1) fixing or changing prices of commodities;
(2) limiting the output or sales of commodities;
(3) dividing the sales market or the raw material procurement market;
(4) restricting the purchase of new technology or new facilities or the development of new technology or new products;
(5) making boycott transactions; or
(6) other monopoly agreements as determined by the Anti-monopoly Authority under the State Council.

For the purposes of this Law, "monopoly agreements" refer to agreements, decisions or other concerted actions which eliminate or restrict competition.

Article 14 Any of the following agreements among business operators and their trading parties are prohibited:

(1) fixing the price of commodities for resale to a third party;
(2) restricting the minimum price of commodities for resale to a third party; or
(3) other monopoly agreements as determined by the Anti-monopoly Authority under the State Council.

Article 15 An agreement among business operators shall be exempted from application of articles 13 and 14 if it can be proven to be in any of the following circumstances:

(1) for the purpose of improving technologies, researching and developing new products;
(2) for the purpose of upgrading product quality, reducing cost, improving efficiency, unifying product specifications or standards, or carrying out professional labor division;
(3) for the purpose of enhancing operational efficiency and reinforcing the competitiveness of small and medium-sized business operators;
(4) for the purpose of achieving public interests such as conserving energy, protecting the environment and relieving the victims of a disaster and so on;
(5) for the purpose of mitigating serious decrease in sales volume or obviously excessive production during economic recessions;
(6) for the purpose of safeguarding the justifiable interests in the foreign trade or foreign economic cooperation; or
(7) other circumstances as stipulated by laws and the State Council.

Where a monopoly agreement is in any of the circumstances stipulated in Items 1 through 5 and is exempt from Articles 13 and 14 of this Law, the business operators must additionally prove that the agreement can enable consumers to share the interests derived from the agreement, and will not severely restrict the competition in relevant market.

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Article 16 Any trade association may not organize the business operators in its own industry to implement the monopolistic conduct as prohibited by this Chapter.

ABUSE OF MARKET DOMINANCE

Article 17 A business operator with a dominant market position shall not abuse its dominant market position to conduct following acts:

(1) selling commodities at unfairly high prices or buying commodities at unfairly low prices;
(2) selling products at prices below cost without any justifiable cause;
(3) refusing to trade with a trading party without any justifiable cause;
(4) requiring a trading party to trade exclusively with itself or trade exclusively with a designated business operator(s) without any justifiable cause;
(5) tying products or imposing unreasonable trading conditions at the time of trading without any justifiable cause;
(6) applying dissimilar prices or other transaction terms to counterparties with equal standing;
(7) other conducts determined as abuse of a dominant position by the Anti-monopoly Authority under the State Council

For the purposes of this Law, “dominant market position” refers to a market position held by a business operator having the capacity to control the price, quantity or other trading conditions of commodities in relevant market, or to hinder or affect any other business operator to enter the relevant market.

Article 18 The dominant market status shall be determined according to the following factors:

(1) the market share of a business operator in relevant market, and the competition situation of the relevant market;
(2) the capacity of a business operator to control the sales markets or the raw material procurement market;
(3) the financial and technical conditions of the business operator;
(4) the degree of dependence of other business operators upon of the business operator in transactions;
(5) the degree of difficulty for other business operators to enter the relevant market; and
(6) other factors related to determine a dominant market position of the said business operator.

Article 19 Where a business operator is under any of the following circumstances, it may be assumed to have a dominant market position:

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(1) the relevant market share of a business operator accounts for1/2 or above in the relevant market;
(2) the joint relevant market share of two business operators accounts for 2/3 or above; or
(3) the joint relevant market share of three business operators accounts for 3/4 or above.

A business operator with a market share of less than 1/10 shall not be presumed as having a dominant market position even if they fall within the scope of second or third item. Where a business operator who has been presumed to have a dominant market position can otherwise prove that they do not have a dominant market, it shall not be determined as having a dominant market position.

CONCENTRATION OF BUSINESS OPERATORS

Article 20 A concentration refers to the following circumstances:

(1) the merger of business operators;
(2) acquiring control over other business operators by virtue of acquiring their equities or assets; or
(3) acquiring control over other business operators or possibility of exercising decisive influence on other business operators by virtue of contact or any other means.

Article 21 Where a concentration reaches the threshold of declaration stipulated by the State Council, a declaration must be lodged in advance with the Anti-monopoly Authority under the State Council, or otherwise the concentration shall not be implemented.

Article 22 Where a concentration is under any of the following circumstances, it may not be declared to the Anti-monopoly Authority under the State Council:

(1) one business operator who is a party to the concentration has the power to exercise more than half the voting rights of every other business operator, whether of the equity or the assets; or
(2) one business operator who is not a party to the concentration has the power to exercise more than half the voting rights of every business operator concerned, whether of the equity or the assets.

Article 23 A business operator shall, when lodge a concentration declaration with the Anti-monopoly Authority under the State Council, submit the following documents and materials:

(1) a declaration paper;
(2) explanations on the effect of the concentration on the relevant market competition;

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(3) the agreement of concentration;
(4) the financial reports and accounting reports of the proceeding accounting year of the business operator; and
(5) other documents and materials as stipulated by the Anti-monopoly Authority under the State Council.

Such items shall be embodied in the declaration paper as the name, domicile and business scopes of the business operators involved in the concentration as well as the date of the scheduled concentration and other items as stipulated by the Anti-monopoly Authority under the State Council.

Article 24 Where the documents or materials submitted by a business operator are incomplete, it shall submit the rest of the documents and materials within the time limit stipulated by the Anti-monopoly Authority under the State Council; otherwise, the declaration shall be deemed as not filed.

Article 25 The Anti-monopoly Authority under the State Council shall conduct a preliminary review of the declared concentration of business operators, make a decision whether to conduct further review and notify the business operators in written form within 30 days upon receipt of the documents and materials submitted by the business operators pursuant to Article 23 of this Law. Before such a decision made by the Anti-monopoly Authority under the State Council, the concentration may be not implemented. Where the Anti-monopoly Authority under the State Council decides not to conduct further review or fails to make a decision at expiry of the stipulated period, the concentration may be implemented.

Article 26 Where the Anti-monopoly Authority under the State Council decides to conduct further review, they shall, within 90 days from the date of decision, complete the review, make a decision on whether to prohibit the concentration, and notify the business operators concerned of the decision in written form. A decision of prohibition shall be attached with reasons therefor. Within the review period the concentration may not be implemented.

Under any of the following circumstances, the Anti-monopoly Authority under the State Council may notify the business operators in written form that the time limit as stipulated in the preceding paragraph may be extended to no more than 60 days:

(1) the business operators concerned agree to extend the time limit;
(2) the documents or materials submitted are inaccurate and need further verification;
(3) things have significantly changed after declaration.

If the Anti-monopoly Authority under the State Council fails to make a decision at expiry of the period, the concentration may be implemented.

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Article 27 In the case of the examination on the concentration of business operators, it shall consider the relevant elements as follows:

(1) the market share of the business operators involved in the relevant market and the controlling power thereof over that market,
(2) the degree of market concentration in the relevant market,
(3) the influence of the concentration of business operators on the market access and technological progress,
(4) the influence of the concentration of business operators on the consumers and other business operators,
(5) the influence of the concentration of business operators on the national economic development, and
(6) other elements that may have an effect on the market competition and shall be taken into account as regarded by the Anti-monopoly Authority under the State Council.

Article 28 Where a concentration has or may have effect of eliminating or restricting competition, the Anti-monopoly Authority under the State Council shall make a decision to prohibit the concentration. However, if the business operators concerned can prove that the concentration will bring more positive impact than negative impact on competition, or the concentration is pursuant to public interests, the Anti-monopoly Authority under the State Council may decide not to prohibit the concentration.

Article 29 Where the concentration is not prohibited, the Anti-monopoly Authority under the State Council may decide to attach restrictive conditions for reducing the negative impact of such concentration on competition.

Article 30 Where the Anti-monopoly Authority under the State Council decides to prohibit a concentration or attaches restrictive conditions on concentration, it shall publicize such decisions to the general public in a timely manner.

Article 31 Where a foreign investor merges and acquires a domestic enterprise or participate in concentration by other means, if state security is involved, besides the examination on the concentration in accordance with this Law, the examination on national security shall also be conducted in accordance with the relevant State provisions.

ABUSE OF ADMINISTRATIVE POWER TO ELIMINATE OR RESTRICT COMPETITION * * *

INVESTIGATION INTO THE SUSPICIOUS MONOPOLISTIC CONDUCTS * * *

LEGAL LIABILITIES * * *

SUPPLEMENTARY PROVISIONS * * *

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XV. CHAPTER 30, ACQUISITIONS OF BANKRUPT CORPORATIONS

A. Page 1232, New Sec. 30.6. Bankruptcy Sale of Investment Banking Assets of Lehman Brothers

Page 1232, New Sec. 30.6. Add at the bottom of the page the following:
New Sec. 30.6. **Bankruptcy Sale of Investment Banking Assets of Lehman Brothers**

Form 8-K, Lehman Brothers Holdings, Inc.
September 22, 2008

COMPLETION OF ACQUISITION OR DISPOSITION OF ASSETS

On September 22, 2008, the Registrant, Lehman Brothers Inc. ("LBI") and LB 745 LLC completed the sale of Lehman's United States and Canadian investment banking and capital markets business, including the fixed income and equities cash trading, brokerage, dealing, trading and advisory businesses, investment banking operations, LBI's business as a futures commission merchant and LBI's commodities business, government securities trading operations and mortgage-backed securities trading operations of LBI, and its private investment management business (collectively, the "Business") to Barclays Capital Inc. ("Barclays"). In addition, Barclays acquired certain securities of LBI held as part of its securities trading operations, equity in certain of the Registrant's subsidiaries, and Lehman's headquarters in New York and two data centers in New Jersey. In connection with its acquisition of the Business, Barclays also assumed certain liabilities relating to the Business.

Pursuant to the terms of the Asset Purchase Agreement, dated as of September 16, 2008, as amended by the First Amendment to Asset Purchase Agreement, dated as of September 19, 2008 and the Letter Agreement, dated as of September 20, 2008 (as so amended, the "Asset Purchase Agreement"), the purchase price for the assets sold to Barclays was $250 million in cash and Assumed Liabilities (as defined in the Asset Purchase Agreement) and $1.29 billion in cash (subject to certain holdbacks in order to effectuate the prorations contemplated by Section 12.2 of the Asset Purchase Agreement) for Lehman's headquarters and two data centers. In connection with the Barclays transaction, Barclays has offered employment to approximately 10,000 employees of Lehman associated with the Business. Among those employees are certain officers of the Registrant who participated in the negotiation and preparation of the Asset Purchase Agreement. The amount and form of the consideration paid by Barclays for the Business (which consideration included the assumption of the Assumed Liabilities) was determined based on a variety of factors, including, but not limited to, Lehman's financial condition in the period leading up to and following the bankruptcy filing and available appraisal information regarding Lehman's headquarters and two data centers sold in the

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transaction. The transaction, including the consideration, was approved by the Registrant's board of directors and the Bankruptcy Court (as defined below).

Because the Asset Purchase Agreement was signed by the Registrant as a debtor-in-possession, the sale was conducted under the provisions of Section 363 of Chapter 11 of Title 11 of the United States Code, and was subject to approval by the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court"), which the Bankruptcy Court granted on September 20, 2008. The Asset Purchase Agreement contemplated the sale of LBI's assets in connection with a case commenced under the Securities Investor Protection Act of 1970, as amended ("SIPA"). In this regard, on September 19, 2008, the Securities Investor Protection Corporation commenced a case under SIPA with respect to LBI in the United States District Court for the Southern District of New York (the "District Court"). James W. Giddens was appointed by the District Court as the trustee for LBI's estate (the "LBI Trustee"), and further proceedings in the case were referred in accordance with SIPA to the Bankruptcy Court, which approved the sale of certain of LBI's business pursuant to the Asset Purchase Agreement.

In accordance with a Letter Agreement, dated September 22, 2008 (the "DTCC Letter Agreement"), among Barclays, The Depository Trust & Clearing Corporation ("DTCC") (on behalf of itself, the Fixed Income Clearing Corporation and the National Securities Clearing Corporation (collectively, the "Clearing Agency Subsidiaries")) and the LBI Trustee, LBI and Barclays agreed that $250 million of the purchase price paid by Barclays for the Business would be paid by Barclays to DTCC to provide collateral against any losses, claims, damages and expenses of DTCC and each of the Clearing Agency Subsidiaries and their respective officers, directors, employee, owners, agents and representatives. If any portion of this deposited amount remains following the closeout of the accounts and the satisfaction of all obligations in accordance with the rules and procedures of the Clearing Agency Subsidiaries, such remaining amount will be remitted to the LBI Trustee.

In addition, in connection with the sale, the Registrant entered into a $450 million Senior Secured Superpriority Debtor-In-Possession Credit Agreement, dated as of September 17, 2008 (the "DIP Credit Agreement"), among the Registrant and Barclays Bank PLC, as Administrative Agent, Collateral Agent and a Lender, and a Transition Services Agreement, dated September 22, 2008 (the "Transition Services Agreement" and, together with the Asset Purchase Agreement, the DTCC Letter Agreement and the DIP Credit Agreement, the "Agreements") between the Registrant and Barclays.

The Agreements were the subject of, and were filed as exhibits to, the Registrant's Current Report on Form 8-K dated September 22, 2008. This item of this Report hereby incorporates by reference the descriptions of the Agreements and their respective transactions contained in Item 1.01 of such report, except to the extent the information in this Report may supersede any portion of such prior descriptions.

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B. Page 1232, New Sec. 30.7. Lehman Seeks to Recover $11 Billion from Barclays

Page 1232, New Sec. 30.7. Add at the end of new Sec. 30.6 the following:
New Sec. 30.7. **Lehman Seeks to Recover $11 Billion from Barclays**

Lehman Holdings, Inc., the parent of the bankrupt Lehman, has sued Barclays seeking the return of $11 billion allegedly overpaid by Lehman in the bankruptcy sale. A May 22, 2010 article in the Wall Street Journal gives the following report on this suit:

Lehman Brothers Holdings Inc.'s (LEHMQ) 2008 deal to sell its broker-dealer assets to Barclays PLC (BCS) was closed so hastily that it was impossible to do the proper due diligence on valuing those assets, the former counsel to Lehman's unsecured creditors said Friday.

Testifying in the U.S. Bankruptcy Court in Manhattan, Luc A. Despins said the unsecured creditors committee had such deep concerns about how some of Lehman's assets were marked that it never consented to Barclays' $45 billion purchase of the investment bank's brokerage in September 2008.

Lehman is trying to recover more than $11 billion that it says Barclays pocketed in the deal. Lehman contends the discounted price of the original assets wasn't disclosed in bankruptcy court. The assets were worth about $50.6 billion.

A key point of contention in the suit is how some of Lehman's illiquid assets were valued. Despins said last-minute changes to how those securities were marked raised questions that couldn't be answered immediately.[339]

C. Page 1232, New Sec. 30.8. Bankruptcy Sale by Chrysler

Page 1232, New Sec. 30.8. Add after the new Sec. 30.6 the following:
New Sec. 30.8. **Bankruptcy Sale by Chrysler**

In Re Chrysler Llc,
United States Court of Appeals, Second Circuit, 2009
576 F.3d 108

Before: JACOBS, Chief Judge, KEARSE and SACK, Circuit Judges.

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[339] Mike Spector and Susanne Craig, *Lehman's Bankruptcy Estate Sues J.P. Morgan*, WALL STREET JOURNAL (May 27, 2010), available at www.wsj.com.

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DENNIS JACOBS, Chief Judge:

The Indiana State Police Pension Trust, the Indiana State Teachers Retirement Fund, and the Indiana Major Moves Construction Fund (collectively, the “Indiana Pensioners” or “Pensioners”), along with various tort claimants and others, appeal from an order entered in the United States Bankruptcy Court for the Southern District of New York, Arthur J. Gonzalez, Bankruptcy Judge, dated June 1, 2009 (the “Sale Order”), authorizing the sale of substantially all of the debtor’s assets to New CarCo Acquisition LLC (“New Chrysler”). On June 2, 2009 we granted the Indiana Pensioners’ motion for a stay and for expedited appeal directly to this Court, pursuant to 28 U.S.C. § 158(d)(2). On June 5, 2009 we heard oral argument, and ruled from the bench and by written order, affirming the Sale Order “for the reasons stated in the opinions of Bankruptcy Judge Gonzalez,” stating that an opinion or opinions would follow. This is the opinion.

In a nutshell, Chrysler LLC and its related companies (hereinafter “Chrysler” or “debtor” or “Old Chrysler”) filed a pre-packaged bankruptcy petition under Chapter 11 on April 30, 2009. The filing followed months in which Chrysler experienced deepening losses, received billions in bailout funds from the Federal Government, searched for a merger partner, unsuccessfully sought additional government bailout funds for a stand-alone restructuring, and ultimately settled on an asset-sale transaction pursuant to 11 U.S.C. § 363 (the “Sale”), which was approved by the Sale Order. The key elements of the Sale were set forth in a Master Transaction Agreement dated as of April 30, 2009: substantially all of Chrysler’s operating assets (including manufacturing plants, brand names, certain dealer and supplier relationships, and much else) would be transferred to New Chrysler in exchange for New Chrysler’s assumption of certain liabilities and $ 2 billion in cash. Fiat S.p.A agreed to provide New Chrysler with certain fuel-efficient vehicle platforms, access to its worldwide distribution system, and new management that is experienced in turning around a failing auto company. Financing for the sale transaction--$ 6 billion in senior secured financing, and debtor-in- financing for 60 days in the amount of $ 4.96 billion--would come from the United States Treasury and from Export Development Canada. The agreement describing the United States Treasury’s commitment does not specify the source of the funds, but it is undisputed that prior funding came from the Troubled Asset Relief Program (“TARP”), 12 U.S.C. § 5211(a)(1), and that the parties expected the Sale to be financed through the use of TARP funds. Ownership of New Chrysler was to be distributed by membership interests, 55% of which go to an employee benefit entity created by the United Auto Workers union, 8% to the United States Treasury and 2% to Export Development Canada. Fiat, for its contributions, would immediately own 20% of the equity with rights to acquire more (up to 51%), contingent on payment in full of the debts owed to the United States Treasury and Export Development Canada. Twelve witnesses testified (either live or through positions), and 48 exhibits were introduced.

At a hearing on May 5, 2009, the bankruptcy court approved the debtor’s proposed bidding procedures. No other bids were forthcoming. From May 27 to May 29, the bankruptcy court held hearings on whether to approve the Sale. Upon extensive findings

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of fact and conclusions of law, the bankruptcy court approved the Sale by order dated June 1, 2009.

After briefing and oral argument, we affirmed the bankruptcy court's order on June 5, but we entered a short stay pending Supreme Court review. The Supreme Court, after an extension of the stay, declined a further extension. The Sale closed on June 10, 2009.

The factual and procedural background is set out in useful detail in the opinions of Bankruptcy Judge Gonzalez. This opinion is confined to a discussion of the arguments made for vacatur or reversal. The Sale Order is challenged essentially on four grounds. First, it is contended that the sale of Chrysler's auto-manufacturing assets, considered together with the associated intellectual property and (selected) dealership contractual rights, so closely approximates a final plan of reorganization that it constitutes an impermissible "*sub rosa* plan," and therefore cannot be accomplished under § 363(b). We consider this question first, because a determination adverse to Chrysler would have required reversal. Second, we consider the argument by the Indiana Pensioners that the Sale impermissibly subordinates their interests as secured lenders and allows assets on which they have a lien to pass free of liens to other creditors and parties, in violation of § 363(f). We reject this argument on the ground that the secured lenders have consented to the Sale, as per § 363(f)(2). Third, the Indiana Pensioners challenge the constitutionality of the use of TARP funds to finance the Sale on a number of grounds, chiefly that the Secretary of the Treasury is using funds appropriated for relief of "financial institutions" to effect a bailout of an auto-manufacturer, and that this causes a constitutional injury to the Indiana Pensioners because the loss of their priorities in bankruptcy amounts to an economic injury that was caused or underwritten by TARP money. We conclude that the Indiana Pensioners lack standing to raise this challenge. Finally, we consider and reject the arguments advanced by present and future tort claimants.

DISCUSSION

We review a bankruptcy court's conclusions of law *de novo*, and its findings of fact under the clearly erroneous standard. See Babitt v. Vebeliunas (In re Vebeliunas), 332 F.3d 85, 90 (2d Cir. 2003).

[PART I]

The Indiana Pensioners characterize the Sale as an impermissible, *sub rosa* plan of reorganization. See Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.), 700 F.2d 935, 940 (5th Cir. 1983) (denying approval of an asset sale because the debtor "should not be able to short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan *sub rosa* in connection with a sale of assets"). As the Indiana Pensioners characterize it, the Sale transaction "is a 'Sale' in name only; upon consummation, new Chrysler will be old Chrysler in essentially every respect. It will be called 'Chrysler.' . . . Its employees, including most management, will be retained. . . . It will manufacture and sell Chrysler and Dodge cars and minivans, Jeeps and Dodge Trucks. . . . The real substance of the

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transaction is the underlying reorganization it implements." Indiana Pensioners' Br. at 46 (citation omitted).

Section 363(b) of the Bankruptcy Code authorizes a Chapter 11 debtor-in-possession to use, sell, or lease estate property outside the ordinary course of business, requiring in most circumstances only that a movant provide notice and a hearing. 11 U.S.C. § 363(b).[340] We have identified an "apparent conflict" between the expedient of a § 363(b) sale and the otherwise applicable features and safeguards of Chapter 11.[341] Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.), 722 F.2d 1063, 1071 (2d Cir. 1983); cf. Braniff, 700 F.2d at 940.

In Lionel, we consulted the history and purpose of § 363(b) to situate § 363(b) transactions within the overall structure of Chapter 11. The origin of § 363(b) is the Bankruptcy Act of 1867, which permitted a sale of a debtor's assets when the estate or any part thereof was "of a perishable nature or liable to deteriorate in value." Lionel, 722 F.2d at 1066 (citing Section 25 of the Bankruptcy Act of 1867, Act of March 2, 1867, 14 Stat. 517) (emphasis omitted). Typically, courts have approved § 363(b) sales to preserve "'wasting asset[s].'" Id. at 1068 (quoting Mintzer v. Joseph (In re Sire Plan, Inc.), 332 F.2d 497, 499 (2d Cir. 1964)). Most early transactions concerned perishable commodities; but the same practical necessity has been recognized in contexts other than fruits and vegetables. "[T]here are times when it is more advantageous for the debtor to begin to sell as many assets as quickly as possible in order to insure that the assets do not lose value." Fla. Dep't of Revenue v. Piccadilly Cafeterias, Inc., 128 S. Ct. 2326, 2342, 171 L. Ed. 2d 203 (2008) (Breyer, J., dissenting) (internal quotation marks omitted); see also In re Pedlow, 209 F. 841, 842 (2d Cir. 1913) (upholding sale of a bankrupt's stock of handkerchiefs because the sale price was above the appraised value and "Christmas sales had commenced and . . . the sale of handkerchiefs depreciates greatly after the holidays"). Thus, an automobile manufacturing business can be within the ambit of the "melting ice cube" theory of § 363(b). As Lionel recognized, the text of § 363(b) requires no "emergency" to justify approval. Lionel, 722 F.2d at 1069. For example, if "a good business opportunity [is] presently available," id., which might soon disappear, quick action may be justified in order to increase (or maintain) the value of an asset to the estate, by means of a lease or sale of the assets. Accordingly, Lionel "reject[ed] the requirement that only an emergency permits the use of § 363(b)." Id. "[I]f a bankruptcy judge is to administer a business reorganization successfully under the Code, then . . . some play for the operation of both § 363(b) and Chapter 11 must be allowed for." Id. at 1071.

At the same time, Lionel "reject[ed] the view that § 363(b) grants the bankruptcy judge *carte blanche*." Id. at 1069.[342] The concern was that a quick, plenary sale of assets

[340] The section provides: "The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate . . . ." 11 U.S.C. § 363(b)(1).
[341] Section 363(b) may apply to cases arising under Chapters 7, 11, 12, and 13 of the Bankruptcy Code. In this se, as in Lionel, we consider only its applicability in the context of Chapter 11 cases.
[342] If unfettered use of § 363(b) had been intended, there would have been no need for the requirement of notice and hearing prior to approval.

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outside the ordinary course of business risked circumventing key features of the Chapter 11 process, which afford debt and equity holders the opportunity to vote on a proposed plan of reorganization after receiving meaningful information. See id. at 1069-70. Pushed by a bullying creditor, a § 363(b) sale might evade such requirements as disclosure, solicitation, acceptance, and confirmation of a plan. See 11 U.S.C. §§ 1122-29. "[T]he natural tendency of a debtor in distress," as a Senate Judiciary Committee Report observed, is "to pacify large creditors with whom the debtor would expect to do business, at the expense of small and scattered public investors." Lionel, 722 F.2d at 1070 (quoting S. Rep. No. 95-989, 2d Sess., at 10 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5787, 5796 (internal quotation marks omitted)).

To balance the competing concerns of efficiency against the safeguards of the Chapter 11 process, Lionel required a "good business reason" for a § 363(b) transaction[343]:
[A bankruptcy judge] should consider all salient factors pertaining to the proceeding and, accordingly, act to further the diverse interests of the debtor, creditors and equity holders, alike. [A bankruptcy judge] might, for example, look to such relevant factors as the proportionate value of the asset to the estate as a whole, the amount of elapsed time since the filing, the likelihood that a plan of reorganization will be proposed and confirmed in the near future, the effect of the proposed disposition on future plans of reorganization, the proceeds to be obtained from the disposition vis-a-vis any appraisals of the property, which of the alternatives of use, sale or lease the proposal envisions and, most importantly perhaps, whether the asset is increasing or decreasing in value. This list is not intended to be exclusive, but merely to provide guidance to the bankruptcy judge.
722 F.2d at 1071.

After weighing these considerations, the Court in Lionel reversed a bankruptcy court's approval of the sale of Lionel Corporation's equity stake in another corporation, Dale Electronics, Inc. ("Dale"). The Court relied heavily on testimony from Lionel's Chief Executive Officer, who conceded that it was "only at the insistence of the Creditors' Committee that Dale stock was being sold and that Lionel 'would very much like to retain its interest in Dale,'" id. at 1072, as well as on a financial expert's acknowledgment that the value of the Dale stock was not decreasing, see id. at 1071-72. Since the Dale stock was not a wasting asset, and the proffered justification for selling the stock was the desire of creditors, no sufficient business reasons existed for approving the sale.

In the twenty-five years since Lionel, § 363(b) asset sales have become common practice in large-scale corporate bankruptcies. See, e.g., Robert E. Steinberg, *The Seven Deadly Sins in § 363 Sales*, Am. Bankr. Inst. J., June 2005, at 22, 22 ("Asset sales under § 363 of the Bankruptcy Code have become the preferred method of monetizing the assets of a debtor company."); Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain A Viable Option for Distressed Businesses for the Twenty-First Century*?, 78 Am. Bankr. L.J. 153, 194-96 (2004). A law review article recounts the phenomenon:

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[343] The Lionel standard has subsequently been adopted in sister Circuits. See, e.g., Stephens Indus. v. McClung, 789 F.2d 386, 389-90 (6th Cir. 1986); Inst. Creditors of Continental Air Lines, Inc. v. Continental Air Lines, Inc. (In re Continental Air Lines, Inc.), 780 F.2d 1223, 1226 (5th Cir. 1986).

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> Corporate reorganizations have all but disappeared. . . . TWA filed only to consummate the sale of its planes and landing gates to American Airlines. Enron's principal assets, including its trading operation and its most valuable pipelines, were sold within a few months of its bankruptcy petition. Within weeks of filing for Chapter 11, Budget sold most of its assets to the parent company of Avis. Similarly, Polaroid entered Chapter 11 and sold most of its assets to the private equity group at BankOne. Even when a large firm uses Chapter 11 as something other than a convenient auction block, its principal lenders are usually already in control and Chapter 11 merely puts in place a preexisting deal.

Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 Stan. L. Rev. 751, 751-52 (2002) (internal footnotes omitted). In the current economic crisis of 2008-09, § 363(b) sales have become even more useful and customary.[344] The "side door" of § 363(b) may well "replace the main route of Chapter 11 reorganization plans." Jason Brege, Note, *An Efficiency Model of Section 363(b) Sales*, 92 Va. L. Rev. 1639, 1640 (2006).

Resort to § 363(b) has been driven by efficiency, from the perspectives of sellers and buyers alike. The speed of the process can maximize asset value by sale of the debtor's business as a going concern. Moreover, the assets are typically burnished (or "cleansed") because (with certain limited exceptions) they are sold free and clear of liens, claims and liabilities. See infra (discussing § 363(f) and tort issues). A § 363 sale can often yield the highest price for the assets because the buyer can select the liabilities it will assume and purchase a business with cash flow (or the near prospect of it). Often, a secured creditor can "credit bid," or take an ownership interest in the company by bidding a reduction in the debt the company owes. See 11 U.S.C. § 363(k) (allowing a secured creditor to credit bid at a § 363(b) sale).

This tendency has its critics. See, e.g., James H.M. Sprayregen et al., *Chapter 11: Not Perfect, but Better than the Alternative*, Am. Bankr. Inst. J., Oct. 2005, at 1, 60 (referencing those who "decr[y] the increasing frequency and rise in importance of § 363 sales"). The objections are not to the quantity or percentage of assets being sold: it has long been understood (by the drafters of the Code,[345] and the Supreme

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[344] For instance, Lehman Brothers sold substantially all its assets to Barclays Capital within five days of filing for bankruptcy. Lehman Brothers filed for bankruptcy in the early morning hours of September 15, 2008. On September 20, 2008, the bankruptcy court approved the sale to Barclays of Lehman's investment banking and capital markets operations, as well as supporting infrastructure including the Lehman headquarters in midtown Manhattan for $ 1.7 billion. See Bay Harbour Mgmt., L.C. v. Lehman Bros. Holdings Inc. (In re Lehman Bros. Holdings Inc.), No. 08-cv-8869(DLC), 415 B.R. 77, 2009 U.S. Dist. LEXIS 20893, 2009 WL 667301, at *8 (S.D.N.Y. Mar. 13, 2009) (affirming the § 363(b) sale order).

[345] As stated in Lionel, "[t]he Commission on the Bankruptcy Laws of the United States submitted a draft provision that would have permitted resort to section 363(b) in the absence of an emergency, even in the case of 'all or substantially all the property of the estate.' See Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 93-137, 93rd Cong., 1st Sess. (1973) at 239 (proposed § 7-205 and accompanying explanatory note). Congress eventually deleted this provision without explanation . . . ." Lionel, 722 F.2d at 1069-70 n.3.

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Court[346]) that § 363(b) sales may encompass all or substantially all of a debtor's assets. Rather, the thrust of criticism remains what it was in Lionel: fear that one class of creditors may strong-arm the debtor-in-possession, and bypass the requirements of Chapter 11 to cash out quickly at the expense of other stakeholders, in a proceeding that amounts to a reorganization in all but name, achieved by stealth and momentum. See, e.g., Motorola, Inc. v. Official Comm. of Unsecured Creditors and J.P. Morgan Chase Bank, N.A. (In re Iridium Operating LLC), 478 F.3d 452, 466 (2d Cir. 2007) ("The reason *sub rosa* plans are prohibited is based on a fear that a debtor-in-possession will enter into transactions that will, in effect, short circuit the requirements of Chapter 11 for confirmation of a reorganization plan." (internal quotation marks and alteration omitted)); Brege, *An Efficiency Model of Section 363(b) Sales*, 92 Va. L. Rev. at 1643 ("The cynical perspective is that [§ 363(b)] serves as a loophole to the otherwise tightly arranged and efficient Chapter 11, through which agents of the debtor-in-possession can shirk responsibility and improperly dispose of assets."); see also Steinberg, *The Seven Deadly Sins in § 363 Sales*, Am. Bankr. Inst. J., at 22 ("Frequently, . . . the § 363 sale process fails to maximize value . . . .").

As § 363(b) sales proliferate, the competing concerns identified in Lionel have become harder to manage. Debtors need flexibility and speed to preserve going concern value; yet one or more classes of creditors should not be able to nullify Chapter 11's requirements. A balance is not easy to achieve, and is not aided by rigid rules and prescriptions. Lionel's multi-factor analysis remains the proper, most comprehensive framework for judging the validity of § 363(b) transactions.

Adopting the Fifth Circuit's wording in Braniff, 700 F.2d at 940, commentators and courts--including ours--have sometimes referred to improper § 363(b) transactions as "*sub rosa* plans of reorganization." See, e.g., In re Iridium, 478 F.3d at 466 ("The trustee is prohibited from such use, sale or lease if it would amount to a *sub rosa* plan of reorganization."). Braniff rejected a proposed transfer agreement in large part because the terms of the agreement specifically attempted to "dictat[e] some of the terms of any future reorganization plan. The [subsequent] reorganization plan would have to allocate the [proceeds of the sale] according to the terms of the [transfer] agreement or forfeit a valuable asset." 700 F.2d at 940. As the Fifth Circuit concluded, "[t]he debtor and the Bankruptcy Court should not be able to short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan *sub rosa* in connection with a sale of assets." Id.

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[346] The Supreme Court has noted that § 363(b) is sometimes used to sell all or substantially all of a debtor's assets. In a footnote in Florida Department of Revenue v. Piccadilly Cafeterias, the Court wrote:
Chapter 11 bankruptcy proceedings ordinarily culminate in the confirmation of a reorganization plan. But in some cases, as here, a debtor sells all or substantially all its assets under § 363(b)(1) (2000 ed., Supp. V) before seeking or receiving plan confirmation. In this scenario, the debtor typically submits for confirmation a plan of liquidation (rather than a traditional plan of reorganization) providing for the distribution of the proceeds resulting from the sale.
128 S. Ct. at 2330 n.2.

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The term "*sub rosa*" is something of a misnomer. It bespeaks a covert or secret activity, whereas secrecy has nothing to do with a § 363 transaction. Transactions blessed by the bankruptcy courts are openly presented, considered, approved, and implemented. Braniff seems to have used "*sub rosa*" to describe transactions that treat the requirements of the Bankruptcy Code as something to be evaded or subverted. But even in that sense, the term is unhelpful. The sale of assets is permissible under § 363(b); and it is elementary that the more assets sold that way, the less will be left for a plan of reorganization, or for liquidation. But the size of the transaction, and the residuum of corporate assets, is, under our precedent, just one consideration for the exercise of discretion by the bankruptcy judge(s), along with an open-ended list of other salient factors. See Lionel, 722 F.2d at 1071 (a bankruptcy judge should consider "such relevant factors as the proportionate value of the asset to the estate as a whole").

Braniff's holding did not support the argument that a § 363(b) asset sale must be rejected simply because it is a sale of all or substantially all of a debtor's assets. Thus a § 363(b) sale may well be a reorganization in effect without being the kind of plan rejected in Braniff.[347] See, e.g., Fla. Dep't of Revenue v. Piccadilly Cafeterias, Inc., 128 S. Ct. at 2330 n.2. Although Lionel did not involve a contention that the proposed sale was a *sub rosa* or *de facto* reorganization, a bankruptcy court confronted with that allegation may approve or disapprove a § 363(b) transfer that is a sale of all or substantially all of a debtor's assets, using the analysis set forth in Lionel in order to determine whether there was a good business reason for the sale. See In re Iridium, 478 F.3d at 466 & n.21 ("The trustee is prohibited from such use, sale or lease if it would amount to a *sub rosa* plan of reorganization. . . . In this Circuit, the sale of an asset of the estate under § 363(b) is permissible if the 'judge determining [the] § 363(b) application expressly find[s] from the evidence presented before [him or her] at the hearing [that there is] a good business reason to grant such an application.'" (citing Lionel, 722 F.2d at 1071)).

The Indiana Pensioners argue that the Sale is a *sub rosa* plan chiefly because it gives value to unsecured creditors (*i.e.*, in the form of the ownership interest in New Chrysler provided to the union benefit funds) without paying off secured debt in full, and without complying with the procedural requirements of Chapter 11. However, Bankruptcy Judge Gonzalez demonstrated proper solicitude for the priority between creditors and deemed it essential that the Sale in no way upset that priority. The lien holders' security interests would attach to all proceeds of the Sale: "Not one penny of value of the Debtors' assets is going to anyone other than the First-Lien Lenders." Opinion Granting Debtor's Motion Seeking Authority to Sell, May 31, 2009, ("Sale Opinion") at 18. As Bankruptcy Judge Gonzalez found, all the equity stakes in New

[347] The transaction at hand is as good an illustration as any. "Old Chrysler" will simply transfer the $ 2 billion in proceeds to the first lien lenders, and then liquidate. The first lien lenders themselves will suffer a deficiency of some $ 4.9 billion, and everyone else will likely receive nothing from the liquidation. Thus the Sale has inevitable and enormous influence on any eventual plan of reorganization or liquidation. But it is not a "sub rosa plan" in the Braniff sense because it does not specifically "dictate," or "arrange" ex ante, by contract, the terms of any subsequent plan.

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Chrysler were entirely attributable to *new* value--including governmental loans, new technology, and new management--which were not assets of the debtor's estate. See, e.g., id. at 22-23.

The Indiana Pensioners' arguments boil down to the complaint that the Sale does not pass the discretionary, multifarious Lionel test. The bankruptcy court's findings constitute an adequate rebuttal. Applying the Lionel factors, Bankruptcy Judge Gonzalez found good business reasons for the Sale. The linchpin of his analysis was that the only possible alternative to the Sale was an immediate liquidation that would yield far less for the estate--and for the objectors. The court found that, notwithstanding Chrysler's prolonged and well-publicized efforts to find a strategic partner or buyer, no other proposals were forthcoming. In the months leading up to Chrysler's bankruptcy filing, and during the bankruptcy process itself, Chrysler executives circled the globe in search of a deal. But the Fiat transaction was the *only* offer available. Sale Opinion at 6; see id. at 16-17 ("Notwithstanding the highly publicized and extensive efforts that have been expended in the last two years to seek various alliances for Chrysler, the Fiat Transaction is the only option that is currently viable. The only other alternative is the immediate liquidation of the company.").[348]

The Sale would yield $ 2 billion. According to expert testimony[349] --not refuted by the objectors--an immediate liquidation of Chrysler as of May 20, 2009 would yield in the range of nothing to $ 800 million.[350] Id. at 19. Crucially, Fiat had conditioned its commitment on the Sale being completed by June 15, 2009. While this deadline was tight and seemingly arbitrary, there was little leverage to force an extension. To preserve resources, Chrysler factories had been shuttered, and the business was hemorrhaging cash. According to the bankruptcy court, Chrysler was losing going concern value of nearly $ 100 million each day. Sale Order at 7.

On this record, and in light of the arguments made by the parties, the bankruptcy court's approval of the Sale was no abuse of discretion. With its revenues sinking, its factories dark, and its massive debts growing, Chrysler fit the paradigm of the

[348] The bankruptcy court noted that Chrysler had discussed potential alliances with General Motors, Fiat, Nissan, Hyundai-Kia, Toyota, Volkswagen, Tata Motors, GAZ Group, Magna International, Mitsubishi Motors, Honda, Beijing Automotive, Tempo International Group, Hawtai Automobiles, and Chery Automobile Co. Sale Opinion at 6.

[349] The Indiana Pensioners moved to strike the testimony of Chrysler's valuation witness because he has a financial interest in the outcome of the case: his firm would receive a transaction fee when the Sale was consummated. The bankruptcy court denied the motion on the grounds that such arrangements are typical; that the Indiana Pensioners did not object to the retention of the witness's firm; and that the witness's interest goes to weight of the evidence, not admissibility. Sale Opinion at 19 n.17. The Indiana Pensioners have not persuaded us that the bankruptcy court abused its discretion. See generally Gen. Elec. Co. v. Joiner, 522 U.S. 136, 138-39, 141-43, 118 S. Ct. 512, 139 L. Ed. 2d 508 (1997); Ball v. A.O. Smith Corp., 451 F.3d 66, 69 (2d Cir. 2006) ("We review the bankruptcy court's evidentiary decisions for abuse of discretion.").

[350] The expert's earlier estimates of liquidation value had been higher. For example, in early May 2009, the same expert opined that a liquidation might yield between nothing and $ 1.2 billion. But, from the beginning of May until the end, Chrysler expended $ 400 million in cash collateral. Sale Opinion at 19.

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melting ice cube. Going concern value was being reduced each passing day that it produced no cars, yet was obliged to pay rents, overhead, and salaries. Consistent with an underlying purpose of the Bankruptcy Code--maximizing the value of the bankrupt estate--it was no abuse of discretion to determine that the Sale prevented further, unnecessary losses. See Toibb v. Radloff, 501 U.S. 157, 163, 111 S. Ct. 2197, 115 L. Ed. 2d 145 (1991) (Chapter 11 "embodies the general [Bankruptcy] Code policy of maximizing the value of the bankruptcy estate.").

The Indiana Pensioners exaggerate the extent to which New Chrysler will emerge from the Sale as the twin of Old Chrysler. New Chrysler may manufacture the same lines of cars but it will also make newer, smaller vehicles using Fiat technology that will become available as a result of the Sale--moreover, at the time of the proceedings, Old Chrysler was manufacturing no cars at all. New Chrysler will be run by a new Chief Executive Officer, who has experience in turning around failing auto companies. It may retain many of the same employees, but they will be working under new union contracts that contain a six-year no-strike provision. New Chrysler will still sell cars in some of its old dealerships in the United States, but it will also have new access to Fiat dealerships in the European market. Such transformative use of old and new assets is precisely what one would expect from the § 363(b) sale of a going concern.

[PART II]

The Indiana Pensioners next challenge the Sale Order's release of all liens on Chrysler's assets. In general, under § 363(f), assets sold pursuant to § 363(b) may be sold "free and clear of any interest" in the assets when, *inter alia*, the entity holding the interest consents to the sale. 11 U.S.C. § 363(f)(2). The bankruptcy court ruled that, although the Indiana Pensioners did not themselves consent to the release, consent was validly provided by the collateral trustee, who had authority to act on behalf of all first-lien credit holders.

We agree. Through a series of agreements, the Pensioners effectively ceded to an agent the power to consent to such a sale; the agent gave consent; and the Pensioners are bound. Accordingly, questions as to the status or preference of Chrysler's secured debt are simply not presented in this case.

The first-lien holders--among them, the Indiana Pensioners--arranged their investment in Chrysler by means of three related agreements: a First Lien Credit Agreement, a Collateral Trust Agreement, and a Form of Security Agreement. Together, these agreements create a framework for the control of collateral property. The collateral is held by a designated trustee for the benefit of the various lenders (including the Indiana Pensioners). In the event of a bankruptcy, the trustee is empowered to take any action deemed necessary to protect, preserve, or realize upon the collateral. The trustee may only exercise this power at the direction of the lenders' agent; but the lenders are required to authorize the agent to act on their behalf, and any action the agent takes at the request of lenders holding a majority of Chrysler's debt is binding on all lenders, those who agree and those who do not.

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When Chrysler went into bankruptcy, the trustee had power to take any action necessary to realize upon the collateral--including giving consent to the sale of the collateral free and clear of all interests under § 363. The trustee could take such action only at the direction of the lenders' agent, and the agent could only direct the trustee at the request of lenders holding a majority of Chrysler's debt. But if those conditions were met--as they were here--then under the terms of the various agreements, the minority lenders could not object to the trustee's actions since they had given their authorization in the first place.

The Indiana Pensioners argue that, by virtue of a subclause in one of the loan agreements, Chrysler required the Pensioners' written consent before selling the collateral assets. The clause in question provides that the loan documents themselves could not be amended without the written consent of *all* lenders if the amendment would result in the release of all, or substantially all, of the collateral property. This clause is no help to the Indiana Pensioners. The § 363(b) Sale did not entail amendment of any loan document. To the contrary, the § 363(b) sale was effected by implementing the clear terms of the loan agreements--specifically, the terms by which (1) the lenders assigned an agent to act on their behalf, (2) the agent was empowered, upon request from the majority lenders, to direct the trustee to act, and (3) the trustee was empowered, at the direction of the agent, to sell the collateral in the event of a bankruptcy. Because the Sale required no amendment to the loan documents, Chrysler was not required to seek, let alone receive, the Pensioners' written consent.

Anticipating the consequence of this contractual framework, the Indiana Pensioners argue as a last resort that the majority lenders were intimidated or bullied into approving the Sale in order to preserve or enhance relations with the government, or other players in the transaction. Absent this bullying, the Pensioners suggest, the majority lenders would not have requested the agent to direct the sale of the collateral, and the Sale would not have gone through. The Pensioners argue that this renders the lenders' consent ineffective or infirm.

The record before the bankruptcy court, and the record before this Court, does not support a finding that the majority lenders were coerced into agreeing to the Sale. On the whole, the record (and findings) support the view that they acted prudently to preserve substantial value rather than risk a liquidation that might have yielded nothing at all. Moreover, it is not at all clear what impact a finding of coerced consent would have on the validity of the consent given, or whether the bankruptcy court would have jurisdiction--or occasion--to adjudicate the Indiana Pensioners' allegation. Because the facts alleged by the Indiana Pensioners are not substantiated in this record, their arguments based on those allegations provide no ground for relief in this proceeding, and we decline to consider whether the allegations might give rise to some independent cause of action. * * *

[PART IV]

Finally, several objectors appeal from that portion of the Sale Order extinguishing all

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existing and future claims against New Chrysler, that "(a) arose prior to the Closing Date, (b) relate[] to the production of vehicles prior to the Closing Date or (c) otherwise [are] assertable against the Debtors or [are] related to the Purchased Assets prior to the closing date." Sale Order at 40. The objectors can be divided into three groups: (1) plaintiffs with existing product liability claims against Chrysler; (2) plaintiffs with existing asbestos-related claims against Chrysler; and (3) lawyers undertaking to act on behalf of claimants who, although presently unknown and unidentified, might have claims in the future arising from Old Chrysler's production of vehicles. We consider each group's arguments in turn.

Existing Product Liability Claims

The Ad Hoc Committee of Consumer-Victims of Chrysler LLC and William Lovitz et al. challenge the foreclosing of New Chrysler's liability for product defects in vehicles produced by Old Chrysler.[351] Section 363(f) provides, in relevant part, that a "trustee may sell property . . . free and clear of *any interest in such property*," under certain circumstances. 11 U.S.C. § 363(f) (emphasis added). The objectors argue that personal injury claims are not "interests in property," and that the district court's reliance on In re Trans World Airlines, Inc., 322 F.3d 283 (3d Cir. 2003) ("TWA"), which advances a broad reading of "interests in property," was misplaced.

We have never addressed the scope of the language "any interest in such property," and the statute does not define the term. See, e.g., Precision Indus., Inc. v. Qualitech Steel SBQ, LLC, 327 F.3d 537, 545 (7th Cir. 2003) ("The Bankruptcy Code does not define 'any interest,' and in the course of applying section 363(f) to a wide variety of rights and obligations related to estate property, courts have been unable to formulate a precise definition.").

In TWA, the Third Circuit considered whether (1) employment discrimination claims and (2) a voucher program awarded to flight attendants in settlement of a class action constituted "interests" in property for purposes of § 363(f). See 322 F.3d at 285. The Third Circuit began its analysis by noting that bankruptcy courts around the country have disagreed about whether "any interest" should be defined broadly or narrowly.[352] Id. at

[351] The Sale Order does not limit the right of tort plaintiffs to pursue existing claims against Old Chrysler. However, it is undisputed that little or no money will be available for damages even if suits against Old Chrysler succeed.

[352] For examples of bankruptcy courts' divergent rulings on this issue, compare, e.g., P.K.R. Convalescent Ctrs., Inc. v. Commonwealth of Va., Dept. of Med. Assistance Serv. (In re P.K.R. Convalescent Ctrs., Inc.), 189 B.R. 90, 94 (Bankr. E.D. Va. 1995) (holding that Virginia's depreciation-recoupment interest in the debtor's property was an "interest in property," even though the interest was not a lien), and Am. Living Sys. v. Bonapfel (In re All Am. of Ashburn, Inc.), 56 B.R. 186, 189-90 (Bankr. N.D. Ga. 1986) (holding that § 363(f) permitted the sale of assets free and clear and precluded successor liability in product liability suit against purchaser for cause of action that arose prior to date of sale), with Schwinn Cycling and Fitness, Inc. v. Benonis (In re Schwinn Bicycle Co.), 210 B.R. 747, 761 (Bankr. N.D. Ill. 1997) (holding that § 363(f) "in no way protects the buyer from current or future product liability; it only protects the purchased assets from lien claims against those assets"), and Volvo White Truck Corp. v. Chambersburg Beverage, Inc. (In re White Motor Credit Corp.), 75 B.R. 944, 948 (Bankr. N.D. Ohio 1987) (stating that

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288-89. The Third Circuit observed, however, that "the trend seems to be toward a more expansive reading of 'interests in property' which 'encompasses other obligations that may flow from ownership of the property.'" Id. at 289 (quoting 3 Collier on Bankruptcy P 363.06[1]); see also George W. Kuney, *Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process*, 76 Am. Bankr. L.J. 235, 267 (2002) ("[T]he dominant interpretation is that § 363(f) can be used to sell property free and clear of claims that could otherwise be assertable against the buyer of the assets under the common law doctrine of successor liability.").

The Third Circuit reasoned that "to equate interests in property with only *in rem* interests such as liens would be inconsistent with section 363(f)(3), which contemplates that a lien is but one type of interest." 322 F.3d at 290. After surveying its owns precedents and the Fourth Circuit's decision in United Mine Workers of Am. 1992 Benefit Plan v. Leckie Smokeless Coal Co. (In re Leckie Smokeless Coal Co.), 99 F.3d 573 (4th Cir. 1996),[353] the TWA court held that "[w]hile the interests of the [plaintiffs] in the assets of TWA's bankruptcy estate are not interests in property in the sense that they are not *in rem* interests, . . . they are interests in property within the meaning of section 363(f) in the sense that they *arise from the property* being sold." 322 F.3d at 290 (emphasis added).

Shortly after TWA was decided, the Southern District of California concluded that TWA applied to tort claimants asserting personal injury claims. See Myers v. United States, 297 B.R. 774, 781-82 (S.D. Cal. 2003). Myers involved claims arising from the negligent handling of toxic materials transported pursuant to a government contract. Id. at 781. Applying TWA, the Myers court ruled that the plaintiff's "claim for personal injury does arise from the property being sold, i.e. the contracts to transport toxic materials." Id.; see also Faulkner v. Bethlehem Steel/Int'l Steel Group, No. 2:04-CV-34 PS, 2005 U.S. Dist. LEXIS 7501, 2005 WL 1172748, at *3 (N.D. Ind. April 27, 2005) (applying TWA to bar successor liability for racial discrimination claim).

Appellants argue that these decisions broadly construing the phrase "any interest in such property" fail to account for the language of 11 U.S.C. § 1141(c), a provision involving confirmed plans of reorganization. Section 1141(c) provides that "except as otherwise provided in the [reorganization] plan or in the order confirming the plan, after confirmation of a plan, the property dealt with by the plan is free and clear of *all claims and interests* of creditors, equity security holders, and of general partners in the debtor." 11 U.S.C. § 1141(c) (emphasis added). Appellants argue that Congress must have intentionally included the word "claims"[354] in § 1141(c), and omitted the word from §

"[g]eneral unsecured claimants including tort claimants, have no specific interest in a debtor's property" for purposes of § 363(f)).

[353] In Leckie, the Fourth Circuit held that Coal Act premium payment obligations owed to employer-sponsored benefit plans were interests in property under § 363(f). 99 F.3d at 582. The Fourth Circuit explained "while the plain meaning of the phrase 'interest in such property' suggests that not all general rights to payment are encompassed by the statute, Congress did not expressly indicate that, by employing such language, it intended to limit the scope of section 363(f) to in rem interests, strictly defined, and [it would] decline to adopt such a restricted reading of the statute . . . ." Id.

[354] The Bankruptcy Code defines "claim" as:

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363(f), because it was willing to extinguish tort claims in the reorganization context, but unwilling to do so in the § 363 sale context. Appellants account for this discrepancy on the basis that reorganization provides unsecured creditors procedural rights that are not assured in a § 363(b) sale.

We do not place such weight on the absence of the word "claims" in § 363(f). The language and structure of § 1141(c) and § 363(f) differ in many respects. Section 1141(c), for example, applies to all reorganization plans; § 363(f), in contrast, applies only to classes of property that satisfy one of five criteria. See 11 U.S.C. § 363(f)(1)-(5). Thus, while § 363 sales do not afford many of the procedural safeguards of a reorganization, § 363(f) is limited to specific classes of property.

Given the expanded role of § 363 in bankruptcy proceedings, it makes sense to harmonize the application of § 1141(c) and § 363(f) to the extent permitted by the statutory language. See In re Golf, L.L.C., 322 B.R. 874, 877 (Bankr. D. Neb. 2004) (noting that, while § 363(f) requires less notice and provides for less opportunity for a hearing than in the reorganization process, "as a practical matter, current practice seems to have expanded § 363(f)'s use from its original intent"). Courts have already done this in other contexts. For example, § 1141(c) does not explicitly reference the extinguishment of liens, while § 363(f) does. Notwithstanding this distinction, courts have uniformly held that confirmation of a reorganization can act to extinguish liens. See, e.g., JCB, Inc. v. Union Planters Bank, NA, 539 F.3d 862, 870 (8th Cir. 2008) ("Confirmation of the reorganization plan replaces prior obligations, and a lien not preserved by the plan may be extinguished." (internal citation omitted)); Elixir Indus., Inc. v. City Bank & Trust Co. (In re Ahern Enters., Inc.), 507 F.3d 817, 820-22 (5th Cir. 2007) (holding that § 1141(c) extinguishes liens that are not specifically preserved in a reorganization plan, and citing cases from the Fourth, Seventh, Eighth and Tenth Circuits reaching the same conclusion).

We agree with TWA and Leckie that the term "any interest in property" encompasses those claims that "arise from the property being sold." See TWA, 322 F.3d at 290. By analogy to Leckie (in which the relevant business was coal mining), "[appellants'] rights are grounded, at least in part, in the fact that [Old Chrysler's] very assets have been employed for [automobile production] purposes: if Appellees had never elected to put their assets to use in the [automobile] industry, and had taken up business in an altogether different area, [appellants] would have no right to seek [damages]." Leckie, 99 F.3d at 582.

"To allow the claimants to assert successor liability claims against [the purchaser] while limiting other creditors' recourse to the proceeds of the asset sale would be inconsistent

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(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or
(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.
11 U.S.C. § 101(5).

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with the Bankruptcy Code's priority scheme." TWA, 322 F.3d at 292. Appellants ignore this overarching principle and assume that tort claimants faced a choice between the Sale and an alternative arrangement that would have assured funding for their claims. But had appellants successfully blocked the Sale, they would have been unsecured creditors fighting for a share of extremely limited liquidation proceeds. Given the billions of dollars of outstanding secured claims against Old Chrysler, appellants would have fared no better had they prevailed.

The possibility of transferring assets free and clear of existing tort liability was a critical inducement to the Sale. As in TWA, "a sale of the assets of [Old Chrysler] at the expense of preserving successor liability claims was necessary in order to preserve some [55],000 jobs, . . . and to provide funding for employee-related liabilities, including retirement benefits [for more than 106,000 retirees]." TWA, 322 F.3d at 293; see also Sale Opinion at 3.

It is the transfer of Old Chrysler's tangible and intellectual property to New Chrysler that could lead to successor liability (where applicable under state law) in the absence of the Sale Order's liability provisions. Because appellants' claims arose from Old Chrysler's property, § 363(f) permitted the bankruptcy court to authorize the Sale free and clear of appellants' interest in the property.

Asbestos Claims

On behalf of herself and others with outstanding or potential claims against Old Chrysler resulting from exposure to asbestos, Patricia Pascale argues that the Sale Order improperly grants New Chrysler immunity without assuring compliance with 11 U.S.C. § 524(g).

Section 524(g) "provides a unique form of supplemental injunctive relief for an insolvent debtor confronting the particularized problems and complexities associated with asbestos liability." Johns-Manville Corp. v. Chubb Indem. Ins. Co. (In re Johns-Manville Corp.), 517 F.3d 52, 67 (2d Cir. 2008), overruled on other grounds by Travelers Indem. Co. v. Bailey, 129 S.Ct. 2195, 174 L. Ed. 2d 99 (2009). The statute authorizes the court "to enjoin entities from taking legal action for the purpose of directly or indirectly collecting, recovering, or receiving payment or recovery with respect to any [asbestos-related] claim or demand." 11 U.S.C. § 524(g)(1)(B). To obtain relief under § 524(g), a debtor must "[c]hannel[] asbestos-related claims to a personal injury trust [to] relieve[] the debtor of the uncertainty of future asbestos liabilities." In re Combustion Eng'g, Inc., 391 F.3d 190, 234 (3d Cir. 2004). Injunctions granting relief under this provision are subject to numerous requirements and conditions. See 11 U.S.C. § 524(g)(2)(B); Combustion Eng'g, 391 F.3d at 234 & n.45.

By its terms, however, § 524(g) applies only to "a court that enters an order confirming a plan of reorganization under chapter 11." 11 U.S.C. § 524(g)(1)(A); see also Combustion Eng'g, 391 F.3d at 234 n.46. Sections I and II of this opinion conclude that the Sale was proper under § 363. That determination forecloses the application of § 524(g) because

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there is no plan of reorganization as yet. Moreover, the bankruptcy court in this case did not issue an injunction, as is permitted by § 524(g)(1)(B), and the debtor did not establish a trust subsuming its asbestos liability. Accordingly, there is no merit to Pascale's argument that the Sale Order violates § 524(g).

Future Claims

The Sale Order extinguished the right to pursue claims "on any theory of successor or transferee liability, . . . whether known or unknown as of the Closing, now existing or hereafter arising, asserted or unasserted, fixed or contingent, liquidated or unliquidated." Sale Order at 40-41. This provision is challenged on the grounds that: (1) the Sale Order violates the due process rights of future claimants by extinguishing claims without providing notice; (2) a bankruptcy court is not empowered to trump state successor liability law; (3) future, unidentified claimants with unquantifiable interests could not be compelled "to accept a money satisfaction," 11 U.S.C. § 363(f)(5); and (4) future causes of action by unidentified plaintiffs based on unknown events cannot be classified as "claims" under the Bankruptcy Code.

We affirm this aspect of the bankruptcy court's decision insofar as it constituted a valid exercise of authority under the Bankruptcy Code. However, we decline to delineate the scope of the bankruptcy court's authority to extinguish future claims, until such time as we are presented with an actual claim for an injury that is caused by Old Chrysler, that occurs after the Sale, and that is cognizable under state successor liability law.

CONCLUSION

We have considered all of the objectors-appellants' contentions on these appeals and have found them to be without merit. For the foregoing reasons, we affirm the June 1, 2009 order of the bankruptcy court authorizing the Sale.

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XVI. CHAPTER 31, INTRODUCTION TO JOINT VENTURES AND STRATEGIC ALLIANCES: AN ALTERNATIVE TO MERGER

A. Page 1247, New Sec. 31.7.Ca. Supreme Court's 2010 Decision on NFL JV—American Needle

Page 1246, New Sec. 31.7.Ca.	Add at the bottom of the page the following:
New Sec. 31.7.Ca.	**Supreme Court's 2010 Decision on NFL JV—*American Needle***

American Needle, Inc. v. National Football League
Supreme Court of the United States, 2010
2010 U.S. LEXIS 4166

JUSTICE STEVENS delivered the opinion of the Court.

"Every contract, combination in the form of a trust or otherwise, or, conspiracy, in restraint of trade" is made illegal by § 1 of the Sherman Act, ch. 647, 26 Stat. 209, as amended, 15 U.S.C. § 1. The question whether an arrangement is a contract, combination, or conspiracy is different from and antecedent to the question whether it unreasonably restrains trade. This case raises that antecedent question about the business of the 32 teams in the National Football League (NFL) and a corporate entity that they formed to manage their intellectual property. We conclude that the NFL's licensing activities constitute concerted action that is not categorically beyond the coverage of § 1. The legality of that concerted action must be judged under the Rule of Reason.

[PART I]

Originally organized in 1920, the NFL is an unincorporated association that now includes 32 separately owned professional football teams. Each team has its own name, colors, and logo, and owns related intellectual property. Like each of the other teams in the league, the New Orleans Saints and the Indianapolis Colts, for example, have their own distinctive names, colors, and marks that are well known to millions of sports fans.

Prior to 1963, the teams made their own arrangements for licensing their intellectual property and marketing trademarked items such as caps and jerseys. In 1963, the teams formed National Football League Properties (NFLP) to develop, license, and market their intellectual property. Most, but not all, of the substantial revenues generated by NFLP have either been given to charity or shared equally among the teams. However, the teams are able to and have at times sought to withdraw from

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this arrangement.

Between 1963 and 2000, NFLP granted nonexclusive licenses to a number of vendors, permitting them to manufacture and sell apparel bearing team insignias. Petitioner, American Needle, Inc., was one of those licensees. In December 2000, the teams voted to authorize NFLP to grant exclusive licenses, and NFLP granted Reebok International Ltd. an exclusive 10-year license to manufacture and sell trademarked headwear for all 32 teams. It thereafter declined to renew American Needle's nonexclusive license.

American Needle filed this action in the Northern District of Illinois, alleging that the agreements between the NFL, its teams, NFLP, and Reebok violated §§ 1 and 2 of the Sherman Act. In their answer to the complaint, the defendants averred that the teams, NFL, and NFLP were incapable of conspiring within the meaning of § 1 "because they are a single economic enterprise, at least with respect to the conduct challenged." App. 99. After limited discovery, the District Court granted summary judgment on the question "whether, with regard to the facet of their operations respecting exploitation of intellectual property rights, the NFL and its 32 teams are, in the jargon of antitrust law, acting as a single entity." *American Needle, Inc.* v. *New Orleans La. Saints*, 496 F. Supp. 2d 941, 943 (2007). The court concluded "that in that facet of their operations they have so integrated their operations that they should be deemed a single entity rather than joint ventures cooperating for a common purpose." *Ibid.*

The Court of Appeals for the Seventh Circuit affirmed. The panel observed that "in some contexts, a league seems more aptly described as a single entity immune from antitrust scrutiny, while in others a league appears to be a joint venture between independently owned teams that is subject to review under § 1." 538 F.3d 736, 741 (2008). Relying on Circuit precedent, the court limited its inquiry to the particular conduct at issue, licensing of teams' intellectual property. The panel agreed with petitioner that "when making a single-entity determination, courts must examine whether the conduct in question deprives the marketplace of the independent sources of economic control that competition assumes." *Id.*, at 742. The court, however, discounted the significance of potential competition among the teams regarding the use of their intellectual property because the teams "can function only as one source of economic power when collectively producing NFL football." *Id.*, at 743. The court noted that football itself can only be carried out jointly. See *ibid.* ("Asserting that a single football team could produce a football game . . . is a Zen riddle: Who wins when a football team plays itself "). Moreover, "NFL teams share a vital economic interest in collectively promoting NFL football . . . [to] compet[e] with other forms of entertainment." *Ibid.* "It thus follows," the court found, "that only one source of economic power controls the promotion of NFL football," and "it makes little sense to assert that each individual team has the authority, if not the responsibility, to promote the jointly produced NFL football." *Ibid.* Recognizing that NFL teams have "license[d] their intellectual property collectively" since 1963, the court held that § 1 did not apply. *Id.*, at 744.

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We granted certiorari. 557 U.S. __, 129 S. Ct. 2859, 174 L. Ed. 2d 575 (2009).

[PART II]

As the case comes to us, we have only a narrow issue to decide: whether the NFL respondents are capable of engaging in a "contract, combination . . ., or conspiracy" as defined by § 1 of the Sherman Act, 15 U.S.C. § 1, or, as we have sometimes phrased it, whether the alleged activity by the NFL respondents "must be viewed as that of a single enterprise for purposes of § 1." *Copperweld Corp.* v. *Independence Tube Corp.*, 467 U.S. 752, 771, 104 S. Ct. 2731, 81 L. Ed. 2d 628 (1984).

Taken literally, the applicability of § 1 to "every contract, combination . . . or conspiracy" could be understood to cover every conceivable agreement, whether it be a group of competing firms fixing prices or a single firm's chief executive telling her subordinate how to price their company's product. But even though, "read literally," § 1 would address "the entire body of private contract," that is not what the statute means. *National Soc. of Professional Engineers* v. *United States*, 435 U.S. 679, 688, 98 S. Ct. 1355, 55 L. Ed. 2d 637 (1978); see also *Texaco Inc.* v. *Dagher*, 547 U.S. 1, 5, 126 S. Ct. 1276, 164 L. Ed. 2d 1 (2006) ("This Court has not taken a literal approach to this language"); cf. *Board of Trade of Chicago* v. *United States*, 246 U.S. 231, 238, 38 S. Ct. 242, 62 L. Ed. 683 (1918) (reasoning that the term "restraint of trade" in § 1 cannot possibly refer to any restraint on competition because "[e]very agreement concerning trade, every regulation of trade, restrains. To bind, to restrain, is of their very essence"). Not every instance of cooperation between two people is a potential "contract, combination . . ., or conspiracy, in restraint of trade." 15 U.S.C. § 1.

The meaning of the term "contract, combination . . . or conspiracy" is informed by the "'basic distinction'" in the Sherman Act "'between concerted and independent action'" that distinguishes § 1 of the Sherman Act from § 2. *Copperweld*, 467 U.S., at 767, 104 S. Ct. 2731, 81 L. Ed. 2d 628 (quoting *Monsanto Co.* v. *Spray-Rite Service Corp.*, 465 U.S. 752, 761, 104 S. Ct. 1464, 79 L. Ed. 2d 775 (1984)). Section 1 applies only to concerted action that restrains trade. Section 2, by contrast, covers both concerted and independent action, but only if that action "monopolize[s]," 15 U.S.C. § 2, or "threatens actual monopolization," *Copperweld,* 467 U.S., at 767, 104 S. Ct. 2731, 81 L. Ed. 2d 628, a category that is narrower than restraint of trade. Monopoly power may be equally harmful whether it is the product of joint action or individual action.

Congress used this distinction between concerted and independent action to deter anticompetitive conduct and compensate its victims, without chilling vigorous competition through ordinary business operations. The distinction also avoids judicial scrutiny of routine, internal business decisions.

Thus, in § 1 Congress "treated concerted behavior more strictly than unilateral

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behavior." *Id.*, at 768, 104 S. Ct. 2731, 81 L. Ed. 2d 628. This is so because unlike independent action, "[c]oncerted activity inherently is fraught with anticompetitive risk" insofar as it "deprives the marketplace of independent centers of decisionmaking that competition assumes and demands." *Id.*, at 768-769, 104 S. Ct. 2731, 81 L. Ed. 2d 628. And because concerted action is discrete and distinct, a limit on such activity leaves untouched a vast amount of business conduct. As a result, there is less risk of deterring a firm's necessary conduct; courts need only examine discrete agreements; and such conduct may be remedied simply through prohibition.[355] See Areeda & Hovenkamp P1464c, at 206. Concerted activity is thus "judged more sternly than unilateral activity under § 2," *Copperweld*, 467 U.S., at 768, 104 S. Ct. 2731, 81 L. Ed. 2d 628. For these reasons, § 1 prohibits any concerted action "in restraint of trade or commerce," even if the action does not "threate[n] monopolization," *Ibid*. And therefore, an arrangement must embody concerted action in order to be a "contract, combination . . . or conspiracy" under § 1.

[PART III]

We have long held that concerted action under § 1 does not turn simply on whether the parties involved are legally distinct entities. Instead, we have eschewed such formalistic distinctions in favor of a functional consideration of how the parties involved in the alleged anticompetitive conduct actually operate.

As a result, we have repeatedly found instances in which members of a legally single entity violated § 1 when the entity was controlled by a group of competitors and served, in essence, as a vehicle for ongoing concerted activity. In *United States* v. *Sealy, Inc.*, 388 U.S. 350, 87 S. Ct. 1847, 18 L. Ed. 2d 1238 (1967), for example, a group of mattress manufacturers operated and controlled Sealy, Inc., a company that licensed the Sealy trademark to the manufacturers, and dictated that each operate within a specific geographic area. *Id.*, at 352-353, 87 S. Ct. 1847, 18 L. Ed. 2d 1238. The Government alleged that the licensees and Sealy were conspiring in violation of § 1, and we agreed. *Id.*, at 352-354, 87 S. Ct. 1847, 18 L. Ed. 2d 1238. We explained that "[w]e seek the central substance of the situation" and therefore "we are moved by the identity of the persons who act, rather than the label of their hats." *Id.*, at 353, 87 S. Ct. 1847, 18 L. Ed. 2d 1238. We thus held that Sealy was not a "separate entity, but . . . an instrumentality of the individual manufacturers." *Id.*, at

[355] If Congress prohibited independent action that merely restrains trade (even if it does not threaten monopolization), that prohibition could deter perfectly competitive conduct by firms that are fearful of litigation costs and judicial error. See Copperweld, 467 U.S., at 768, 104 S. Ct. 2731, 81 L. Ed. 2d 628 ("Judging unilateral conduct in this manner reduces the risk that the antitrust laws will dampen the competitive zeal of a single aggressive competitor"); cf. United States v. United States Gypsum Co., 438 U.S. 422, 441, 98 S. Ct. 2864, 57 L. Ed. 2d 854 (1978) ("[S]alutary and procompetitive conduct . . . might be shunned by businessmen who chose to be excessively cautious in the face of uncertainty"). Moreover, if every unilateral action that restrained trade were subject to antitrust scrutiny, then courts would be forced to judge almost every internal business decision. See 7 P. Areeda & H. Hovenkamp, Antitrust Law P1464c, at 206 (2d ed. 2003) (hereinafter Areeda & Hovenkamp) (unilateral behavior is "often difficult to evaluate or remedy").

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356, 87 S. Ct. 1847, 18 L. Ed. 2d 1238. In similar circumstances, we have found other formally distinct business organizations covered by § 1. See, *e.g., Northwest Wholesale Stationers, Inc.* v. *Pacific Stationery & Printing Co.*, 472 U.S. 284, 105 S. Ct. 2613, 86 L. Ed. 2d 202 (1985); *National Collegiate Athletic Ass'n* v. *Board of Regents*, 468 U.S. 85, 104 S. Ct. 2948, 82 L. Ed. 2d 70 (1984) (NCAA); *United States* v. *Topco Associates, Inc.*, 405 U.S. 596, 609, 92 S. Ct. 1126, 31 L. Ed. 2d 515 (1972); *Associated Press* v. *United States*, 326 U.S. 1, 65 S. Ct. 1416, 89 L. Ed. 2013 (1945); *id.*, at 26, 65 S. Ct. 1416, 89 L. Ed. 2013 (Frankfurter, J., concurring); *United States* v. *Terminal R. Ass'n*, 224 U.S. 383, 32 S. Ct. 507, 56 L. Ed. 810 (1912); see also Rock, Corporate Law Through an Antitrust Lens, 92 Colum. L. Rev. 497, 506-510 (1992) (discussing cases). We have similarly looked past the form of a legally "single entity" when competitors were part of professional organizations[356] or trade groups.[357]

Conversely, there is not necessarily concerted action simply because more than one legally distinct entity is involved. Although, under a now-defunct doctrine known as the "intraenterprise conspiracy doctrine," we once treated cooperation between legally separate entities as necessarily covered by § 1, we now embark on a more functional analysis.

The roots of this functional analysis can be found in the very decision that established the intraenterprise conspiracy doctrine. In *United States* v. *Yellow Cab Co.*, 332 U.S. 218, 67 S. Ct. 1560, 91 L. Ed. 2010 (1947), we observed that "corporate interrelationships . . . are not determinitive of the applicability of the Sherman Act" because the Act "is aimed at substance rather than form." *Id.*, at 227, 67 S. Ct. 1560, 91 L. Ed. 2010. We nonetheless held that cooperation between legally separate entities was necessarily covered by § 1 because an unreasonable restraint of trade "may result as readily from a conspiracy among those who are affiliated or integrated under common ownership as from a conspiracy among those who are otherwise independent." *Ibid.;* see also *Kiefer-Stewart Co.* v. *Joseph E. Seagram & Sons, Inc.*, 340 U.S. 211, 215, 71 S. Ct. 259, 95 L. Ed. 219 (1951).

The decline of the intraenterprise conspiracy doctrine began in *Sunkist Growers, Inc.* v. *Winckler & Smith Citrus Products Co.*, 370 U.S. 19, 82 S. Ct. 1130, 8 L. Ed. 2d 305 (1962). In that case, several agricultural cooperatives that were owned by the same farmers were sued for violations of § 1 of the Sherman Act. *Id.*, at 24-25, 82 S. Ct. 1130, 8 L. Ed. 2d 305. Applying a specific immunity provision for agricultural cooperatives, we held that the three cooperatives were "in practical effect" one "organization," even though the controlling farmers "have formally organized

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[356] See, e.g., FTC v. Indiana Federation of Dentists, 476 U.S. 447, 106 S. Ct. 2009, 90 L. Ed. 2d 445 (1986); Arizona v. Maricopa County Medical Soc., 457 U.S. 332, 102 S. Ct. 2466, 73 L. Ed. 2d 48 (1982); National Soc. of Professional Engineers v. United States, 435 U.S. 679, 98 S. Ct. 1355, 55 L. Ed. 2d 637 (1978); Goldfarb v. Virginia State Bar, 421 U.S. 773, 95 S. Ct. 2004, 44 L. Ed. 2d 572 (1975).

[357] See, e.g., Allied Tube & Conduit Corp. v. Indian Head, Inc., 486 U.S. 492, 108 S. Ct. 1931, 100 L. Ed. 2d 497 (1988); Radiant Burners, Inc. v. Peoples Gas Light & Coke Co., 364 U.S. 656, 81 S. Ct. 365, 5 L. Ed. 2d 358 (1961) (per curiam); Fashion Originators' Guild of America, Inc. v. FTC, 312 U.S. 457, 61 S. Ct. 703, 85 L. Ed. 949, 32 F.T.C. 1856 (1941).

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themselves into three separate legal entities." *Id.*, at 29, 82 S. Ct. 1130, 8 L. Ed. 2d 305. "To hold otherwise," we explained, "would be to impose grave legal consequences upon organizational distinctions that are of *de minimis* meaning and effect" insofar as "use of separate corporations had [no] economic significance." *Ibid.*

Next, in *United States* v. *Citizens & Southern Nat. Bank*, 422 U.S. 86, 95 S. Ct. 2099, 45 L. Ed. 2d 41 (1975), a large bank, Citizens and Southern (C&S), formed a holding company that operated *de facto* suburban branch banks in the Atlanta area through ownership of the maximum amount of stock in each local branch that was allowed by law, "ownership of much of the remaining stock by parties friendly to C&S, use by the suburban banks of the C&S logogram and all of C&S's banking services, and close C&S oversight of the operation and governance of the suburban banks." *Id.*, at 89, 95 S. Ct. 2099, 45 L. Ed. 2d 41 (footnote omitted). The Government challenged the cooperation between the banks. In our analysis, we observed that "'corporate interrelationships . . . are not determinative,'" *id.*, at 116, 95 S. Ct. 2099, 45 L. Ed. 2d 41, "looked to economic substance," and observed that "because the sponsored banks were not set up to be competitors, § 1 did not compel them to compete." Areeda & Hovenkamp P1463, at 200-201; see also *Citizens & Southern*, 422 U.S., at 119-120, 95 S. Ct. 2099, 45 L. Ed. 2d 41; Areeda, Intraenterprise Conspiracy in Decline, 97 Harv. L. Rev. 451, 461 (1983).

We finally reexamined the intraenterprise conspiracy doctrine in *Copperweld Corp.* v. *Independence Tube Corp.*, 467 U.S. 752, 104 S. Ct. 2731, 81 L. Ed. 2d 628 (1984), and concluded that it was inconsistent with the "'basic distinction between concerted and independent action.'" *Id.*, at 767, 104 S. Ct. 2731, 81 L. Ed. 2d 628. Considering it "perfectly plain that an internal agreement to implement a single, unitary firm's policies does not raise the antitrust dangers that § 1 was designed to police," *id.,* at 769, 104 S. Ct. 2731, 81 L. Ed. 2d 628, we held that a parent corporation and its wholly owned subsidiary "are incapable of conspiring with each other for purposes of § 1 of the Sherman Act," *id.,* at 777, 104 S. Ct. 2731, 81 L. Ed. 2d 628. We explained that although a parent corporation and its wholly owned subsidiary are "separate" for the purposes of incorporation or formal title, they are controlled by a single center of decisionmaking and they control a single aggregation of economic power. Joint conduct by two such entities does not "depriv[e] the marketplace of independent centers of decisionmaking," *id.,* at 769, 104 S. Ct. 2731, 81 L. Ed. 2d 628, and as a result, an agreement between them does not constitute a "contract, combination . . . or conspiracy" for the purposes of § 1.

[PART IV]

As *Copperweld* exemplifies, "substance, not form, should determine whether a[n] …entity is capable of conspiring under § 1." 467 U.S., at 773, n. 21, 104 S. Ct. 2731, 81 L. Ed. 2d 628. This inquiry is sometimes described as asking whether the alleged conspirators are a single entity. That is perhaps a misdescription, however, because the question is not whether the defendant is a legally single entity or has a

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single name; nor is the question whether the parties involved "seem" like one firm or multiple firms in any metaphysical sense. The key is whether the alleged "contract, combination . . ., or conspiracy" is concerted action -- that is, whether it joins together separate decisionmakers. The relevant inquiry, therefore, is whether there is a "contract, combination . . . or conspiracy" amongst "separate economic actors pursuing separate economic interests," *id.*, at 769, 104 S. Ct. 2731, 81 L. Ed. 2d 628, such that the agreement "deprives the marketplace of independent centers of decisionmaking," *ibid.*, and therefore of "diversity of entrepreneurial interests," *Fraser* v. *Major League Soccer, L. L. C.,* 284 F.3d 47, 57 (CA1 2002) (Boudin, C. J.), and thus of actual or potential competition, see *Freeman* v. *San Diego Ass'n of Realtors*, 322 F.3d 1133, 1148-1149 (CA9 2003) (Kozinski, J.); *Rothery Storage & Van Co.* v. *Atlas Van Lines, Inc.*, 792 F.2d 210, 214-215, 253 U.S. App. D.C. 142 (CADC 1986) (Bork, J.); see also Areeda & Hovenkamp P1462b, at 193-194 (noting that the "central evil addressed by Sherman Act § 1" is the "elimin[ation of] competition that would otherwise exist").

Thus, while the president and a vice president of a firm could (and regularly do) act in combination, their joint action generally is not the sort of "combination" that § 1 is intended to cover. Such agreements might be described as "really unilateral behavior flowing from decisions of a single enterprise." *Copperweld*, 467 U.S., at 767, 104 S. Ct. 2731, 81 L. Ed. 2d 628. Nor, for this reason, does § 1 cover "internally coordinated conduct of a corporation and one of its unincorporated divisions," *id.*, at 770, 104 S. Ct. 2731, 81 L. Ed. 2d 628, because "[a] division within a corporate structure pursues the common interests of the whole," *ibid.*, and therefore "coordination between a corporation and its division does not represent a sudden joining of two independent sources of economic power previously pursuing separate interests," *id.*, at 770-771, 104 S. Ct. 2731, 81 L. Ed. 2d 628. Nor, for the same reasons, is "the coordinated activity of a parent and its wholly owned subsidiary" covered. See *id.*, at 771, 104 S. Ct. 2731, 81 L. Ed. 2d 628. They "have a complete unity of interest" and thus "[w]ith or without a formal 'agreement,' the subsidiary acts for the benefit of the parent, its sole shareholder." *Ibid.*

Because the inquiry is one of competitive reality, it is not determinative that two parties to an alleged § 1 violation are legally distinct entities. Nor, however, is it determinative that two legally distinct entities have organized themselves under a single umbrella or into a structured joint venture. The question is whether the agreement joins together "independent centers of decisionmaking." *Id.*, at 769, 104 S. Ct. 2731, 81 L. Ed. 2d 628. If it does, the entities are capable of conspiring under § 1, and the court must decide whether the restraint of trade is an unreasonable and therefore illegal one.

[PART V]

The NFL teams do not possess either the unitary decisionmaking quality or the single aggregation of economic power characteristic of independent action. Each of the teams is a substantial, independently owned, and independently managed

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business. “[T]heir general corporate actions are guided or determined” by “separate corporate consciousnesses,” and “[t]heir objectives are” not “common.” *Copperweld*, 467 U.S., at 771, 104 S. Ct. 2731, 81 L. Ed. 2d 628; see also *North American Soccer League* v. *NFL*, 670 F.2d 1249, 1252 (CA2 1982) (discussing ways that “the financial performance of each team, while related to that of the others, does not . . . necessarily rise and fall with that of the others”). The teams compete with one another, not only on the playing field, but to attract fans, for gate receipts and for contracts with managerial and playing personnel. See *Brown* v. *Pro Football, Inc.*, 518 U.S. 231, 249, 116 S. Ct. 2116, 135 L. Ed. 2d 521 (1996); *Sullivan* v. *NFL*, 34 F.3d 1091, 1098 (CA1 1994); *Mid-South Grizzlies* v. *NFL*, 720 F.2d 772, 787 (CA3 1983); cf. *NCAA*, 468 U.S., at 99, 104 S. Ct. 2948, 82 L. Ed. 2d 70.

Directly relevant to this case, the teams compete in the market for intellectual property. To a firm making hats, the Saints and the Colts are two potentially competing suppliers of valuable trademarks. When each NFL team licenses its intellectual property, it is not pursuing the “common interests of the whole” league but is instead pursuing interests of each “corporation itself,” *Copperweld*, 467 U.S., at 770, 104 S. Ct. 2731, 81 L. Ed. 2d 628; teams are acting as “separate economic actors pursuing separate economic interests,” and each team therefore is a potential “independent cente[r] of decisionmaking,” *id.*, at 769, 104 S. Ct. 2731, 81 L. Ed. 2d 628. Decisions by NFL teams to license their separately owned trademarks collectively and to only one vendor are decisions that “depriv[e] the marketplace of independent centers of decisionmaking,” *ibid.*, and therefore of actual or potential competition. See *NCAA*, 468 U.S., at 109, n. 39, 104 S. Ct. 2948, 82 L. Ed. 2d 70 (observing a possible § 1 violation if two separately owned companies sold their separate products through a “single selling agent”); cf. Areeda & Hovenkamp P1478a, at 318 (“Obviously, the most significant competitive threats arise when joint venture participants are actual or potential competitors”).

In defense, respondents argue that by forming NFLP, they have formed a single entity, akin to a merger, and market their NFL brands through a single outlet. But it is not dispositive that the teams have organized and own a legally separate entity that centralizes the management of their intellectual property. An ongoing § 1 violation cannot evade § 1 scrutiny simply by giving the ongoing violation a name and label. “Perhaps every agreement and combination in restraint of trade could be so labeled.” *Timken Roller Bearing Co.* v. *United States*, 341 U.S. 593, 598, 71 S. Ct. 971, 95 L. Ed. 1199 (1951).

The NFL respondents may be similar in some sense to a single enterprise that owns several pieces of intellectual property and licenses them jointly, but they are not similar in the relevant functional sense. Although NFL teams have common interests such as promoting the NFL brand, they are still separate, profit-maximizing entities, and their interests in licensing team trademarks are not necessarily aligned. See generally Hovenkamp, Exclusive Joint Ventures and Antitrust Policy, 1995 Colum. Bus. L. Rev. 1, 52-61 (1995); Shishido, Conflicts of Interest and Fiduciary Duties in

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the Operation of a Joint Venture, 39 Hastings L. J. 63, 69-81 (1987). Common interests in the NFL brand "*partially* unit[e] the economic interests of the parent firms," Broadley, Joint Ventures and Antitrust Policy, 95 Harv. L. Rev. 1521, 1526 (1982) (emphasis added), but the teams still have distinct, potentially competing interests.

It may be, as respondents argue, that NFLP "has served as the 'single driver" of the teams' "promotional vehicle," "'pursu[ing] the common interests of the whole.'" Brief for NFL Respondents 28 (quoting *Copperweld*, 467 U.S., at 770-771, 104 S. Ct. 2731, 81 L. Ed. 2d 628; brackets in original). But illegal restraints often are in the common interests of the parties to the restraint, at the expense of those who are not parties. It is true, as respondents describe, that they have for some time marketed their trademarks jointly. But a history of concerted activity does not immunize conduct from § 1 scrutiny. "Absence of actual competition may simply be a manifestation of the anticompetitive agreement itself." *Freeman*, 322 F.3d at 1149.

Respondents argue that nonetheless, as the Court of Appeals held, they constitute a single entity because without their cooperation, there would be no NFL football. It is true that "the clubs that make up a professional sports league are not completely independent economic competitors, as they depend upon a degree of cooperation for economic survival." *Brown*, 518 U.S., at 248, 116 S. Ct. 2116, 135 l. Ed. 2d 521. But the Court of Appeals' reasoning is unpersuasive.

The justification for cooperation is not relevant to whether that cooperation is concerted or independent action.[358] A "contract, combination . . . or conspiracy," § 1, that is necessary or useful to a joint venture is still a "contract, combination . . . or conspiracy" if it "deprives the marketplace of independent centers of decisionmaking," *Copperweld*, 467 U.S., at 769, 104 S. Ct. 2731, 81 L. Ed. 2d 628. See *NCAA,* 468 U.S., at 113, 104 S. Ct. 2948, 82 L. Ed. 2d 70 ("[J]oint ventures have no immunity from antitrust laws"). Any joint venture involves multiple sources of economic power cooperating to produce a product. And for many such ventures, the participation of others is necessary. But that does not mean that necessity of cooperation transforms concerted action into independent action; a nut and a bolt can only operate together, but an agreement between nut and bolt manufacturers is still subject to § 1 analysis. Nor does it mean that once a group of firms agree to produce a joint product, cooperation amongst those firms must be treated as independent conduct. The mere fact that the teams operate jointly in some sense does not mean that they are immune.[359]

[358] As discussed infra, necessity of cooperation is a factor relevant to whether the agreement is subject to the Rule of Reason. See NCAA, 468 U.S., at 101, 104 S. Ct. 2948, 82 L. Ed. 2d 70 (holding that NCAA restrictions on televising college football games are subject to Rule of Reason analysis for the "critical" reason that "horizontal restraints on competition are essential if the product is to be available at all").

[359] In any event, it simply is not apparent that the alleged conduct was necessary at all. Although two teams are needed to play a football game, not all aspects of elaborate interleague cooperation are necessary to produce a game. Moreover, even if leaguewide agreements are necessary to produce football, it does not follow that concerted activity in marketing intellectual property is necessary to produce football.

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The question whether NFLP decisions can constitute concerted activity covered by § 1 is closer than whether decisions made directly by the 32 teams are covered by § 1. This is so both because NFLP is a separate corporation with its own management and because the record indicates that most of the revenues generated by NFLP are shared by the teams on an equal basis. Nevertheless we think it clear that for the same reasons the 32 teams' conduct is covered by § 1, NFLP's actions also are subject to § 1, at least with regards to its marketing of property owned by the separate teams. NFLP's licensing decisions are made by the 32 potential competitors, and each of them actually owns its share of the jointly managed assets. Cf. *Sealy*, 388 U.S., at 352-354, 87 S. Ct. 1847, 18 L. Ed. 2d 1238. Apart from their agreement to cooperate in exploiting those assets, including their decisions as the NFLP, there would be nothing to prevent each of the teams from making its own market decisions relating to purchases of apparel and headwear, to the sale of such items, and to the granting of licenses to use its trademarks.

We generally treat agreements within a single firm as independent action on the presumption that the components of the firm will act to maximize the firm's profits. But in rare cases, that presumption does not hold. Agreements made within a firm can constitute concerted action covered by § 1 when the parties to the agreement act on interests separate from those of the firm itself, and the intrafirm agreements may simply be a formalistic shell for ongoing concerted action. See, *e.g.*, *Topco Associates, Inc.*, 405 U.S., at 609, 92 S. Ct. 1126, 31 L. Ed. 2d 515; *Sealy,* 388 U.S., at 352-354, 87 S. Ct. 1847, 18 L. Ed. 2d 1238.

For that reason, decisions by the NFLP regarding the teams' separately owned intellectual property constitute concerted action. Thirty-two teams operating independently through the vehicle of the NFLP are not like the components of a single firm that act to maximize the firm's profits. The teams remain separately controlled, potential competitors with economic interests that are distinct from NFLP's financial well-being. See generally Hovenkamp, 1995 Colum. Bus. L. Rev., at 52-61. Unlike typical decisions by corporate shareholders, NFLP licensing decisions effectively require the assent of more than a mere majority of shareholders. And each team's decision reflects not only an interest in NFLP's profits but also an interest in the team's individual profits. See generally Shusido, 39 Hastings L. J., at 69-71. The 32 teams capture individual economic benefits separate and apart from NFLP profits as a result of the decisions they make for the NFLP. NFLP's decisions thus affect each team's profits from licensing its own intellectual property. "Although the business interests of" the teams "will *often* coincide with

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The Court of Appeals carved out a zone of antitrust immunity for conduct arguably related to league operations by reasoning that coordinated team trademark sales are necessary to produce "NFL football," a single NFL brand that competes against other forms of entertainment. But defining the product as "NFL football" puts the cart before the horse: Of course the NFL produces NFL football; but that does not mean that cooperation amongst NFL teams is immune from § 1 scrutiny. Members of any cartel could insist that their cooperation is necessary to produce the "cartel product" and compete with other products.

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those of the" NFLP "as an entity in itself, that commonality of interest exists in every cartel." *Los Angeles Memorial Coliseum Comm'n* v. *NFL*, 726 F.2d 1381, 1389 (CA9 1984) (emphasis added). In making the relevant licensing decisions, NFLP is therefore "an instrumentality" of the teams. *Sealy,* 388 U.S., at 352-354, 87 S. Ct. 1847, 18 L. Ed. 2d 1238; see also *Topco Associates, Inc.*, 405 U.S., at 609, 92 S. Ct. 1126, 31 L. Ed. 2d 515.

If the fact that potential competitors shared in profits or losses from a venture meant that the venture was immune from § 1, then any cartel "could evade the antitrust law simply by creating a 'joint venture' to serve as the exclusive seller of their competing products." *Major League Baseball Properties, Inc.* v. *Salvino, Inc.*, 542 F.3d 290, 335 (CA2 2008) (Sotomayor, J., concurring in judgment). "So long as no agreement," other than one made by the cartelists sitting on the board of the joint venture, "explicitly listed the prices to be charged, the companies could act as monopolies through the 'joint venture.'" *Ibid.* (Indeed, a joint venture with a single management structure is generally a better way to operate a cartel because it decreases the risks of a party to an illegal agreement defecting from that agreement). However, competitors "cannot simply get around" antitrust liability by acting "through a third-party intermediary or 'joint venture'." *Id.*, at 336.[360]

[PART VI]

Football teams that need to cooperate are not trapped by antitrust law. "[T]he special characteristics of this industry may provide a justification" for many kinds of agreements. *Brown*, 518 U.S., at 252, 116 S. Ct. 2116, 135 L. Ed. 2d 521 (STEVENS, J., dissenting). The fact that NFL teams share an interest in making the entire league successful and profitable, and that they must cooperate in the production and scheduling of games, provides a perfectly sensible justification for making a host of collective decisions. But the conduct at issue in this case is still concerted activity under the Sherman Act that is subject to § 1 analysis.

When "restraints on competition are essential if the product is to be available at all," *per se* rules of illegality are inapplicable, and instead the restraint must be judged according to the flexible Rule of Reason.[361] *NCAA*, 468 U.S., at 101, 104 S. Ct.

[360] For the purposes of resolving this case, there is no need to pass upon the Government's position that entities are incapable of conspiring under § 1 if they "have effectively merged the relevant aspect of their operations, thereby eliminating actual and potential competition . . . in that operational sphere" and "the challenged restraint [does] not significantly affect actual or potential competition . . . outside their merged operations." Brief for United States as Amicus Curiae 17. The Government urges that the choices "to offer only a blanket license" and "to have only a single headwear licensee" might not constitute concerted action under its test. Id., at 32. However, because the teams still own their own trademarks and are free to market those trademarks as they see fit, even those two choices were agreements amongst potential competitors and would constitute concerted action under the Government's own standard. At any point, the teams could decide to license their own trademarks. It is significant, moreover, that the teams here control NFLP. The two choices that the Government might treat as independent action, although nominally made by NFLP, are for all functional purposes choices made by the 32 entities with potentially competing interests.

[361] Justice Brandeis provided the classic formulation of the Rule of Reason in Board of Trade of Chicago v. United States, 246 U.S. 231, 238, 38 S. Ct. 242, 62 L. Ed. 683 (1918):

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2948, 82 L. Ed. 2d 70; see *id.*, at 117 ("Our decision not to apply a *per se* rule to this case rests in large part on our recognition that a certain degree of cooperation is necessary if the type of competition that petitioner and its member institutions seek to market is to be preserved"); see also *Dagher*, 547 U.S., at 6, 126 S. Ct. 1276, 164 L. Ed. 2d 1. In such instances, the agreement is likely to survive the Rule of Reason. See *Broadcast Music, Inc.* v. *Columbia Broadcasting System, Inc.*, 441 U.S. 1, 23, 99 S. Ct. 1551, 60 L. Ed. 2d 1 (1979) ("Joint ventures and other cooperative arrangements are also not usually unlawful . . . where the agreement . . . is necessary to market the product at all"). And depending upon the concerted activity in question, the Rule of Reason may not require a detailed analysis; it "can sometimes be applied in the twinkling of an eye." *NCAA*, 468 U.S., at 109, n. 39, 104 S. Ct. 2948, 82 L. Ed. 2d 70.

Other features of the NFL may also save agreements amongst the teams. We have recognized, for example, "that the interest in maintaining a competitive balance" among "athletic teams is legitimate and important," *NCAA*, 468 U.S., at 117, 104 S. Ct. 2948, 82 L. Ed. 2d 70. While that same interest applies to the teams in the NFL, it does not justify treating them as a single entity for § 1 purposes when it comes to the marketing of the teams' individually owned intellectual property. It is, however, unquestionably an interest that may well justify a variety of collective decisions made by the teams. What role it properly plays in applying the Rule of Reason to the allegations in this case is a matter to be considered on remand.

* * *

Accordingly, the judgment of the Court of Appeals is reversed, and the case is remanded for further proceedings consistent with this opinion.

It is so ordered.

HN17 "The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition. To determine that question the court must ordinarily consider the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint is imposed; the nature of the restraint and its effect, actual or probable. The history of the restraint, the evil believed to exist, the reason for adopting the particular remedy, the purpose or end sought to be attained, are all relevant facts. This is not because a good intention will save an otherwise objectionable regulation or the reverse; but because knowledge of intent may help the court to interpret facts and to predict consequences." See also Leegin Creative Leather Products, Inc. v. PSKS, Inc., 551 U.S. 877, 885-887, 127 S. Ct. 2705, 168 L. Ed. 2d 623 (2007); National Soc. of Professional Engineers, 435 U.S., at 688-691, 98 S. Ct. 1355, 55 L. Ed. 2d 637.

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XVII. CHAPTER 32, ETHICAL ISSUES FACING ATTORNEYS IN M&A

A. Page 1259, New Sec. 32.3. Dow Seeks to Disqualify Wachtell Because of a Conflict

Page 1259, New Sec. 32.3. Before the References add the following:
New Sec. 32.3. **Dow Seeks to Disqualify Wachtell Because of a Conflict**

Re: Rohm and Haas Co. v. The Dow Chemical Co., et al.
Court of Chancery Delaware, 2009
Civil Action No. 4309-CC, Letter from Chancellor Chandler III to the Parties (February 12, 2009)

Dear Counsel:

Before me is defendants' motion to disqualify Wachtell, Lipton, Rosen & Katz ("Wachtell") from conducting discovery against The Dow Chemical Company and examining Dow witnesses. I have considered the parties' briefs, and oral argument was presented to the Court on February 11, 2009. For the reasons set forth briefly below, the motion to disqualify is denied.

Dow argues that Wachtell should be disqualified because the firm's representation of Rohm and Haas Company in this matter presents a conflict of interest as a result of Wachtell's representation of Dow. Dow alleges that Wachtell is in violation of the Delaware Rules of Professional Conduct because Dow is both a current client of Wachtell and a client whom Wachtell has previously represented in matters substantially related to the instant proceedings. Dow alleges that it is prejudiced in this action because Wachtell was privy to sensitive information in its capacity as Dow's counsel.

Dow argues that it is a current client of Wachtell because the firm never took steps to inform Dow that it was no longer a client following Wachtell's representation of Dow in 2007 and 2008 in connection with the termination of two Dow executives and potential defensive measures in response to rumors of a takeover bid. Dow further argues that Wachtell represented Dow in matters substantially related to this proceeding and in the course of that representation obtained confidential information that will materially advance Rohm and Haas's position in the instant litigation.

Plaintiff Rohm and Haas counters that there is not a concurrent conflict of interest because Dow is no longer a Wachtell client. According to Rohm and Haas, it should have been clear to Dow that Dow was no longer a Wachtell client when the firm appeared opposite Dow in its representation of Rohm and Haas in the negotiations of the initial confidentiality agreement and the merger agreement in mid-2008. Rohm and Haas further argues that the nature and scope of the prior representation and the current litigation are distinct and that Wachtell received no confidences from Dow that could be used to advantage Rohm and Haas in this proceeding.

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While the Court's evaluation of these issues is guided by the Delaware Rules of Professional Conduct, the moving party is not entitled to disqualification merely by showing a violation of the ethical rules. The Supreme Court of this State made this clear when it stated that:

> While we recognize and confirm a trial court's power to ensure the orderly and fair administration of justice in matters before it, including the conduct of counsel, the Rules may not be applied in extra-disciplinary proceedings solely to vindicate the legal profession's concerns in such affairs. Unless the challenged conduct prejudices the fairness of the proceedings, such that it adversely affects the fair and efficient administration of justice, only this Court has the power and responsibility to govern the Bar, and in pursuance of that authority to enforce the Rules for disciplinary purposes.[362]

Thus, a mere showing that a law firm violated the Rules of Professional Conduct is not sufficient to warrant disqualification. Instead, I must determine whether allowing Wachtell to continue its representation of Rohm and Haas will affect the fair and efficient administration of justice. When making this determination, the Court must weigh the interest of the former client in protecting confidences against the prejudice that will be caused to the current client if the firm were disqualified.[363] I am also mindful of the skepticism with which courts view motions for disqualification. Because of the risk that the ethical rules may be "invoked by opposing parties as procedural weapons," courts impose a significant burden on the party seeking disqualification.[364]

After careful consideration of the parties' arguments, I am not convinced that allowing Wachtell to continue representing Rohm and Haas in this matter will prejudice the fairness of the proceedings or affect the fair and efficient administration of justice. First, I am not convinced by the argument that Dow reasonably believes it is a current client of Wachtell or that Dow relied on such a belief. Dow knew that Wachtell was representing Rohm and Hass during the negotiations of the merger agreement and did not object. Rather, Dow obtained its own separate counsel to represent Dow in the merger negotiations. Wachtell sent its final bill to Dow in June 2008, and there is no convincing evidence that Wachtell continued to perform services for Dow that would justify a reasonable belief by Dow that it is a current Wachtell client. I am also not convinced by Dow's argument that there was an implicit promise by Wachtell that they would represent Rohm and Haas in the negotiations but would discontinue the representation if litigation arose. In short, if Dow truly felt that they were a current client of Wachtell and that they should not be "across the table" from their own lawyers, then Dow should have objected at the outset of the negotiations of the merger agreement that eventually lead to this litigation rather than waiting until this expedited litigation was commenced to attempt to make Rohm and Haas obtain new counsel.

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[362] Appeal of Infotechnology, Inc., 582 A.2d 215, 216-17 (Del. 1990).
[363] *Express Scripts, Inc. v. Crawford*, C.A. No. 2663-N, 2007 WL 417193, at *1 (Del. Ch. Jan. 25, 2007).
[364] *Infotechnology*, 582 A.2d at 220.

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Second, I am not convinced that Wachtell possesses confidential information that it obtained during its representation of Dow that will materially enhance the position of Rohm and Haas in this litigation. Wachtell represented Dow in 2007and early 2008 regarding matters related to a possible takeover attempt and the termination of two Dow executives. Dow alleges that this is a complex and difficult case that will involve many issues regarding Dow's motivations for entering into the merger agreement, its current condition, and the feasibility of the merger. According to Dow, Wachtell has confidential Dow information that is relevant to these issues, including Dow's internal strategies in connection with the takeover attempt and Dow's general business strategies and inner workings. Specifically, Dow alleges that Wachtell has information relevant to Rohm and Haas's claim that Dow should sell assets to consummate the merger because Wachtell had access to information regarding the synergies that could be gained through performance acquisitions and the strategic value of various Dow assets.

Again, I am not persuaded that Wachtell's access to this information will materially advance Rohm and Haas's position or undermine the fair and efficient administration of justice. Dow's defense to specific performance is that conditions in the market and within Dow have changed significantly since December 2008 and that it is no longer feasible for the merger to close. Dow has failed to convince me that the information Wachtell had access to regarding Dow's strategies and asset values in 2006 and 2007 will substantially advance the interest of Rohm and Haas in this litigation. Additionally, Wachtell has assured the Court that its attorneys who obtained confidential Dow information have not and will not share Dow's client confidences with the Wachtell attorneys working on this matter. While Dow is correct that the ethical rules impute knowledge of one attorney to other attorneys in the firm, the issue before the Court is not whether there was a violation of the ethical rules. To justify disqualification, the Court must find that allowing the representation to continue would threaten the fair and efficient administration of justice, a threat that is greatly reduced by a credible representation to the Court that the firm will ensure that the attorneys working on this matter do not have access to Dow's client confidences. Dow has failed to point to information or confidences obtained by Wachtell in its 2006-2007 work for Dow that will have a material influence on the proceedings before me today.

For the foregoing reasons, the motion to disqualify is denied.

IT IS SO ORDERED.

Very truly yours,
William B. Chandler III

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B. Page 1259, New Sec. 32.4. AirGas Seeks to Disqualify Cravath Because of a Conflict

Page 1259, New Sec. 32.4. Add after the New Sec. 32.3 the following:
New Sec. 32.4. **AirGas Seeks to Disqualify Cravath Because of a Conflict**

Air Products and Chemicals, Inc. v. AirGas, Inc.

Court of Chancery Delaware, 2010
Teleconference, Ruling of the Court, Chancellor Chandler, III, (March 5, 2010)

The Court: Good Afternoon, counsel.
I understand that we have a court reporter on the line with us, is that correct?

Ms. McCafferey: Yes.

The Court: Thank you, Miss McCaffery.

Counsel, I appreciate your cooperation in being available for this conference call on such short notice. But given the nature of the underlying dispute, and the importance of moving the case forward, I have decided that it is more important that I provide you with a prompt ruling on the pending motion than that I provide you with a lengthy explanation of the reasons for my decision.

You have provided me with careful and thoughtful briefing under fairly extreme time pressures that I regrettable inflicted on you. And I in not way want to understate the importance of your efforts by this somewhat abbreviated ruling. But I do think it is my job to try to move the matter forward as efficiently and as quickly as possible, consistent, of course, with the proper administration of justice.

Now, the real meat of this lawsuit, as you know, is a dispute about the potential business combination of two Delaware firms, Air Products, and Chemicals Inc. and Airgas Inc.

After tentative contacts about that business combination between these two companies in October and November, and perhaps December of 2009, all of which proved fruitless, Air Products, on February 4, 2010, announced publicly its intention to offer to purchase all outstanding Airgas stock for $60 per share in cash. That same day, Air Products filed a complaint in the Delaware Court of Chancery against Airgas and its board of directors seeking declaratory and injunctive relief based on allegations of breach of fiduciary duty by the Airgas board.

At issue in this litigation, therefore, are the actions and decisions of the Airgas board beginning late October up until the present in responding to Air Products' all-shares, all-cash offer, and specifically whether the Airgas board may properly rely on certain defensive measures, effectively just saying no to the offer, while resting on its poison pill,

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staggered board and the strictures of Section 203 of the Delaware General Corporation Law.

Now, on the very next day, February 5th, 2010, Airgas filed a lawsuit in the Pennsylvania Court of Common Please, not against Air Products, but against Cravath, Swaine & Moore, the New York law firm representing Air Products in connection with the proposed business combination, and in the lawsuit filed in this Court.

After winning an initial skirmish in the Pennsylvania State Court, Cravath had Airgas' State Court action removed to the United States District Court for the Eastern District of Pennsylvania where, on February 22nd, 2010, the Honorable Eduardo Robreno issued an opinion and order that stayed Airgas' lawsuit against Cravath until this Court ruled on Air Products' motion seeking a determination here that Cravath may properly represent Air Products in this lawsuit.

With that truncated background, I now turn to Air Products' motion for a declaration that Cravath, Swaine & Moore may continue to serve as Air Products' counsel in this case. Airgas, of course, opposes the motion, even going so far as to ask me to revoke pro hac vice orders I have entered allowing two Cravath attorneys to appear before me.

Airgas also objects to Cravath's continuing role as an advisor to Air Products with respect to the proposed business combination with Airgas.

After considering counsel's correspondence, briefs and affidavits, including affidavits submitted by four different experts on legal ethics, I make the following findings and reach the following conclusions.

First, I hold that Delaware law, in particular, the Delaware Lawyers Rules of Professional Conduct, and Delaware's common law rules regarding lawyer disqualifications applies to this dispute. * * *

Second, and turning now to the substantive question before me, I find and determine that no basis exists for me to disqualify Cravath, Swaine & Moore from representing Air Products in the litigation pending in this court.

Although the parties strenuously disagree regarding the propriety of Cravath's role in connection with its previous work for Airgas wile it was simultaneously engaged as counsel for Air Products, and although the ethics experts diverge over whether Cravath has compiled with the strict requirements of Rules 1.7 or 1.9 of the Professional Conduct rules, I need not formally decide that question in order to dispose of the motion and objections before me.

Before this Court may enter the Draconian order of disqualification, a moving party seeking that drastic relief must come forward with clear and convincing evidence establishing a violation of the Delaware Rules of Professional Conduct so extreme that it

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calls into question the fairness or the efficiency of the administration of justice. That is the holding of our Supreme Court in a case styled In Re: Dunlap.

Motions seeking disqualification, of course, are often viewed with suspicion as they are known to be filed for tactical reasons rather than genuine concerns about client loyalty. In addition, courts recognize that a litigant should be able to use the counsel of his or her choice.

For those reasons, the Delaware Supreme Court has instructed the trial courts to exercise the utmost care in addressing motions to disqualify, noting that the purpose of the Rules of Professional Conduct can be subverted when they are invoked by opposing parties as procedural weapons.

In fact, I have held in similar circumstance that even when a violation of the ethical rules has, in fact, occurred, it need not automatically result in disqualification. And, more recently, in the Dow Chemical case, I refused to disqualify counsel when there was no showing that counsel's participation as an advocate unfairly benefited its present client, in that instance Rohm & Hass, or unfairly prejudiced its former client, the Dow Chemical Company, even though the representation of the two clients may have overlapped.

Like Dow Chemical and the Rohm & Haas case, Airgas here has not demonstrated even simply persuasively, let alone clearly and convincingly, that it would be disadvantaged by the presences of its former counsel as advocate for its opponent, Air Products.

Nothing before me shows that Cravath had access to or learned internal and non-public confidential information, corporate strategies or defensive tactics during the course of its narrowly focused work for Airgas from 2001 until late October of 2009, or that such information, even if available to Cravath, would prejudice the fairness or the integrity of this proceeding.

The evidence presented to me indicates that Cravath's work for Airgas between 2001 and 2009 was limited in scope and nature, confined to advising Airgas regarding the completion of debt financings and involved neither contact nor advice regarding corporate governance, litigation matters, charter or by-law issues, merger and acquisition advice, defensive tactics or corporate counseling.

Cravath did not counsel or meet with the most senior Airgas executives or the Airgas board of directors, and Airgas, in fact, had other long-standing counsel advising it on litigation, corporate governance and mergers and acquisitions issues.

What's more, even if Cravath had access from its earlier representation to information that might be relevant in this proceeding, it has represented to this Court that is has no intention of using such information, and as is customary, Cravath has erected an ethical wall to seal off those members of the firm who worked on the Airgas debt financings from those members of the firm working on the Air Products proposed business combination with Airgas.

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A similar ethical wall was erected in the Rohm & Haas matter as a means to further assure this Court that no prejudice or unfairness in the proceedings that would result to Dow Chemical, the former client in that case. The same is true here.

Next, Airgas is represented by extremely capable and highly skilled counsel in this takeover battle. Disqualification of Cravath, which has been the long-time counsel to Air Products on a wide range of matters, including mergers and acquisitions, would be a serious blow, forcing Air Products to search out and retain new counsel in the heat of an already launched hostile acquisition contest.

Given the absence of any credible threat of prejudice to Airgas from Cravath's continued participation in this lawsuit, I think the threat of harm to Air Products from disqualification far outweighs the threat of harm to Airgas from a failure to disqualify.

I am even more confident in reaching this calculus because of the nature and timing of Airgas' objection to Cravath's participation.

For all of these reasons, I find and conclude that disqualification of Cravath is not necessary to protect the integrity or the fairness of the proceedings before me or to maintain public confidence in the judicial system.

I am not persuaded that Cravath possess confidential Airgas information that is not already publicly disclosed, but, of course, if it does, it recognizes that it is under a continuing duty not to reveal it or to use it the disadvantage of its former client, Airgas.

Accordingly, I grant Air Products' motion, declare that Cravath may continue to represent it in this litigation, and deny Airgas' objection to the Cravath lawyers who have been previously admitted pro hac vice in this matter. * * *