67979-1

67979-1

CASE NO. 67979-1-I

COURT OF APPEALS, DIVISION I
STATE OF WASHINGTON

JOHN MCKAY, A Washington Resident, GEORGE MCKAY, A Washington Resident, JOHN MCKAY *ex rel.* SUNSET CARS OF RENTON, INC., A Washington Corporation, and GEORGE MCKAY *ex rel.* SUNSET CARS OF RENTON, INC., A Washington Corporation,

Appellants,

vs.

MORRIS PROSZEK and "JANE DOE" PROSZEK, Husband and Wife and the Marital Community Comprised Thereof,

Respondent.

Appellants' Brief on Appeal

Mark D. Kimball, WSBA No. 13146
Mark@mdklaw.com
James P. Ware, WSBA No. 36799
James@mdklaw.com
MDK Law Associates
10900 NE 4th St., Suite 2030
Bellevue, WA 98004
(425) 455-9610

Attorneys for Appellants John McKay
and George McKay

ORIGINAL

TABLE OF CONTENTS

Page

TABLE OF AUTHORITY

Page

Cases

TABLE OF AUTHORITIES (Continued)

Page

Foreign Cases/Federal Cases

Statues, Codes, and Civil Rules

I. ASSIGNMENT OF ERROR

1. The Trial Court erred when it granted a 12(b)(6) Order dismissing Appellants' claims with prejudice based on a finding that Appellants lacked standing and had failed to follow procedural requirements in their pleadings.

2. The Trial Court erred when it granted Respondent an award of attorney fees based upon CR 11 and RCW § 4.84.185 under the reasoning that Appellants' claims were not grounded in law or fact.

II. ISSUE PRESENTED.

Is an Order granting dismissal with prejudice pursuant to CR 12(b)(6) proper when shareholders assert a derivative action, plead the necessary facts to assert the substantive claims but fail to comply with CR 23.1 and do not clearly assert that pre-litigation notice would have been futile instead of affording the shareholders the opportunity to cure the pleading defects before dismissing the derivative claims with prejudice?

III. STATEMENT OF THE CASE.

This Appeal arises from a grant of a 12(b)(6) motion to dismiss with prejudice third-party claims asserted by Appellants John McKay and George McKay (hereinafter "McKays"). Factually, the underlying case arose from the actions taken by Morris Proszek (hereinafter "Proszek") that caused damage to John McKay individually and to Sunset Cars of Renton, Inc. (hereinafter "Sunset Cars"). At the time of the acts alleged, Proszek was the President, and a Board Member of Sunset Cars along with John McKay. At the time Proszek took the actions complained of, Proszek owned 40% of Sunset Cars' shares, John McKay owned 30%, and George McKay owned 30%.

On April 22, 2011, Fife Commercial (the financial institution that provided Sunset Cars with its line of credit) initiated litigation in King County Superior Court against Sunset Cars, John McKay, and Tina McKay for Replevin, a Temporary Injunction, a Permanent Injunction, and Damages for Sunset Cars' alleged breach of the terms and conditions of its line of credit. Proszek, John McKay, and Tina McKay (John McKay's wife) were named because Proszek and John McKay personally guaranteed the line of credit given to Sunset Cars.

In response, John McKay and George McKay filed a Third-Party Complaint on behalf of the corporation and individually against Proszek alleging breach of fiduciary duty, conversion, implied indemnification, and breach of contract. McKays labeled the complaint a "third-party complaint" because George McKay was not listed as a defendant in the cause of action filed by Fife Commercial. However, the complaint related to the action taken by Fife Commercial and statements Proszek made regarding McKays and Sunset Cars to agents of Fife Commercial. Specifically, McKays alleged that Proszek had instructed Sunset Cars' financial institution to cancel the line of credit. Proszek also told the financial institution, other lenders, and auction houses not to do business with Sunset Cars because it was going out of business and because the McKays were violent individuals and were using Sunset Cars for improper means. Further, McKays pled that they demanded that Proszek cease his activities but he refused and despite their attempts to strip Proszek of authority to speak as the agent of Sunset Cars, he continued to do so.

In response to McKays' Third-Party Complaint, Proszek filed a Motion to Dismiss alleging that McKays lacked standing to bring their claims, that McKays could not sue personally for corporate damages, and that McKays violated certain procedural requirements for a shareholder derivative action. In reply, the McKays noted that the majority of claims and damages alleged were corporate damages and fell within claims McKays brought on behalf of Sunset Cars. Therefore, they were not alleging personal damage but rather damage to the corporation. Further, McKays noted that John McKay, individually, had a cognizable action against Proszek for implied indemnification because John McKay signed a personal guaranty that guarantied Sunset Cars' performance of the terms and conditions for the line of credit. McKay noted that Proszek and John McKay's relationship was such that their interdependence created a basis for implied indemnification. Finally, McKays noted that to the extent the Third-Party Complaint contained pleading defects, the concerns did not warrant dismissal with prejudice. Rather, Washington law provided that the claims should be dismissed without prejudice with leave to amend, or a reasonable amount of time to amend should be given before claims were dismissed with prejudice.

Despite McKays' assertions, the Trial Court dismissed the McKays' claims with prejudice stating that McKays lacked standing and failed to follow procedural requirements. McKays sought reconsideration, which was denied, and the Trial Court awarded Proszek attorney fees and costs stating that McKay's claims lacked legal and factual support in violation of CR 11 and RCW § 4.84.185. McKays then filed this Appeal.

IV. FACTUAL AND PROCEDURAL HISTORY

This case arises from alleged breaches of fiduciary duty, conversion, and breach of contract by the president of Sunset Cars of Renton, Inc., a Washington Corporation that sold used vehicles in Renton, Washington. Sunset Cars of Renton has three shareholders: John McKay with 30% of outstanding shares, George McKay with 30% of outstanding shares, and Proszek with 40% of outstanding shares. (CP 19-20) At the time of the underlying action, Proszek was also a Board Member. (CP 19-20) On April 22, 2011, the financial institution that provided a line of credit for Sunset Cars filed an action for Replevin of Personal Property, a Temporary Restraining Order, a Permanent Injunction, and Damages against Sunset Cars of Renton, Inc., John McKay, Tina McKay (John McKay's wife), Morris Proszek and "Jane Doe" Proszek. (CP 3-13) The basis of the suit was to take possession of collateral and to enforce the personal guaranties signed by Sunset Car's principals, John McKay and Morris Proszek, for an alleged breach of the terms of Sunset Car's line of credit. (CP 4-6)

In response, John McKay and George McKay (hereinafter collectively "McKays") filed a Third-Party Complaint against Morris Proszek (hereinafter "Proszek") in their individual capacity and on behalf of Sunset Cars. (CP 16-21) In their Complaint McKays set forth several causes of action: Breach of Fiduciary Duty, Conversion, Tortious Interference with Business Expectancies; Indemnification, and Breach of Contract. (CP 21-25) The factual basis for each claim was as follows:

<u>Breach of Fiduciary Duty.</u>

- At the time, Proszek was the President of Sunset Cars;

- As President and a Board Member of Sunset Cars, Proszek owed certain fiduciary duties to Sunset Cars and McKay as Shareholders;
- Proszek breached his fiduciary duties by committing the following acts:
    - Proszek unilaterally cancelled Sunset Cars' line of credit;[1]
    - Proszek instructed financial institutions not to provide loans and/or lines of credit to Sunset Cars;
    - Proszek provided false information regarding the business practices of Sunset Cars and McKay;
    - Proszek instructed auction houses not to allow agents of Sunset Cars to purchase vehicles on Sunset Cars' accounts;
    - Proszek converted titles of vehicles on Sunset Cars' dealership lot;
    - Proszek liquidated Sunset Cars' bank accounts that were used to pay employee wages and to meet state and federal tax obligations;

---

[1] The line of credit is referred to as a "flooring line" which is an industry term to describe the credit line a car dealership uses to purchase vehicles from car manufacturers, other dealership, auction, etc. that the dealership then sells to retail customers.

    - Proszek Incorporated a company to compete against Sunset Cars; and
    - Proszek misused and misdirected Sunset Cars' funds. (CP 22-3)

Conversion.

- Proszek deprived Sunset Cars of its property by committing the following acts:
    - Proszek liquidated Sunset Cars' bank accounts; and
    - Proszek removed titles to vehicles owned by Sunset Cars from the dealership premise. (CP 23)

Tortious Interference with Business Expectancies.

- Proszek had actual knowledge that Sunset Cars had business and/or contractual relationships with various financial institutions and auction houses;
- Sunset Cars had contractual and business relationships with various financial institutions and auction houses;
- In his personal capacity and/or as a third-party agent, Proszek contacted the financial institutions and auction houses with which Sunset Cars had contractual and business relationships and instructed them not to conduct business with Sunset Cars;

- Proszek's contact with the financial institutions and auction houses tortiously interfered with Sunset Cars' business expectancies. (CP 23-4)

<u>Indemnification.</u>

- Proszek had personal knowledge that John Mckay signed personal guaranties that guaranteed the performance of Sunset Cars obligations for its line of credit.
- Proszek instructed Sunset Cars' financial institution to cancel its line of credit, and when he did so he was not acting as an agent of Sunset Cars and was acting without the consent of the majority of shareholders or John McKay;
- Proszek knew or should have known that when he instructed the financial institution to cancel the line of credit the institution would enforce the personal guaranty signed by John McKay;
- Proszek took steps to encourage Sunset Cars' financial institution to enforce the personal guaranty signed by John McKay before it would enforce the personal guaranty signed by Proszek. (CP 24)

<u>Breach of Contract.</u>

- Proszek agreed to the terms of the corporate documents of Sunset Cars when he signed them and incorporated Sunset Cars in Washington state; and

- Proszek breached the corporate documents when he attempted either to unilaterally quit his position as president and/or abandoned his role as president of Sunset Cars. (CP 25)

Importantly, McKays pled specific facts to support both John McKay's claims and McKays' derivative action against Proszek. McKays alleged that Proszek instructed the financial institution to cancel Sunset Cars' line of credit in February 2011. (CP 20) Proszek told Sunset Cars' financial institution that John and George McKay were violent and had been improperly selling vehicles subject to Sunset Cars' line of credit. (CP 21) Proszek refused to assist Sunset Cars in obtaining a new line of credit. (Id.) Proszek liquidated Sunset Cars' accounts that contained funds dedicated to the payment of employees' wages and state and federal tax obligations. (Id.) Proszek contacted financial institutions that provided consumer loans for customers to purchase cars from Sunset Cars and instructed them to cease doing business with Sunset Cars because it was going out of business and because McKays were using the business for improper purposes. (CP 21-22) Proszek told employees that once Sunset Cars went out of business he would hire them as employees at a new company. (CP 22) Proszek formed Sunset Select, LLC in April 2011 in order to compete directly against Sunset Cars. (Id.) Proszek told auction houses that he owned 60% of Sunset Cars' outstanding shares, that he was disbanding Sunset Cars, and that no auction house was to allow agents of Sunset Cars to purchase vehicles on the auction house accounts owned by Sunset Cars. (Id.) Therefore, McKays did not simply provide general vague allegations of fact for the causes of action but rather pled specific facts to support each claim.

In response to McKays' Third-Party Complaint, Proszek filed a CR 12(b)(6) Motion to Dismiss seeking to dismiss with prejudice McKays' Third-Party Complaint. (CP 105-114) As a basis for his Motion, Proszek alleged that: McKays' Third-Party Complaint should not have been filed as a third-party complaint; George McKay was not a party to the original suit; McKays lacked standing to bring suit individually because all damages were incurred by Sunset Cars; John McKay could not bring suit for indemnification against Proszek because Proszek owed no duty to John McKay; and that McKays' derivative action should be dismissed because McKays' pleadings were statutorily and procedurally defective. (Id.)

In opposition to Proszek's Motion, McKays asserted that John McKay could assert an implied indemnification claim (CP 121-2), that McKays properly asserted a derivative action and to the extent any technical defect exists, the proper remedy was leave to amend (CP 122-4), and that even if some of the claims should have been fashioned as cross-claims, said pleading defect does not warrant dismissal with prejudice. (CP 124-5)

Despite McKays' opposition, the Court granted Proszek's Motion and dismissed McKays' claims with prejudice stating that the McKays "lacked standing" and "failed to meet statutory requirements" to bring their claims. (CP 142-3) McKays sought reconsideration (147-60), which was denied (219-21), and the Trial Court awarded Proszek attorney fees. (289-91) As the basis for an award of fees, the Trial Court determined that McKays lacked a legal and factual basis for their claims. (CP 220) McKays then appealed.

V. STANDARD OF REVIEW.

This appeal arises from the dismissal with prejudice upon a CR 12(b)(6) Motion to Dismiss. CR 12(b)(6) states that dismissal is proper when a party "fails to state a claim upon which relief can be sought." CR 12(b)(6). Review of a CR 12(b)(6) dismissal is de novo and the Appellate Court makes the same inquiries as the trial court. **Neigel v. Harrell,** 82 Wn. App. 782, 784, 919 P.2d 630 (1996). The Court accepts all facts plead as true for purposes of review. **Standard v. Bolin,** 88 Wn.2d 614, 615, 565 P.2d 94 (1977). Upon review, the proper inquiry is whether "it appears beyond a reasonable doubt that no facts exist that would justify recovery, or if the plaintiff's allegations reveal an insurmountable bar to relief." **Neigel,** 82 Wn. App. at 784.

Here, the facts alleged set forth the elements necessary for each claim. Further, to the extent technical defects *may* have existed in the pleadings, Washington Courts clearly hold that the proper action is to afford the plaintiff the opportunity to amend its complaint to cure the defective pleading. **Rcl Northwest v. Colo. Res.,** 72 Wn. App. 265, 271, 864 P.2d 12 (1993). Put simply, McKays set forth the factual elements necessary to assert their claims and no insurmountable bar to relief exists. Because the McKays set forth factual allegations that supported each of the subject claims, the trial court erred when it dismissed McKays' claims with prejudice and awarded attorney fees under the auspice that McKays' claims lacked factual and legal merit.

VI. LEGAL ARGUMENT.

A. The McKays Had Standing to Bring Claims Through a Derivative Action.

The McKays had (and have) standing to assert a derivative action because at the time the action was filed John McKay and George McKay were shareholders who, combined, owned 60% of Sunset Cars' outstanding shares. As noted above, for purposes of review, an appellate court will accept the facts pled in the underlying action by McKays as true. **Standard v. Bolin,** 88 Wn.2d 614, 615, 565 P.2d 94 (1977). Notably, RCW § 23B.07.400 provides that "[a] person may not commence a proceeding in the right of a domestic or foreign corporation unless the person was a shareholder of the corporation when the transactions complained of occurred…" RCW § 23B.07.400(1)(emphasis ours).

Here, McKays alleged that both John McKay and George McKay were shareholders. (CP 19, 20) Because McKays alleged that when the acts complained of occurred they were shareholders, they had standing to assert claims in the right of Sunset Cars.

B. To the Extent McKay did not Plead the Technical Requirements of RCW § 23B.07.400 and CR 23.1, Dismissal With Prejudice Was Not An Appropriate Result.

The Trial Court erred when it dismissed McKay's derivative claims with prejudice because McKay pled facts sufficient to show that Proszek was one of two Board Members and that demanding action by the Board would have been futile. In addition, Washington Courts and the U.S. Supreme Court have ruled that the appropriate remedy where a violation of Civil Rule 23.1 is asserted and found is to allow the plaintiff to cure the subject pleading or procedural defects. In Washington, before a shareholder may bring a derivative action, he must either allege that he made demands to the Board and that it refused to initiate the litigation or he must plead facts that show the demand would have been futile. **In re F5 Networks, Inc.,** 166 Wn.2d 229, 237, 207 P.3d 433 (2009). In addition, CR 23.1 requires that a complaint be certified by a shareholder to ensure its accuracy. CR 23.1. These requirements are procedural and a plaintiff's failure to plead in strict compliance with the provisions of RCW § 23B.07.400 and CR 23.1 can not serve as a basis for dismissal with prejudice. Rather, Washington and Federal law holds that a plaintiff should be afforded the opportunity to cure pleading defects if its substantive claims are valid.

Here, the Trial Court clearly erred when it dismissed McKays' claims with prejudice. The question before the trial court was not that they were not shareholders that alleged harm to Sunset Cars but rather that they purportedly failed to show the futility of a pre-litigation demand and because a shareholder did not sign the Third-Party Complaint pursuant to CR 23.1.

1. McKay has Shown Reasonable Doubt that the Board Would Have Exercised its Independent and Disinterested Business Judgment in Response to a Pre-Litigation Demand.

Washington Courts have relaxed the pre-litigation demand requirements of RCW § 23.07.400 through adoption of the futility doctrine. **In re F5 Networks, Inc.,** 166 Wn.2d at 237. "Under the futility standard, courts look to the complaint to determine whether or not the particularized factual allegations of a derivative stockholder complaint creates 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 the demand." **Id.** at 237-8. "The concept of reasonable doubt is akin to the concept that the stockholder has a reasonable belief that the board lacks independence." **Grimes v. Donald**, 673 A.2d 1207, 1217 n. 17 (Del. 1996)(overruled on other grounds by **Brehm v. Eisner**, 746 A.2d 244, 253 n.13 (Del. 2000)). Therefore, futility is determined not by the objective view of an onlooker into corporate activities but rather whether the facts alleged in the complaint show that the stockholder had a reasonable belief that the board lacked independence when the shareholder filed the derivative action.

Here, McKays' Complaint sets forth reasonable doubt that the Board Members of this closely held corporation would initiate litigation against Proszek. First, Proszek was a Board Member. (CP 22, 123) Further, McKays demanded action by Proszek and he refused. (CP 22) Proszek refused to assist in obtaining a new line of credit for Sunset Cars. (CP 22) Proszek was liquidating Sunset Cars' bank accounts and instructing entities that Sunset Cars was going to cease conducting business. (CP 21-22) Finally, Proszek created a new business to compete against Sunset Cars. (CP 22) Given these facts, McKays reasonably determined that a demand to the Board would have been futile.

Even if the Court did not believe that these facts could serve as a reasonable doubt by McKays, dismissal with prejudice was not warranted. At best the appropriate action would have been either to dismiss without prejudice with leave to amend, or afford McKays reasonable time to amend the Third-Party Complaint before dismissal to show that reasonable doubt existed and that a pre-litigation demand would have been futile. *See* **In re Cray Inc. Derivative Litig.,** 431 F. Supp. 2d 1114, 1121 (W.D. Wash., 2006) By dismissing the McKays' claims with prejudice, the Court has forever precluded the action by McKays and ignored the basic realities that surround a closely held corporation. The pre-litigation requirement is akin to many procedural requirements found within both state and federal civil procedural rules. As observed by Justice Black "The basic purpose of the Federal Rules is to administer justice through fair trials, not through summary dismissals as necessary as they may be on occasion." **Surowitz v. Hilton Hotels Corp.**, 383 U.S. 363, 372 (U.S. 1966).

McKays do not dispute that pre-litigation demands or showing of futility serve a basic purpose to prevent unnecessary and inappropriate litigation. However, to bar claims without first affording a litigant the opportunity to show that a pre-litigation demand would have been futile is contrary to the intent of the law.

2. Failure to Obtain CR 23.1 Certification of a Complaint Cannot Serve as the Basis for Dismissal With Prejudice.

Similarly, if the Trial Court based its dismissal with prejudice upon McKay's failure to comply with CR 23.1 certification requirements, then dismissal with prejudice was clear error. Washington Courts have adopted the United States Supreme Court's holdings that failure to comply with the procedural requirements of Federal Rules of Civil Procedure CR 23.1 cannot serve as the basis for a dismissal with prejudice. *See* **Rcl Northwest v. Colo. Res.,** 72 Wn. App. 265, 271, 864 P.2d 1230 (1990)(Noting that certification requirements of a derivative action are to prevent strike suits and that dismissal, if required, should be with leave to amend or conditioned on a failure to cure the defect within a reasonable period of time.). Failure to comply with CR 23.1 is not a basis to dismiss claims with prejudice shortly after suit is filed. If the Trial Court dismissed McKay's claims for failure to certify, then it erred when it failed to afford McKay the opportunity to cure the procedural defect.

C. John McKay had Standing to Bring his Implied Indemnification Claim.

The Trial Court erred when it dismissed McKays' indemnification claim with prejudice as they set forth the facts necessary to establish implied indemnification by Proszek. Washington law recognizes the common law doctrine of implied indemnification. **Fortune View Condominium Ass'n v. Fortune Star Development, Inc.,** 151 Wn.2d 534, 90 P.3d 1062 (2004). Implied indemnification rests in equity and is based upon the theory that one party has paid more than his fair share. **Toste v. Durham & Bates Agencies**, 116 Wn. App. 516, 67 P.3d 506 (2003). Importantly, the basis for a claim of implied indemnification is the special nature of the relationship between the parties. **Fortune View Condominium Ass'n,** 151 Wn.2d at 539.

Here, John McKay had established an interdependent relationship between himself and Proszek in the governance and operations of the subject corporation. Importantly, both individuals jointly and severally guarantied that Sunset Cars would comply with the terms and conditions of its line of credit. (CP 24) Further, McKays alleged in their Third-Party Complaint that Proszek knowingly took steps to have Sunset Cars' financial institution enforce John McKay's personal guaranty before it enforced Proszek's personal guaranty. (Id.) Finally, in his Declaration John McKay noted that he signed similar personal guaranties with other businesses. (CP 275) Given these facts, John McKay had established a relationship between himself and Proszek that would give rise to a claim for implied indemnification.

The basis for the trial court's claim that John McKay lacked standing to assert his implied indemnification claim is unclear from the Order Dismissing Third-Party Plaintiffs' Claims. Nevertheless, because McKay alleged specific facts that established the special nature of the relationship between John McKay and Proszek, the Trial Court erred when it dismissed John McKay's indemnification claim with prejudice. Again, dismissal occurred in this matter in the context of a 12(b)(6) motion, not following trial or even summary judgment.

D. The Trial Court Erred When it Awarded Attorney Fees to Proszek.

The Trial Court erred when it awarded Proszek attorney fees because McKays' claims were grounded in the facts pled and were based upon sound legal doctrine. An award of attorney fees under Civil Rule 11 (or other theories) is to discourage filings that are not warranted either by existing law, or a good faith argument for an extension, modification, or reversal of existing law. **Bryan v. Joseph Tree, Inc.,** 119 Wn.2d 210, 219, 829 P.2d 1099 (1992). Importantly, CR 11 should be applied cautiously so that it does not chill an attorney's enthusiasm or creativity in pursuing legal or factual theories. **Id.** Similarly, an award of attorney fees under RCW § 4.84.185 should only be granted if the claims or defenses are deemed to be frivolous. The purpose of RCW § 4.84.185 is to serve as a deterrence against meritless claims asserted for harassment, delay, nuisance or spite. **Suarez v. Newquist**, 70 Wn. App. 827, 855 P.2d 1200 (1993).

As noted above, McKays' claims were based on established Washington law and were grounded in the facts pled. To the extent defects existed in McKays' pleadings, they were not fatal and should not serve as the basis for an award of fees under either CR 11 or RCW § 4.84.185. Importantly, the rationale behind the Trial Court's award of fees is its position that McKays lacked standing to bring their claims and a failure to follow procedural requirements warranted dismissal with prejudice. As noted above however, the trial court erred in that determination. McKays set forth a sufficient factual basis for all their claims and established reasonable doubt as to whether a pre-litigation notice to the Board would have yielded results. Further, Washington law clearly establishes that procedural defects in a derivative action should not serve as the basis for a dismissal with prejudice.

Because McKays grounded their claims in properly-alleged facts and because any pleading defects that existed were procedural, the Trial Court erred when it awarded Proszek attorney fees on the factual finding that McKay's claims lacked a factual or legal basis. Accordingly, reversal is proper.

VII. CONCLUSION.

A party's claims should be dismissed only if it appears beyond a reasonable doubt that no facts exist that would justify recovery, or if the plaintiff's allegations reveal an insurmountable bar to relief. Here the McKays pled the elements necessary for each of their claims. Further, the McKays had established that at the time they filed their Third-Party Complaint, they had reasonable doubt that any request to the Board would have been futile. Additionally, McKays pled facts necessary to establish that the relationship between John McKay and Proszek was so interdependent that Proszek's blatant actions gave rise to an implied indemnification claim. Finally, McKay's claims were not contrary to the applicable law and complied with both CR 11 and RCW § 4.84.185 standards.

Dismissal of McKays' Third-Party Complaint with prejudice was in error. To the extent defects existed in the Complaint, Washington law provides that McKays should have been afforded the opportunity to cure the defects. Because McKays set forth facts that established both standing requirements and the factual elements of each claim, the trial court erred when it dismissed McKays' claims with prejudice and awarded Proszek attorney fees under CR 11 and RCW 4.84.185. Accordingly, reversal and remand is proper.

Respectfully submitted this 17th day of February 2012.

MDK Law Associates
MARK DOUGLAS KIMBALL, P.S.
Attorneys for John McKay and George McKay

James P. Ware, WSBA No. 36799

Mark D. Kimball, WSBA No. 13146

DECLARATION OF SERVICE

I certify that on February 17, 2012 I caused a true and correct copy of the Appellants' Brief on Appeal to be served on the following in the manner indicated below:

Matthew J. Smith, WSBA 33309
James Aiken, WSBA 1993
Aiken Law Group
2131 Second Avenue
Seattle, Washington 98121
mjsmith@aiken-lawgroup.com
(206) 728-4500
Attorneys for Respondents

ABC Legal Messenger with a delivery date of February 17, 2012.

Dated: February 17, 2012.

James P. Ware, WSBA # 36799
MDK Law Associates
(425) 455-9610

VIII. APPENDIX

Grimes v. Donald,
673 A.2d 1207, 1217 n. 17 (Del. 1996)

Brehm v. Eisner,
746 A.2d 244, 253 n.13 (Del. 2000)

In re Cray Inc. Derivative Litig.,
431 F. Supp. 2d 1114 (W.D. Wash., 2006)

Surowitz v. Hilton Hotels Corp.,
383 U.S. 363 (U.S. 1966)

Grimes v. Donald,
673 A.2d 1207, 1217 n. 17 (Del. 1996)

C. L. GRIMES, Plaintiff Below, Appellant, v. JAMES L. DONALD, CLEMENT M. BROWN, JR., FRANK J. CUMMISKEY, RAYMOND J. DEMPSEY, JOHN FAIRCLOUGH, JAMES L. FISCHER, ROBERT S. FOLSOM, JAMES P. LEAKE, JAMES M. NOLAN, AND JIM A. WATSON, Defendants Below, Appellees, and DSC COMMUNICATIONS CORPORATION, Nominal Defendant Below, Appellee.

No. 79, 1995

SUPREME COURT OF DELAWARE

673 A.2d 1207*; *1996 Del. LEXIS 154

January 25, 1996, Submitted
April 11, 1996, Decided

SUBSEQUENT HISTORY: Released for Publication April 29, 1996.
Subsequent appeal at *Grimes v. Donald, 755 A.2d 388, 2000 Del. LEXIS 188 (Del., 2000)*

PRIOR HISTORY: [**1] Court Below: Court of Chancery of the State of Delaware in and for New Castle County. C.A. No. 13358.
Grimes v. Donald, 1995 Del. Ch. LEXIS 3 (Del. Ch., Jan. 11, 1995)

DISPOSITION: AFFIRMED.

COUNSEL: Clark W. Furlow, Esquire (argued), of Smith, Katzenstein & Furlow, Wilmington, and Thaddeus Holt, Esquire (argued) of Point Clear, Alabama, for Appellant C.L. Grimes.

Robert K. Payson, Esquire, and Stephen C. Norman, Esquire, of Potter, Anderson & Corroon, Wilmington; Samara L. Kline, Esquire (argued) of Baker & Botts, Dallas, for Appellee James L. Donald.

Thomas R. Hunt, Jr., Esquire; Michael L. Vild, Esquire; and Thomas C. Grimm, Esquire, of Morris, Nichols, Arsht & Tunnell, Wilmington; Chester A. Hinshaw, Esquire (argued) of Jones, Day, Reavis & Pogue, Dallas, for Appellees Clement M. Brown, Frank J. Cummiskey, Raymond J. Dempsey, John Fairclough, James L. Fischer, Robert S. Folsom, James P. Leake, James M. Nolan and Jim A. Watson.

Stephen E. Jenkins, Esquire, of Ashby & Geddes, Wilmington, for Appellee DSC Communications Corporation.

JUDGES: Before VEASEY, Chief Justice, WALSH, HOLLAND, HARTNETT and BERGER, [**2] Justices, constituting the Court en Banc.

OPINION BY: VEASEY

OPINION

[*1210] VEASEY, Chief Justice:

In this appeal we address the following issues: (1) the distinction between a direct claim of a stockholder and a derivative claim; (2) a direct claim of alleged abdication by a board of directors of its statutory duty; (3) when a pre-suit demand in a derivative suit is required or excused; and (4) the consequences of demand by a stockholder and the refusal by the board to act on such a demand.

We hold that the Court of Chancery correctly dismissed this stockholder action for the failure to state a claim upon which relief can be granted where the plaintiff stockholder: (a) asserted a direct claim that the directors abdicated their statutory duty to manage or direct the management of the business and affairs of the corporation by entering various employment contracts (the "Agreements") with the chief executive officer ("CEO") providing that the CEO "shall be responsible for the general management of the affairs of the company" and further providing that the CEO can declare a constructive termination of the Employment Agreement for "unreasonable interference" by the Board with the CEO; (b) made a [**3] pre-suit demand on the Board to abrogate the Agreements, the demand was refused, and the stockholder thereafter sought to assert other legal theories relating to the Agreements, arguing that demand was excused.

We hold as follows: First, an abdication claim can be stated by a stockholder as a direct claim, as distinct from a derivative claim, but here the complaint fails to state a claim upon which relief can be granted. Second, when a stockholder demands that the board of directors take action on a claim allegedly belonging to the corporation and demand is refused, the stockholder may not thereafter assert that demand is excused with respect to other legal theories in support of the same claim, although the stockholder may have a remedy for wrongful refusal or may submit further demands which are not repetitious.

Accordingly, on the state of this record, we **AFFIRM** the dismissal of this action by the Court of Chancery.

I. The Facts

C.L. Grimes ("Grimes"), plaintiff below-appellant, appeals from the dismissal, for failure to state a claim, of his complaint against James L. Donald ("Donald") (the CEO) and the Board of Directors (the "Board") of DSC Communications [**4] Corporation ("DSC" or the "Company"). Grimes seeks a declaration of the invalidity of the Agreements between Donald and the Company. He also seeks an award of damages against Donald and other members of the Board. He alleges that the Board has breached its fiduciary duties by abdicating its authority, failing to exercise due care and committing waste.

The following facts have been drawn from the face of the complaint. The Company is a Delaware corporation headquartered in Plano, Texas, a suburb of Dallas. The Company, whose shares are traded on the Nasdaq National Market System, designs, manufactures, markets and services telecommunication systems.

The Agreements, executed during 1990, are the focus of the complaint. The Employment Agreement provides that Donald "shall be responsible for the general management of the affairs of the company . . .," and that Donald "shall report to the Board." The [*1211] Employment Agreement runs until the earlier of Donald's 75th birthday or his termination (1) by reason of death or disability; (2) for cause; or (3) without cause. Under the Employment Agreement, Donald can declare a "Constructive Termination Without Cause" by the Company of his employment [**5] as a result of, *inter alia,* "unreasonable interference, in the good-faith judgment of . . . [Donald], by the Board or a substantial stockholder of the Company, in [Donald's] carrying out his duties and responsibilities under the [Employment] Agreement." A Constructive Termination Without Cause takes effect after delivery of notice by Donald and the failure by the Board to remedy such interference.

In the event of a Termination Without Cause, constructive or otherwise, Donald is entitled to the following:

> 1. Continued payment of his "Base Salary" at the level in effect immediately prior to termination for the remainder of his "Term of Employment," which, as stated, will be 6 1/2 years unless Donald dies or turns 75 first. In 1992, Donald's Base Salary exceeded $ 650,000.
>
> 2. Annual incentive awards for the remainder of the Term of Employment equal to the average of the three highest annual bonuses awarded to Donald during his last ten years as CEO. In 1992, such award allegedly equaled $ 300,000.
>
> 3. Medical benefits for Donald and his wife for life, as well as his children until the age of 23.
>
> 4. Continued participation in all employee benefit plans [**6] in which Donald is participating on the date of termination until the earlier of the expiration of the Term of Employment or the date on which he receives equivalent benefits from a subsequent employer.
>
> 5. Other (unidentified) benefits in accordance with DSC's plans and programs. *See* Am.Cplt.Ex. 1 § 11(d).

Grimes v. Donald, Del. Ch., *20 Del. J. Corp. L. 757, 765 (1995).*

The Income Continuation Plan provides, *inter alia,* that after Base Salary payments cease under the Employment Agreement, Donald is entitled to receive, for the remainder of his life, annual payments equal to the average of the sum of his Base Salary plus bonuses in the three highest years, multiplied by 3%, multiplied by his years of service. Donald has also been awarded 200,000 "units" under the Long Term Incentive Plan. In the event of a Change of Control, as defined in the Incentive Plan, Donald will have the right to cash payments for his units, which Grimes alleges could total $ 60,000,000 at the stock price in effect at the time the complaint was filed.

As required by Court of Chancery Rule 23.1, Grimes alleges in his complaint that he wrote to the Board on September 23, 1993 and demanded [**7] that the Board abrogate the Agreements. The demand letter states, in part:

> Paragraph 2(c) of the Employment Agreement dated as of January 1, 1990, between the Company and Mr. Donald purports to vest in Mr. Donald "the general management of the affairs of the Company." Under Paragraph 1(f)(vii) of the Employment Agreement, Mr. Donald is deemed to have been constructively terminated without cause, if there is "unreasonable interference, in the good-faith judgment of [Mr. Donald], by the Board or a substantial stockholder of the Company, in [Mr. Donald's] carrying out his duties and responsibilities under the Agreement."
>
> Paragraph 1(f)(vii), therefore, purports to put Mr. Donald in a position unilaterally to declare a "constructive termination without cause" whenever he declares that the Board has "unreasonably interfered" with his general management of the affairs of the Company. Other provisions, including, without limitation, Paragraphs 11(d) and 27 of the Employment Agreement and Paragraph 4(b) of the DSC Communications Corporation Executive Income Continuation Plan dated as of January 1, 1990, between the Company and Mr. Donald, would impose drastic costs and burdens on [**8] the Company in the event of such a "constructive termination without cause."
>
> [*1212] The effect of the cited provision is to delegate the duties and responsibilities of the Board of Directors to Mr. Donald. This delegation is contrary to law and inconsistent with the certificate of incorporation and bylaws of the Company.
>
> * * *
>
> The cited provisions of the Employment Agreement are therefore void as a matter of law. Although they are void, they should be abrogated so as to leave no cloud upon the lawful conduct of the Company's affairs. And it should go without saying that the Board must refrain from conducting the business of the Company as if they were valid.
>
> * * *
>
> Accordingly, I hereby demand that the Board of Directors take immediate steps to abrogate Paragraphs 1(f)(vii) and 2(c) of the Employment Agreement dated as of January 1, 1990, between the Company and James L. Donald, and the 1990 Long-Term Incentive Compensation Plan insofar as it applies to Mr. Donald.

The Board refused the demand in a letter dated November 8, 1993, which states in part:

> The Compensation Committee of our Board of Directors, as well as the entire Board, have seriously considered the issues set [**9] forth in your letter of September 29. To assist in the review, the Board obtained reports analyzing the relevant issues from the Company's outside benefits consultant, Hirschfeld, Stern, Moyer & Ross, Inc. and from the Company's outside legal counsel, Jones, Day, Reavis & Pogue. The Compensation Committee and the full Board of Directors believe that a thorough analysis of the applicable provisions of Delaware law necessarily leads to a conclusion that Mr. Donald's duties as described in the Employment Agreement do not constitute an impermissible delegation of the duties of the Board of Directors.
>
> * * *
>
> Accordingly, the provisions relating to the Board's actions set forth in Sections 11(d) and 1(f)(vii) of the Employment Agreement simply relate to the consequences of the Board's unreasonable interference with Mr. Donald's properly

> delegated duties. These provisions do not limit the Board's right to guide the Company through the formulation of policy or its right to take any other action it desires to take. They simply represent the agreement between the Company and Mr. Donald regarding the circumstances that will create a constructive termination of his employment and the consequences [**10] of such an event.
>
> Based on the foregoing, the Board has concluded that the description of Mr. Donald's duties in the Employment Agreement do not constitute an impermissible delegation of the duties of the Board of Directors. Consequently, the Board declines to take any action to abrogate any provision of the Employment Agreement or the 1990 Long-Term Incentive Compensation Plan as you have requested.

II. Grimes Has Not Stated a Claim for Abdication of Directorial Duty.

Despite the fact that Grimes demanded that the Board abrogate the Agreements and his demand was refused, the Court of Chancery declined to review the Board's decision to refuse the demand under the business judgment rule, stating:

> Whether these contracts do violate *Section 141* is a question of law directly concerning the legal character of the contract and its effect upon the directors. The question whether these contracts are valid or not does not fall into the realm of business judgment; it cannot be definitively determined by the informed, good faith judgment of the board. It must be determined by the court.

Grimes, 20 Del. J. Corp. L. at 771 (citing *Blasius Indus., Inc. v. Atlas* [**11] *Corp., Del. Ch., 564 A.2d 651, 663 (1988)*, which involved a direct action against the board of directors). We agree that the Court of Chancery appropriately analyzed the abdication claim as a direct--as distinct from a derivative--claim.

Courts have long recognized that the same set of facts can give rise both to a direct claim and a derivative claim. *Bennett v. Breuil Petroleum Corp., Del. Ch., 34 Del. Ch. 6, 99 A.2d* [*1213] *236, 241 (1953)*; *Borak v. J.I. Case Co., 7th Cir., 317 F.2d 838, 844-45 (1963), aff'd, 377 U.S. 426, 12 L. Ed. 2d 423, 84 S. Ct. 1555 (1964)*. The due care, waste and excessive compensation claims asserted here are derivative and will be considered as such. *Kramer v. Western Pacific Indus., Inc., Del. Supr., 546 A.2d 348, 353 (1988)*. The abdication claim, however, is a direct claim. In order to reach this conclusion, we believe a further exploration of the distinction between direct and derivative claims is appropriate.

A. Distinction Between Direct and Derivative Claims, Generally

As the Court of Chancery has noted: "Although the tests have been articulated many times, it is often difficult to distinguish between a derivative and an individual [**12] action." *In re Rexene Corp. Shareholders Litig.*, Del. Ch., *17 Del. J. Corp. L. 342, 348 (1991)*; *see also Abelow v. Symonds, Del. Ch., 38 Del. Ch. 572, 156 A.2d 416, 420 (1959)* ("line of distinction ... is often a narrow one..."). The distinction depends upon "'the nature of the wrong alleged' and the relief, if any, which could result if plaintiff were to prevail." *Kramer v. Western Pacific, 546 A.2d at 352* (quoting *Elster v. American Airlines, Inc., Del. Ch., 34 Del. Ch. 94, 100 A.2d 219, 221-223 (1953))*. To pursue a direct action, the stockholder-plaintiff "must allege more than an injury resulting from a wrong to the corporation." *Id. at 351*. The plaintiff must state a claim for "'an injury which is separate and distinct from that suffered by other shareholders,' ... or a wrong involving a contractual right of a shareholder ... which exists independently of any right of the corporation." *Moran v. Household Int'l, Inc., Del. Ch., 490 A.2d 1059, 1070, aff'd, Del. Supr., 500 A.2d 1346 (1985)* (quoting 12B FLETCHER CYCLOPEDIA CORPS., § 5291 (Perm. Ed. 1984)).

The American Law Institute ("ALI") *Principles of Corporate Governance: Analysis and Recommendations* [**13] (1992) *("Principles")* is helpful in this instance. Section 7.01 of the *Principles* undertakes to state the common law with respect to the distinction between direct and derivative actions. *Id.* § 7.01, cmt. a. The Comment also discusses a situation relevant to the case *sub judice:*

> In some instances, actions that essentially involve the structural relationship of the shareholder to the corporation ... may also give rise to a derivative action when the corporation suffers or is threatened with a loss. One example would be a case in which a corporate official knowingly acts in a manner that the certificate of in-

> corporation [or the Delaware General Corporation Law] denied the official authority to do, thereby violating both specific restraints imposed by the shareholders [or the GCL] and the official's duty of care.

Id., cmt. c. The Comment further notes that, "courts have been more prepared to permit the plaintiff to characterize the action as direct when the plaintiff is seeking only injunctive or prospective relief." *Id.*, cmt. d.

With respect to the abdication claim, Grimes seeks only a declaration of the invalidity of the Agreements. Monetary [**14] recovery will not accrue to the corporation as a result. Chancellor Seitz illustrated this distinction in *Bennett.* The Court of Chancery there allowed the plaintiff-stockholder to proceed individually on his claim that stock was issued for an improper purpose and entrenchment; he proceeded derivatively on his claim that the stock was issued for an insufficient price. *99 A.2d at 241.*

B. Applicable Pleading Standards

Since the abdication claim is direct, not derivative, a motion to dismiss such a claim pursuant to Chancery Rule 12(b)(6) implicates the pleading standard of Chancery Rule 8(a). *Solomon v. Pathe Communications Corp., Del. Supr., 672 A.2d 35, 39*, Hartnett, J. (1996). Neither the pleading standard of Chancery Rule 9(b) ("circumstances constituting fraud or mistake shall be stated with particularity") nor that of Chancery Rule 23.1 which requires, with respect to derivative claims, that a plaintiff plead "with particularity the efforts, if any . . . to obtain the action the plaintiff desires . . . and the reasons for the . . . failure to obtain the action or for not making the effort," is implicated. Chancery Rule [**15] 8(a), which is implicated here, requires only "a short and plain statement of the claim." In considering a motion to dismiss for failure to state a direct claim, the Court of Chancery assumes the truth of well-pleaded [*1214] allegations, giving to the plaintiff "the benefit of all reasonable inferences that can be drawn from ... [the] pleading." *In re USA Cafes, L.P. Litig., Del. Ch., 600 A.2d 43, 47 (1991)*; *see also In re Santa Fe Pacific Corp. Shareholder Litig., Del. Supr., 669 A.2d 59, 65-66 (1995)*. Conclusory statements without supporting factual averments will not be accepted as true for purposes of a motion to dismiss. *In re Tri-Star Pictures, Inc. Litig., Del. Supr., 634 A.2d 319, 326 (1995)*. We review *de novo* the decision by the Court of Chancery on a motion to dismiss a direct claim, applying the same legal standard. *Solomon v. Pathe Communications Corp., 672 A.2d at 38.*

C. Analysis of Grimes' Abdication Claim

In the case before us, the abdication claim fails as a matter of law. Grimes claims that the potentially severe financial penalties which the Company would incur in the event that the Board attempts to interfere in Donald's management of the Company [**16] will inhibit and deter the Board from exercising its duties under *Section 141(a)*. [1] The Court of Chancery assumed that, if a contract could have the practical effect of preventing a board from exercising its duties, it would amount to a *de facto* abdication of directorial authority. [2] The Chancellor concluded, however, that Grimes has not set forth well-pleaded allegations which would establish such a situation. We agree.

1 *Section 141(a)* provides that: "The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors...." *8 Del. C. § 141(a)*.

2 The cases cited by Grimes involve *formal* abdication by a board of directors. *See Chapin v. Benwood Foundation, Inc., Del. Ch., 402 A.2d 1205 (1979)* (trustees agreed to appoint particular person to future vacancy on board); *Abercrombie v. Davies, Del. Ch., 35 Del. Ch. 599, 123 A.2d 893 (1956), rev'd on other grounds, Del. Supr., 130 A.2d 338, 36 Del. Ch. 371 (1957)* (directors agreed to vote unanimously or submit to outside arbitrator).

[**17] Putting aside the payments which would result from a change of control, Grimes has pleaded, at most, that Donald would be entitled to $ 20 million in the event of a Constructive Termination. The Chancellor found, in light of the financial size of DSC reflected in the exhibits to the complaint, that this amount would not constitute a *de facto* abdication. Grimes contends, however, that the payments could amount to a *de facto* abdication in possible future circumstances. Such a set of facts has not been pleaded, is not before this Court, is based on speculation, and is not ripe for adjudication. [3]

3 The Chancellor perceptively notes that "an even more difficult case would be presented where the terms of a CEO's employment contract came to have the practical effect of precluding the board from exercising its statutory powers and satisfying its fiduciary duty, but that effect was not reasonably foreseeable at the time the contract rights were negotiated at arm's-length." *Grimes, 20 Del. J. Corp. L. at 775* n.8.

[**18]

Directors may not delegate duties which lie "at the heart of the management of the corporation." *Chapin v. Benwood, Del. Ch., 402 A.2d 1205, 1210 (1979), aff'd sub nom. Harrison v. Chapin, Del. Supr., 415 A.2d 1068 (1980).* A court "cannot give legal sanction to agreements which have the effect of removing from directors in a very substantial way their duty to use their own best judgment on management matters." *Abercrombie v. Davies, Del. Ch., 35 Del. Ch. 599, 123 A.2d 893, 899 (1956), rev'd on other grounds, Del. Supr., 130 A.2d 338, 36 Del. Ch. 371 (1957).* Distinguishing these cases, however, the Court of Chancery stated: "Unlike the agreements considered in *Abercrombie* and *Chapin,* the Donald Agreements do not formally preclude the DSC board from exercising its statutory powers and fulfilling its fiduciary duty." *Grimes, 20 Del. J. Corp. L. at 774-775. Compare Rosenblatt v. Getty Oil Co., Del. Supr., 493 A.2d 929, 943-44 (1985)* (delegation to independent appraiser of responsibility to value oil and gas reserves as part of a merger agreement was proper exercise of business judgment).

With certain exceptions, "an informed decision to delegate a task is as much an exercise [**19] of business judgment as any other." *Rosenblatt, 493 A.2d at 943.* Likewise, business decisions are not an abdication of directorial authority merely because they limit a board's freedom of future action. A board which has decided to manufacture bricks has less freedom to decide to make bottles. In a world of scarcity, a decision to do one thing will commit [*1215] a board to a certain course of action and make it costly and difficult (indeed, sometimes impossible) to change course and do another. This is an inevitable fact of life and is not an abdication of directorial duty.

If the market for senior management, in the business judgment of a board, demands significant severance packages, boards will inevitably limit their future range of action by entering into employment agreements. Large severance payments will deter boards, to some extent, from dismissing senior officers. If an independent and informed board, acting in good faith, determines that the services of a particular individual warrant large amounts of money, whether in the form of current salary or severance provisions, the board has made a business judgment. That judgment normally will receive the protection of the business [**20] judgment rule unless the facts show that such amounts, compared with the services to be received in exchange, constitute waste or could not otherwise be the product of a valid exercise of business judgment. *See, e.g., Saxe v. Brady, Del. Ch., 40 Del. Ch. 474, 184 A.2d 602, 610 (1962).*

The Board of DSC retains the ultimate freedom to direct the strategy and affairs of the Company. If Donald disagrees with the Board, the Company may or may not (depending on the circumstances) be required to pay him a substantial sum of money in order to pursue its chosen course of action. So far, we have only a rather unusual contract, but not a case of abdication. [4] The Chancellor correctly dismissed the abdication claim.

> 4 The unfortunate choice of language in the Employment Agreement should not obscure the fact that, in many cases, large severance payments do not necessarily preclude a formerly passive board from asserting its power over a CEO. The Court of Chancery, in dismissing the claim, nonetheless disparaged as "foolish" and "ill-conceived" the language of the agreement introducing the concept of the Board committing "unreasonable interference" in the discharge of Donald's duties, "in the good faith judgment of the Executive. . . ." *20 Del. J. Corp. L. at 777.* We agree that, on the surface, this unfortunate choice of words is "badly flawed" in terms of traditional concepts of corporate governance. *Id.* When the Employment Agreement is read as a whole, however, the initial perception of unlawful delegation gives way to the reality that the Agreement is not--on its face--a wrongful delegation. This poor choice of language in the Agreements is not actionable *per se.* What actually may happen in the future may or may not ever become a litigable issue that is ripe for adjudication.

[**21] **III. Grimes' Demand on The Board With Respect to The DerivativeClaim Conceded That Demand Was Required.**

The complaint alleges that Grimes made a pre-suit demand on the Board in the September 29, 1993, letter quoted above. In summary, the letter described the relevant provisions of the Donald Agreements and demanded that the Board "take immediate steps to abrogate" the cited sections of the Agreements. The Court of Chancery held that, by "making demand upon the board, plaintiff has in effect conceded that the board was in a position to consider and act upon his demand." *Grimes, 20 Del. J. Corp. L. at 772* (citing *Spiegel v. Buntrock, Del. Supr., 571 A.2d 767, 775 (1990)).* Contending that demand was excused, Grimes later filed suit alleging waste, excessive compensation and due care claims arising out of the Agreements. But the Chancellor held that Grimes waived his right to argue that demand was excused with respect to these claims because he had already made demand that the agreements be abrogated as unlawful. *Id.* We agree.

A. The Demand Requirement in Perspective

Because the prolix (43 page) complaint tends to confuse the issues in this case, [**22] it is appropriate to restate, as a matter of background, the Delaware jurisprudence relating to stockholder derivative litigation.

If a claim belongs to the corporation, it is the corporation, acting through its board of directors, which must make the decision whether or not to assert the claim. "The derivative action impinges on the managerial freedom of directors." *Pogostin v. Rice, Del. Supr., 480 A.2d 619, 624 (1984)*. "The demand requirement is a recognition of the fundamental precept that directors manage the business and affairs of the corporation." *Aronson v. Lewis, Del. Supr., 473 A.2d 805, 812 (1984)*.

[*1216] A stockholder filing a derivative suit must allege either that the board rejected his pre-suit demand that the board assert the corporation's claim or allege with particularity why the stockholder was justified in not having made the effort to obtain board action. This is a "basic principle of corporate governance" and is a matter of substantive law embodied in the procedural requirements of Chancery Rule 23.1. [5]

5 *Kamen v. Kemper Fin. Svcs., Inc., 500 U.S. 90, 111 S. Ct. 1711, 1719, 114 L. Ed. 2d 152 (1991)*; *see also Fed. R. Civ. P. 23.1.*

[**23]

One ground for alleging with particularity that demand would be futile is that a "reasonable doubt" exists that the board is capable of making an independent decision to assert the claim if demand were made. [6] The basis for claiming excusal would normally be that: (1) a majority of the board has a material financial or familial interest; [7] (2) a majority of the board is incapable of acting independently for some other reason such as domination or control; [8] or (3) the underlying transaction is not the product of a valid exercise of business judgment. [9] If the stockholder cannot plead such assertions consistent with Chancery Rule 11, [10] after using the "tools at hand" [11] to obtain the necessary information before filing a derivative action, then the stockholder must make a pre-suit demand on the board.

6 *Aronson, 473 A.2d at 814.*

7 *Id. at 815.*

8 *Rales v. Blasband, Del. Supr., 634 A.2d 927, 936 (1993)*. Demand is not excused simply because plaintiff has chosen to sue all directors. *Id.* Likewise, a plaintiff cannot necessarily disqualify all directors simply by attacking a transaction in which all participated. *Pogostin v. Rice, 480 A.2d at 627*. To hold otherwise would permit plaintiffs to subvert the particularity requirements of Rule 23.1 simply by designating all the directors as targets.

[**24]

9 *Aronson, 473 A.2d at 814.*

10 Rule 11 mandates that by signing a pleading, the attorney certifies "that to the best of the person's knowledge, information and belief, formed after an inquiry reasonable under the circumstances . . . the allegations and other factual contentions have evidentiary support, or if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery; . . ." Ct. Ch. R. 11(b)(3).

11 In *Rales* we undertook to describe some of those "tools at hand":

> Although derivative plaintiffs may believe it is difficult to meet the particularization requirement of *Aronson* because they are not entitled to discovery to assist their compliance with Rule 23.1, *see Levine v. Smith, 591 A.2d 194, 208-10 (Del. 1991)*, they have many avenues available to obtain information bearing on the subject of their claims. For example, there is a variety of public sources from which the details of a corporate act may be discovered, including the media and governmental agencies such as the Securities and Exchange Commission. In addition, a stockholder who has met the procedural requirements and has shown a specific proper purpose may use the summary procedure embodied in *8 Del. C. § 220* to investigate the possibility of corporate wrongdoing. *Compaq Computer Corp. v. Horton, Del. Supr., 631 A.2d 1 (1993)....* Surprisingly, little use has been made of *section 220* as an information-gathering tool in the derivative context. Perhaps the problem arises in some cases out of an unseemly race to the court house, chiefly generated by the "first to file" custom seemingly permitting the winner of the race to be named lead counsel. The result has been a plethora of superficial complaints that could not be sustained. Nothing requires the Court of Chancery, or any other court having appropriate jurisdiction, to coun-

> tenance this process by penalizing diligent counsel who has employed these methods, including *section 220*, in a deliberate and thorough manner in preparing a complaint that meets the demand excused test of *Aronson.*

634 A.2d at 934-935 n.10.

[**25] The demand requirement serves a salutary purpose. First, by requiring exhaustion of intracorporate remedies, the demand requirement invokes a species of alternative dispute resolution procedure which might avoid litigation altogether. [12] Second, if litigation is beneficial, the corporation can control the proceedings. Third, if demand is excused or wrongfully refused, the stockholder will normally control the proceedings. [13]

12 *Aronson, 473 A.2d at 811-812*; *Cramer v. General Tel. & Elecs. Corp., 3d Cir., 582 F.2d 259, 275 (1978), cert. denied, 439 U.S. 1129, 59 L. Ed. 2d 90, 99 S. Ct. 1048 (1979).*

13 This Court has held that in demand-excused cases the board of directors may sometimes reassert its authority over a derivative claim in certain instances through the device of the Special Litigation Committee ("SLC"). *Zapata Corp. v. Maldonado, Del. Supr., 430 A.2d 779 (1981).* The use of a committee of the board formed to respond to a demand or to advise the board on its duty in responding to a demand is not the same as the SLC process contemplated by *Zapata,* however. It is important that these discrete and quite different processes not be confused.

[**26] [*1217] The jurisprudence of *Aronson* and its progeny is designed to create a balanced environment which will: (1) on the one hand, deter costly, baseless suits by creating a screening mechanism to eliminate claims where there is only a suspicion expressed solely in conclusory terms; [14] and (2) on the other hand, permit suit by a stockholder who is able to articulate particularized facts showing that there is a reasonable doubt either that (a) a majority of the board is independent for purposes of responding to the demand, or (b) the underlying transaction is protected by the business judgment rule. [15]

14 Block, Radin & Maimone, *Derivative Litigation: Current Law Versus The American Law Institute, 48 Bus. Law. 1443, 1454 (1993)*; Dooley & Veasey, *The Role of the Board in Derivative Litigation, 44 Bus. Law. 503, 539 (1989).* Such a concern is not of recent vintage. *See* Note, *Extortionate Corporate Litigation: The Strike Suit,* 34 Colum. L. Rev. 1308 (1934). While the Delaware approach differs from that developed in Part VII of the American Law Institute's Principles of Corporate Governance, many of the goals are the same: "The end result should be that the board's or committee's determinations serve as a vehicle by which an early screening of the action's probable merit and its likely impact upon the corporation is achieved." PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, Part VII, Ch. 1, Introductory Notes, at 9 (1992); *see also* M0DEL BUSINESS CORP. ACT § 7.42 (1991).

[**27]

15 Such a test implicates a determination by the Court of Chancery which involves "essentially a discretionary ruling on a predominately factual issue." *Grobow v. Perot, Del. Supr., 539 A.2d 180, 186 (1988).* Judging whether demand is excused "is inescapably a question of judgment... ." *Harris v. Carter, Del. Ch., 582 A.2d 222, 229 (1990).* The exercise of discretion by experienced and capable judges is a satisfactory screening mechanism, in our view.

Aronson introduced the term "reasonable doubt" into corporate derivative jurisprudence. Some courts and commentators have questioned why a concept normally present in criminal prosecution would find its way into derivative litigation. [16] Yet the term is apt and achieves the proper balance. Reasonable doubt can be said to mean that there is a reason to doubt. [17] This concept is sufficiently flexible and workable to provide the stockholder with "the keys to the courthouse" [18] in an appropriate case where the claim is not based on mere suspicions or stated solely in conclusory terms.

16 *See* Coffee, *New Myths and Old Realities: The American Law Institute Faces the Derivative Action, 48 Bus. Law. 1407, 1413 (1993)*; *Starrels v. First Nat'l Bank of Chicago, 7th Cir., 870 F.2d 1168, 1174 (1989)* (Easterbrook, J., concurring). Some have contended that the Delaware jurisprudence has erected unfortunate barriers to derivative litigation. *See* Coffee, *48 Bus. Law. at 1411. See also* Seligman, *The New Corporate Law, 59 Brook. L. Rev. 1, 27 (1993)*; Gevurtz, *Who Represents the Corporation? In Search of a Better Method for Determining the Corporate Interest in Derivative Suits, 46 U. Pitt. L. Rev. 265, 285 (1985).* We disagree. *See Rales, 634 A.2d at 934*; *see also* Moore, *Shareholder Rights Still Alive and Well in Delaware: The Derivative Suit: A Death Greatly Exaggerated, 38 St. Louis L. J. 947 (1994).* Professor Coffee admits the possibil-

ity that: "Arguably, the open-textured latitude inherent in *Aronson's* test may be its saving grace." *48 Bus. Law. at 1413.*

[**28]

17 Stated obversely, the concept of reasonable doubt is akin to the concept that the stockholder has a "reasonable belief" that the board lacks independence or that the transaction was not protected by the business judgment rule. The concept of reasonable belief is an objective test and is found in various corporate contexts. *See 8 Del. C. § 145(a) & (b). Cf.* THE MODEL BUSINESS CORP. ACT § 8.30. *See also* ALI, PRINCIPLES 0F CORP. GOVERNANCE § 4.01(a). *Compare* Veasey & Manning, *Codified Standard--Safe Harbor or Unchartered Reef,* 35 Bus. Law. 919 (1980), *with* Arsht & Hinsey, *Codified Standard--Safe Harbor but Chartered Channel,* 35 Bus. Law. No. 4, ix (1980).

18 *See* Dooley & Veasey, *44 Bus. Law. at 504.*

B. Wrongful Refusal Distinguished from Excusal

Demand has been excused in many cases in Delaware under the *Aronson* test. [19] The law regarding wrongful refusal is [*1218] not as well developed, however. [20] Although Delaware law does not require demand in every case [21] because Delaware does have the mechanism of demand excusal, it is important that [**29] the demand process be meaningful. Therefore, a stockholder who makes a demand is entitled to know promptly what action the board has taken in response to the demand. A stockholder who makes a serious demand and receives only a peremptory refusal has the right to use the "tools at hand" to obtain the relevant corporate records, such as reports or minutes, reflecting the corporate action and related information in order to determine whether or not there is a basis to assert that demand was wrongfully refused. [22] In no event may a corporation assume a position of neutrality and take no position in response to the demand. *Kaplan v. Peat, Marwick, Mitchell & Co., Del. Supr., 540 A.2d 726 (1988).*

19 Some of the relatively recent cases include the following: *Heineman v. Datapoint Corp., Del. Supr., 611 A.2d 950 (1992)*; *Harris v. Carter, Del. Ch., 582 A.2d 222 (1990)*; *Friedman v. Beningson,* Del. Ch., C.A. No. 12232, 1995 WL 716762, Allen C. (Dec. 4, 1995); *Good v. Texaco, Inc.,* Del. Ch., *9 Del. J. Corp. L. 461 (1984)*; *Kells-Murphy v. McNiff,* C.A. No. 11009, 1991 WL 137143, Jacobs, V.C. (July 12, 1991); *Seibert v. Harper & Row Publishers, Inc.,* Del. Ch., *10 Del. J. Corp. L. 645 (1984)*; *Edelman v. Phillips Petroleum Co.,* Del. Ch., *10 Del. J. Corp. L. 835 (1985)*; *Moran v. Household Int'l, Inc., Del. Ch., 490 A.2d 1059, aff'd on other grounds, Del. Supr., 500 A.2d 1346 (1985)*; *L.A. Partners, L.P. v. Allegis Corp.,* Del. Ch., [1987 - 1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,505 at 97,247 (1987); *In re Chrysler Corp. Shareholders Litig.,* Del. Ch., [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,505 (1992); *Chrysogelos v. London,* Del. Ch., C.A. No. 11910, 1992 WL 58516, Jacobs, V.C. (Mar. 25, 1992); *Abajian v. Kennedy,* Del. Ch., *18 Del. J. Corp. L. 179 (1992)*; *Strougo v. Carroll,* Del. Ch., *17 Del. J. Corp. L. 352 (1991)*; *In re NVF Co. Litig.,* Del. Ch., *16 Del. J. Corp. L. 361 (1989)*; *Manchester v. Narragansett Capital, Inc., Del. Ch., C.A. No. 10822, 1989 Del. Ch. LEXIS 141 (Oct. 18, 1989)*; *Siegman v. Tri-Star Pictures, Inc.,* Del. Ch., *15 Del. J. Corp. L. 218 (1989), aff'd and rev'd on other grounds sub nom., In re Tri-Star Pictures, Inc. Litig., Del. Supr., 634 A.2d 319 (1993)*; *Sealy Mattress Co. of N.J., Inc. v. Sealy, Inc., Del. Ch., Fed. Sec. L. Rep. (CCH) P 93,331 (July 20, 1987)*; *Tomczak v. Morton Thiokol, Inc.,* Del. Ch., *12 Del. J. Corp. L. 381 (1986)*; *Lewis v. Hea,* Del. Ch., *10 Del. J. Corp. L. 240 (1984)* (waste); *Stein v. Orloff,* Del. Ch., *11 Del. J. Corp. L. 312 (1985)* (waste); *Avacus Partners, L.P. v. Brian,* Del. Ch., [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,232 (Oct. 24, 1990); *Andreae v. Andreae,* Del. Ch., *18 Del. J. Corp. L. 197 (1992)*; *Rosan v. Chicago Milwaukee Corp.,* Del. Ch., *16 Del. J. Corp. L. 378 (1990)*; *Lewis v. Aronson,* Del. Ch., *11 Del. J. Corp. L. 243 (1985)*; *Katell v. Morgan Stanley Group, Inc.,* Del. Ch., [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,437 (1993); *Steiner v. Meyerson, [1995 Transfer Binder] 1995 Del. Ch. LEXIS 95, Fed. Sec. L. Rep. (CCH) P 98,857 (1995)*; *Kahn v. Tremont* Corp., Del. Ch., C.A. No. 12339, 1994 WL 162613, Allen, C. (April 21, 1994); *Yaw v. Talley,* Del. Ch., *20 Del. J. Corp. L. 454 (1994)*; *Leslie v. Telephonics Office Tech., Inc.,* Del. Ch., *19 Del. J. Corp. L. 1237 (1993)*; *Kahn v. Roberts,* Del. Ch., [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,201 (1994); *Emerald Partners v. Berlin,* Del. Ch., *19 Del. J. Corp. L. 1182 (1993)*; *Rothenberg v. Santa Fe Pacific Corp.,* Del. Ch., C.A. No. 11749, 1995 WL 523559, Jacobs, V.C. (Sept. 5, 1995).

[**30]

20 *See, e.g., Levine v. Smith, Del. Supr., 591 A.2d 194 (1991)*; *Allison v. General Motors Corp., D. Del., 604 F. Supp. 1106 (1985)*; *Levit v. Shrontz,* Del. Ch., C.A. No. 11273, 1994 WL 30542, Berger, V.C. (Jan. 19, 1994); *Mount Mo-*

riah Cemetery v. Moritz, Del. Ch., Fed. Sec. L. Rep. (CCH) P 95,900 (April 4, 1991); *Stepak v. Addison, 11th Cir., 20 F.3d 398 (1994). See also* Coffee, *48 Bus. Law. 1407.*

21 The ALI *Principles* and the American Bar Association's *Model Business Corporation Act* § 7.42(1), both are premised upon the concept of universal demand--that is, a requirement that demand must be made in every case. The *Principles* and the *Model Act* then go in directions which are different from Delaware law and different from each other in determining the manner in which derivative litigation is to be conducted or terminated after demand has been made. In reversing the decision of the United States Court of Appeals for the Seventh Circuit, which had adopted the universal demand rule in a derivative suit under the Investment Company Act of 1940, the Supreme Court of the United States held that state law applied and analyzed the implications of the universal demand rule compared with the traditional rule exemplified by Delaware law. *Kamen v. Kemper Fin. Svcs., Inc., 500 U.S. 90, 111 S. Ct. 1711, 1719-23, 114 L. Ed. 2d 152 (1991).*

[**31]

22 *See* note 11, *supra.* Normally, however, the discovery procedures of Chancery Rules 26-37 are not available to a stockholder to uncover the basis for a claim not yet stated with particularity. *Levine, 591 A.2d at 209.* For a view to the contrary, see Note, *Discovery in Federal Demand-Refused Litigation, 105 Harv. L. Rev. 1025 (1992).*

If a demand is made, the stockholder has spent one--but only one--"arrow" in the "quiver." The spent "arrow" is the [*1219] right to claim that demand is excused. [23] The stockholder does not, by making demand, waive the right to claim that demand has been wrongfully refused. [24]

23 *Spiegel, 571 A.2d 767*; *accord* Demott, SHAREHOLDER DERIVATIVE ACTIONS LAW AND PRACTICE § 5:11.

24 *Levine, 591 A.2d at 210*; *Allison, 604 F. Supp. at 1121.*

Simply because the composition of the board provides no basis *ex ante* for the stockholder to claim with particularity [**32] and consistently with Rule 11 that it is reasonable to doubt that a majority of the board is either interested or not independent, it does not necessarily follow *ex post* that the board in fact acted independently, disinterestedly or with due care in response to the demand. A board or a committee of the board may appear to be independent, but may not always act independently. [25] If a demand is made and rejected, the board rejecting the demand is entitled to the presumption of the business judgment rule unless the stockholder can allege facts with particularity creating a reasonable doubt that the board is entitled to the benefit of the presumption. [26] If there is reason to doubt [27] that the board acted independently or with due care in responding to the demand, the stockholder may have the basis *ex post* to claim wrongful refusal. The stockholder then has the right to bring the underlying action with the same standing which the stockholder would have had, *ex ante,* if demand had been excused as futile. *See Stepak v. Addison, 11th Cir., 20 F.3d 398 (1994).*

25 *See Kahn v. Lynch Communication Sys., Del. Supr., 638 A.2d 1110, 1120-21 (1994) ("Kahn I")* ("independent committee" of the board did not act independently when it succumbed to threat of controlling stockholder, thus invoking entire fairness analysis rather than business judgment rule).

[**33]

26 *Levine, 591 A.2d at 212*; *Allison, 604 F. Supp. at 1121.* For an analysis, generally, of the nature of the business judgment rule presumption and the manner in which it may be overcome, *see Cinerama, Inc. v. Technicolor, Inc., Del. Supr., 663 A.2d 1156, 1162 (1995)*; 1 Balotti & Finkelstein, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.6 at 4-43 to 4-67 (1996 Supp.).

27 This may be clear on the face of the refusal or may be developed through the tools at hand. *See* note 11 *supra. See also Thorpe v. CERBCO, Inc., Del. Ch., 611 A.2d 5, 11(1991).*

C. Application to This Case

In the case before the Court, plaintiff made a pre-suit demand. [28] Later, however, plaintiff contended that demand was excused. Under the doctrine articulated by this Court in *Spiegel v. Buntrock,* [29] plaintiff, by making a demand, waived his right to contest the independence of the board. As the Court Of Chancery properly held, plaintiff may not bifurcate his theories relating to the same claim. Thus, demand having been made as to the propriety of the Agreements, [**34] it cannot be excused as to the claim that the Agreements constituted waste, excessive compensation or was the product of a lack of due care.

28 Plaintiff also used the *8 Del. C. § 220* procedure.

29 *571 A.2d 767.*

The Court Of Chancery implicitly applied a test analogous to *res judicata* to determine whether Grimes' demand letter conceded that demand was required for all legal theories arising out of the set of facts described in the demand letter. We believe this to be a correct approach. The alternative claims raised in the complaint fit squarely within the same transactional rubric as the demand since all of the claims, however denominated, arise out of the Agreements. As the Court of Chancery stated: "There is little to recommend a process in which a shareholder seeks board consideration of only some aspects of a transaction or puts forward only selected theories for board consideration, while reserving other theories for judicial consideration. Such a process would be neither efficient nor [**35] fair." *Grimes, 20 Del. J. Corp. L. at 772.*

The same concerns are expressed in the *Restatement (Second) of Judgments,* which asserts that "fairness to the defendant, and sound judicial administration, require that at some point litigation over the particular controversy come to an end." *RESTATEMENT (SECOND) OF JUDGMENTS § 19, cmt. a.* (1980). Since the making of a pre-suit demand concedes [*1220] that demand is required, the concession should apply "to all or any part of the transaction, or series of connected transactions, out of which the action [demand] arose." *Id.* § 24; *see Foltz v. Pullman, Inc., Del. Super., 319 A.2d 38, 40 (1974).*

In *Spiegel,* this Court held that "a shareholder who makes a demand can no longer argue that demand is excused." *571 A.2d at 775.* Permitting a stockholder to demand action involving only one theory or remedy and to argue later that demand is excused as to other legal theories or remedies arising out of the same set of circumstances as set forth in the demand letter would create an undue risk of harassment.

In this case, the Board of DSC considered and rejected the demand. After investing the time and resources to consider and decide [**36] whether or not to take action in response to the demand, the Board is entitled to have its decision analyzed under the business judgment rule unless the presumption of that rule can be rebutted. *Spiegel, 571 A.2d at 776.* Grimes cannot avoid this result by holding back or bifurcating legal theories based on precisely the same set of facts alleged in the demand.

Since Grimes made a pre-suit demand with respect to all claims arising out of the Agreements, he was required by Chancery Rule 23.1 to plead with particularity why the Board's refusal to act on the derivative claims was wrongful. *Levine v. Smith, 591 A.2d at 211.* The complaint recites the Board's rejection of Grimes' demand and proceeds to assert why Grimes disagrees with the Board's conclusion. The complaint generally asserts that the refusal could not have been the result of an adequate, good faith investigation since the Board decided not to act on the demand. Such conclusory, *ipse dixit,* assertions are inconsistent with the requirements of Chancery Rule 23.1. *See Levine, 591 A.2d at 214.* The complaint fails to include particularized allegations which would raise a reasonable doubt that the Board's decision [**37] to reject the demand was the product of a valid business judgment. [30]

30 Counsel for defendants conceded at oral argument that there is nothing to bar plaintiff from making another such demand. Whether or not there may be a basis to assert wrongful refusal of any such future demand is not before us.

IV. Conclusion

Accordingly, the judgment Of the Court of Chancery is **AFFIRMED.**

WILLIAM BREHM and GERALDINE BREHM, as Trustees and Custodians; MICHAEL GRENING; RICHARD KAPLAN and DAVID KAPLAN, as Trustees; THOMAS M. MALLOY; RICHARD J. KAGER and CAROL R. KAGER, as Joint Tenants; MICHAEL CAESAR, as Trustee for Howard Gunty, Inc., Profit Sharing Plan; ROBERT S. GOLDBERG, I.R.A.; MICHAEL SHORE; MICHELE De BENDICTIS; PETER LAWRENCE, I.R.A.; MELVIN ZUPNICK; JUDITH B. WOHL, I.R.A.; JAMES C. HAYS; and BARNETT STEPAK, Plaintiffs Below, Appellants, v. MICHAEL D. EISNER, MICHAEL S. OVITZ, STEPHEN F. BOLLENBACH, REVETA F. BOWERS, ROY E. DISNEY, STANLEY P. GOLD, SANFORD M. LITVACK, IGNACIO E. LOZANO, JR., GEORGE J. MITCHELL, THOMAS S. MURPHY, RICHARD A. NUNIS, LEO J. O'DONOVAN, SIDNEY POITIER, IRWIN E. RUSSELL, ROBERT A.M. STERN, E. CARDON WALKER, RAYMOND L. WATSON and GARY L. WILSON, Defendants Below, Appellees. and THE WALT DISNEY COMPANY, Nominal Defendant Below, Appellee.

No. 469, 1998

SUPREME COURT OF DELAWARE

746 A.2d 244; 2000 Del. LEXIS 51

September 14, 1999, Submitted
February 9, 2000, Decided

SUBSEQUENT HISTORY: [**1] Released for Publication February 25, 2000.
On remand at, Motion denied by, Sub nomine at *In re Walt Disney Co. Derivative Litig., 2003 Del. Ch. LEXIS 52 (Del. Ch., May 28, 2003)*

PRIOR HISTORY: Court Below: Court of Chancery of the State of Delaware, in and for New Castle County. C.A. No. 15452.
In re Walt Disney Co. Derivative Litig., 731 A.2d 342, 1998 Del. Ch. LEXIS 186 (Del. Ch., 1998)

DISPOSITION: AFFIRMED IN PART, REVERSED IN PART AND REMANDED.

COUNSEL: Joseph A. Rosenthal, Esquire, Kevin Gross, Esquire of Rosenthal, Monhait, Gross & Goddess, Wilmington, Delaware; Steven G. Schulman, Esquire (argued), Edith M. Kallas, Esquire, U. Seth Ottensoser, Esquire of Milberg Weiss Bershad Hynes & Lerach, New York, New York, for Appellants.

R. Franklin Balotti, Esquire (argued), Anne C. Foster, Esquire, Srinivas M. Raju, Esquire, Peter B. Ladig, Esquire of Richards, Layton and Finger, Wilmington, Delaware, for Director Appellees.

David C. McBride, Esquire, of Young, Conaway, Stargatt & Taylor, Wilmington, Delaware; Ronald L. Olson, Esquire, George M. Garvey, Esquire. Mark H. Epstein, Esquire (argued) of Munger, Tolles & Olson, Los Angeles, California, for Appellee Ovitz.

Andre G. Bouchard, Esquire, Joel Friedlander, Esquire of Bouchard, Friedlander & MaloneyHuss, Wilmington, Delaware; Edward J. Nowak, Esquire, Jay S. Handlin, Esquire, [**2] Burbank, California; David S. McLeod, Esquire, John P. Flynn, Esquire, of Dewey Ballantine, Los Angeles, California, for Appellee The Walt Disney Company.

Stuart M. Grant, Esquire, Jay W. Eisenhofer, Esquire, Megan D. McIntyre, Esquire, of Grant & Eisenhofer, Wilmington, Delaware, for Amicus Curiae Council of Institutional Investors.

JUDGES: Before VEASEY, Chief Justice, WALSH, HOLLAND, HARTNETT and BERGER, Justices, constituting the Court en Banc. HARTNETT, Justice, concurring.

OPINION BY: VEASEY

OPINION

[*248] Upon appeal from the Court of Chancery.

VEASEY, Chief Justice:

In this appeal from the Court of Chancery, we agree with the holding of the Court of Chancery that the stockholder derivative Complaint [1] was subject to dismissal for failure to set forth particularized facts creating a reasonable doubt that the director defendants were disinterested and independent or that their conduct was protected by the business judgment rule. [2] Our affirmance, however, is in part based on a somewhat different analysis than that of the Court below or the parties. Accordingly, in the interests of justice, we reverse only to the extent of providing that one aspect of the dismissal shall be without prejudice, [**3] and we remand to the Court of Chancery to provide plaintiffs a reasonable opportunity to file a further amended complaint consistent with this opinion.

1 According to the docket entries in the Court of Chancery for C.A. No. 15452, the original complaint was filed on January 8, 1997. After some procedural steps that are not relevant to this appeal, an amended complaint was filed on May 28, 1997, apparently by agreement among the parties and in full substitution for the Complaint filed in the constituent actions. It is this amended complaint that was dismissed with prejudice by the Court of Chancery. We will, for convenience, refer to it as "the Complaint."

2 *See In re The Walt Disney Co. Derivative Litig., Del. Ch., 731 A.2d 342, 350-65, 380 (1998).*

The claims before us are that: (a) the board of directors of The Walt Disney Company ("Disney") as it was constituted in 1995 (the "Old Board") breached its fiduciary duty in approving an extravagant and wasteful Employment Agreement of [**4] Michael S. Ovitz as president of Disney; (b) the Disney board of directors as it was constituted in 1996 (the "New Board") breached its fiduciary duty in agreeing to a non-fault" termination of the Ovitz Employment Agreement, a decision that was [*249] extravagant and wasteful; and (c) the directors were not disinterested and independent. [3]

3 The Complaint sets forth other claims decided by the Court of Chancery. These included a disclosure claim along with contract and other claims against Ovitz. *See In re The Disney Co. Derivative Litig., 731 A.2d at 365-80.* No appeal was taken from the judgment of the Court of Chancery dismissing those claims with prejudice. Thus, those claims are not before us and the dismissal is final as to them.

The Complaint, consisting of 88 pages and 285 paragraphs, is a pastiche of prolix invective. It is permeated with conclusory allegations of the pleader and quotations from the media, mostly of an editorial nature (even including a cartoon). A pleader may rely on [**5] factual statements in the media as some of the "tools at hand" [4] from which the pleader intends to derive the particularized facts necessary to comply with Chancery Rule 11(b)(3) and Chancery Rule 23.1. But many of the quotations from the media in the Complaint simply echo plaintiffs' conclusory allegations. Accordingly, they serve no purpose other than to complicate the work of reviewing courts.

4 *See Rales v. Blasband, Del. Supr., 634 A.2d 927, 935 n. 10 (1993).*

This is potentially a very troubling case on the merits. On the one hand, it appears from the Complaint that: (a) the compensation and termination payout for Ovitz were exceedingly lucrative, if not luxurious, compared to Ovitz' value to the Company; and (b) the processes of the boards of directors in dealing with the approval and termination of the Ovitz Employment Agreement were casual, if not sloppy and perfunctory. On the other hand, the Complaint is so inartfully drafted that it was properly dismissed under our pleading standards [**6] for derivative suits. From what we can ferret out of this deficient pleading, the processes of the Old Board and the New Board were hardly paradigms of good corporate governance practices. Moreover, the sheer size of the payout to Ovitz, as alleged, pushes the envelope of judicial respect for the business judgment of directors in making compensation decisions. Therefore, both as to the processes of the two Boards and the waste test, this is a close case.

But our concerns about lavish executive compensation and our institutional aspirations that boards of directors of Delaware corporations live up to the highest standards of good corporate practices do not translate into a holding that these plaintiffs have set forth particularized facts excusing a pre-suit demand under our law and our pleading requirements.

This appeal presents several important issues, including: (1) the scope of review that this Court applies to an appeal from the dismissal of a derivative suit; (2) the extent to which the pleading standards required by Chancery Rule 23.1 exceed those required by Rule 8 of that Court; and (3) the scope of the business judgment rule as it interacts with the relevant pleading requirements. [**7] To some extent, the principles enunciated in this opinion restate and clarify our prior jurisprudence.

Facts

This statement of facts is taken from the Complaint. We have attempted to summarize here the essence of Plaintiffs' factual allegations on the key issues before us, disregarding the many conclusions that are not supported by factual allegations.

A. The 1995 Ovitz Employment Agreement

By an agreement dated October 1, 1995, Disney hired Ovitz as its president. He was a long-time friend of Disney Chairman and CEO Michael Eisner. At the time, Ovitz was an important talent broker in Hollywood. Although he lacked experience managing a diversified public company, other companies with entertainment operations had been interested in hiring him for high-level executive positions. [*250] The Employment Agreement was unilaterally negotiated by Eisner and approved by the Old Board. Their judgment was that Ovitz was a valuable person to hire as president of Disney, and they agreed ultimately with Eisner's recommendation in awarding him an extraordinarily lucrative contract.

Ovitz' Employment Agreement had an initial term of five years and required that Ovitz "devote his full time and best [**8] efforts exclusively to the Company," with exceptions for volunteer work, service on the board of another company, and managing his passive investments. [5] In return, Disney agreed to give Ovitz a base salary of $ 1 million per year, a discretionary bonus, and two sets of stock options (the "A" options and the "B" options) that collectively would enable Ovitz to purchase 5 million shares of Disney common stock.

5 The agreement implicitly emphasized the importance of having Disney receive Ovitz' full attention by mentioning, in a section stating the unique nature of Ovitz' services, that the Company would specifically be entitled to equitable relief if Ovitz failed to provide it with "the exclusivity of his services."

The "A" options were scheduled to vest in three annual increments of 1 million shares each, beginning on September 30, 1998 *(i.e.,* at the end of the third full year of employment) and continuing for the following two years (through September 2000). The agreement specifically provided that [**9] the "A" options would vest immediately if Disney granted Ovitz a non-fault termination of the Employment Agreement. The "B" options, consisting of 2 million shares, differed in two important respects. Although scheduled to vest annually starting in September 2001 (*i.e.,* the year *after* the last "A" option would vest), the "B" options were conditioned on Ovitz and Disney first having agreed to extend his employment beyond the five-year term of the Employment Agreement. Furthermore, Ovitz would forfeit the right to qualify for the "B" options if his initial employment term of five years ended prematurely for any reason, even if from a non-fault termination.

The Employment Agreement provided for three ways by which Ovitz' employment might end. He might serve his five years and Disney might decide against offering him a new contract. If so, Disney would owe Ovitz a $ 10 million termination payment. [6] Before the end of the initial term, Disney could terminate Ovitz for "good cause" only if Ovitz committed gross negligence or malfeasance, or if Ovitz resigned voluntarily. Disney would owe Ovitz no additional compensation if it terminated him for "good cause." Termination without [**10] cause (non-fault termination) would entitle Ovitz to the present value of his remaining salary payments through September 30, 2000, a $ 10 million severance payment, an additional $ 7.5 million for each fiscal year remaining under the agreement, and the immediate vesting of the first 3 million stock options (the "A" Options).

6 All the "A" options would have vested, but he would not receive the "B" options.

Plaintiffs allege that the Old Board knew that Disney needed a strong second-in-command. Disney had recently made several acquisitions, and questions lingered about Eisner's health due to major heart surgery. The Complaint further alleges that "Eisner had demonstrated little or no capacity to work with important or well-known subordinate executives who wanted to position themselves to succeed him," citing the departures of Disney executives Jeffrey Katzenberg, Richard Frank, and Stephen Bollenbach as examples. Thus, the Board knew that, to increase the chance for long-term success, it had to take extra [**11] care in reviewing a decision to hire Disney's new president.

But Eisner's decision that Disney should hire Ovitz as its president was not entirely well-received. When Eisner told three members of the Old Board in mid-August 1995 that he had decided to hire Ovitz, all three "denounced the decision." Although [*251] not entirely clear from the Complaint, the vote of the Old Board approving the Ovitz Employment Agreement two months later appears to have been unanimous. Aside from a conclusory attack that the Old Board followed Eisner's bidding, the Complaint fails to allege any particularized facts that the three directors changed their initial reactions through anything other than the typical process of further discussion and individual contemplation.

The Complaint then alleges that the Old Board failed properly to inform itself about the total costs and incentives of the Ovitz Employment Agreement, especially the severance package. This is the key allegation related to this issue on appeal. Specifically, plaintiffs allege that the Board failed to realize that the contract gave Ovitz an incentive to find a way to exit the Company via a non-fault termination as soon as possible because doing [**12] so would permit him to earn more than he could by fulfilling his contract. The Complaint alleges, however, that the Old Board had been advised by a corporate compensation expert, Graef Crystal, in connection with its decision to approve the Ovitz Employment Agreement. Two public statements by Crystal form the basis of the allegation that the Old Board failed to consider the incentives and the total cost of the severance provisions, but these statements by Crystal were not made until after Ovitz left Disney in December 1996, approximately 14 1/2 months after being hired.

The first statement, published in a December 23, 1996 article in the web-based magazine *Slate,* quoted Crystal as saying, in part, "Of course, the overall costs of the package would go up sharply in the event of Ovitz's termination *(and I wish now that I'd made a spreadsheet showing just what the deal would total if Ovitz had been fired at any time).*" [7] The second published statement appeared in an article about three weeks later in the January 13, 1997 edition of *California Law Business.* The article appears first to paraphrase Crystal: "With no one expecting failure, the sleeper clauses in Ovitz's contract [**13] seemed innocuous, Crystal says, explaining that no one added up the total cost of the severance package." The article then quotes Crystal as saying that the amount of Ovitz' severance was "shocking" and that *"nobody quantified this and I wish we had."* [8] One of the charging paragraphs of the Complaint concludes:

> 57. As has been conceded by Graef Crystal, the executive compensation consultant who advised the Old Board with respect to the Ovitz Employment Agreement, the Old Board *never* considered the costs that would be incurred by Disney in the event Ovitz was terminated from the Company for a reason other than cause prior to the natural expiration of the Ovtiz Employment Agreement.

7 Emphasis is in the Complaint.

8 Emphasis is in the Complaint.

Although repeated in various forms in the Complaint, these quoted admissions by Crystal constitute the extent of the factual support for the allegation that the Old Board failed properly to consider the severance elements of the agreement. [**14] This Court, however, must juxtapose these allegations with the legal presumption that the Old Board's conduct was a proper exercise of business judgment. That presumption includes the statutory protection for a board that relies in good faith on an expert advising the Board. [9] We must decide whether plaintiffs' factual allegations, if proven, would rebut that presumption.

9 *See 8 Del. C. § 141(e)*, quoted *infra* at note 51.

B. The New Board's Actions in Approving the Non-Fault Termination

Soon after Ovitz began work, problems surfaced and the situation continued to deteriorate during the first year of his employment. To support this allegation, [*252] the plaintiffs cite various media reports detailing internal complaints and providing external examples of alleged business mistakes. The Complaint uses these reports to suggest that the New Board had reason to believe that Ovitz' performance and lack of commitment met the gross negligence or malfeasance standards of the termination-for-cause provisions [**15] of the contract.

The deteriorating situation, according to the Complaint, led Ovitz to begin seeking alternative employment and to send Eisner a letter in September 1996 that the Complaint paraphrases as stating his dissatisfaction with his role and expressing his desire to leave the Company. [10] The Complaint also admits that Ovitz would not actually resign before negotiating a non-fault severance agreement because he did not want to jeopardize his rights to a lucrative severance in the form of a "non-fault termination" under the terms of the 1995 Employment Agreement.

10 The plaintiffs allegedly have never seen the actual letter.

On December 11, 1996, Eisner and Ovitz agreed to arrange for Ovitz to leave Disney on the non-fault basis provided for in the 1995 Employment Agreement. Eisner then "caused" the New Board [11] "to rubber-stamp his decision (by 'mutual consent')." This decision was implemented by a December 27, 1996 letter to Ovitz from defendant Sanford M. Litvack, an officer and director of Disney. [**16] That letter stated:

> This will confirm the terms of your agreement with the Company as follows:
>
> 1. The Term of your employment under your existing Employment Agreement with The Walt Disney Company will end at the close of business today. Consequently, your signature confirms the end of your service as an officer, and your resignation as a director, of the Company and its affiliates.
>
> 2. This letter will for all purposes of the Employment Agreement be treated as a "Non-Fault Termination." By our mutual agreement, the total amount payable to you under your Employment Agreement, including the amount payable under Section 11(c) in the event of a "Non-Fault Termination," is $ 38,888,230.77, net of withholding required by law or authorized by you. By your signature on this letter, you acknowledge receipt of all but $ 1,000,000 of such amount. Pursuant to our mutual agreement, this will confirm that payment of the $ 1,000,000 balance has been deferred until February 5, 1997, pending final settlement of accounts.
>
> 3. This letter will further confirm that the option to purchase 3,000,000 shares of the Company's Common Stock granted to you pursuant to Option A described in [**17] your Employment Agreement will vest as of today and will expire in accordance with its terms on September 30, 2002.

11 The composition of the New Board differed slightly from the composition of the Old Board. The Old Board and the New Board both included Michael D. Eisner, Roy B. Disney, Stanley P. Gold, Sanford M. Litvack, Richard A. Nunis, Sidney Poitier, Irwin E. Russell, Robert A.M. Stern, B. Cardon Walker, Raymond L. Watson, Gary L. Wilson, Reveta F. Bowers, Ignacio B. Lozano Jr. and George J. Mitchell. The Old Board included Stephen F. Bollenbach, who was not on the New Board. The New Board included Leo J. O'Donovan and Thomas S. Murphy, neither of whom was on the Old Board. Although the Complaint included Ovitz as a member of the New Board, his resignation appeared to have occurred before the New Board approved the non-fault termination. *See In re The Walt Disney Co. Derivative Litig., 731 A.2d at 351 n.3.*

Although the non-fault termination left Ovitz with what essentially was [**18] a very lucrative severance agreement, it is important to note that Ovitz and Disney had negotiated for that severance payment at the time they initially contracted in 1995, and in the end the payout to Ovitz did not exceed the 1995 contractual benefits. Consequently, Ovitz received the $ 10 million termination payment, $ 7.5 million for part of the fiscal year remaining under the [*253] agreement and the immediate vesting of the 3 million stock options (the "A" options). As a result of his termination Ovitz would not receive the 2 million "B" options that he would have been entitled to if he had completed the full term of the Employment Agreement and if his contract were renewed. [12]

> 12 Under the 1995 Employment Agreement, Ovitz' "B" options to purchase 2,000.000 shares were scheduled to vest "in increments of 1,000,000 shares on each of September 30, 2001 and September 30, 2002." But they would not vest if Ovitz' employment "shall have terminated for any reason whatsoever more than three months prior to such scheduling date." If Ovitz' employment should terminate before October 1, 2000 (the expiration of the 1995 agreement), the "B" options "shall thereupon irrevocably terminate."

[**19] The Complaint charges the New Board with waste, computing the value of the severance package agreed to by the Board at over $ 140 million, consisting of cash payments of about $ 39 million and the value of the immediately vesting "A" options of over $ 101 million. The Complaint quotes Crystal, the Old Board's expert, as saying in January 1997 that Ovitz' severance package was a "shocking amount of severance.

The allegation of waste is based on the inference most favorable to plaintiffs that Disney owed Ovitz nothing, either because he had resigned *(de facto)* or because he was unarguably subject to firing for cause. These allegations must be juxtaposed with the presumption that the New Board exercised its business judgment in deciding how to resolve the potentially litigable issues of whether Ovitz had actually resigned or had definitely breached his contract. We must decide whether plaintiffs' factual allegations, if proven, would rebut that presumption.

Scope of Review

Certain dicta in our jurisprudence suggest that this Court will review under a deferential abuse of discretion standard a decision of the Court of Chancery on a Rule 23.1 motion to dismiss a derivative [**20] suit. These statements, apparently beginning in 1984 in *Aronson v. Lewis,* state that the Court of Chancery's decision is discretionary in determining whether the allegations of the complaint support the contention that pre-suit demand is excused.

> Our view is that in determining demand futility the Court of Chancery *in the proper exercise of its discretion* must decide whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment). [13]

13 *Aronson v. Lewis, Del. Supr., 473 A.2d 805, 814 (1984)* (emphasis added). This language *in Aronson* was followed, sequentially, by: *Pogostin v. Rice, Del. Supr., 480 A.2d 619, 624-25 (1984)*; *Grobow v. Perot, Del. Supr., 539 A.2d 180, 186 (1988)*; *Levine v. Smith, Del. Supr., 591 A.2d 194, 207 (1991)*; *Heineman v. Datapoint Corp., Del. Supr., 611 A.2d 950, 952 (1992)*; *Grimes v. Donald, Del. Supr., 673 A.2d 1207, 1217 n.15 (1996)*; and *Scattered Corp. v. Chicago Stock Exch., Del. Supr., 701 A.2d 70, 72-73 (1997).*

[**21] By implication, therefore, these dicta would suggest that our review is deferential, limited to a determination of whether the Court of Chancery abused its discretion. Indeed, all parties to this appeal agree that our review is for abuse of discretion.

The view we express today, however, is designed to make clear that our review of decisions of the Court of Chancery applying Rule 23.1 is *de novo* and plenary. We apply the law to the allegations of the Complaint as does the Court of Chancery. Our review is not a deferential review that requires us to find an abuse of discretion. We see no reason to perpetuate the concept of discretion in this context. The nature of our analysis of a complaint in a derivative suit is the same as that applied by the Court of Chancery in making its decision in the first instance.

Analyzing a pleading for legal sufficiency is not, for example, the equivalent of the [*254] deferential review of certain discretionary rulings, such as: an administrative agency's findings of fact; [14] a trial judge's evaluation of witness credibility; [15] findings of the Court of Chancery in a statutory stock appraisal; [16] a decision whether to grant or deny injunctive relief [**22] or the scope of that relief; [17] or what rate of interest to apply. [18] In a Rule 23.1 determination of pleading sufficiency, the Court of Chancery, like this Court, is merely reading the English language of a pleading and applying to that pleading statutes, case law and Rule 23.1 requirements. To that extent, our scope of review is analogous to that accorded a ruling under Rule 12(b)(6).

14 *See Public Water Supply Co. v. DiPasquale, Del. Supr., 735 A.2d 378, 381 (1999).*
15 *See Schock v. Nash, Del. Supr., 732 A.2d 217, 234 (1999).*
16 *See M.P.M. Enterprises, Inc. v. Gilbert, Del. Supr., 731 A.2d 790, 795 (1998).*
17 *See SI Management L.P. v. Wininger, Del. Supr., 707 A.2d 37, 40 (1998).*
18 *See Shell Petroleum, Inc. v. Smith, Del. Supr., 606 A.2d 112, 117 (1992).*

Therefore, our scope of review must be *de novo.* To the extent *Aronson* and its progeny contain dicta expressing or suggesting [**23] an abuse of discretion scope of review, that language is overruled. We now proceed to decide *de novo* whether the Complaint was properly dismissed for failure to set forth particularized facts to support the plaintiffs' claim that demand is excused.

Pleading Requirements in Derivative Suits

Pleadings in derivative suits are governed by Chancery Rule 23.1, [19] just as pleadings alleging fraud are governed by Chancery Rule 9(b). [20] Those pleadings must comply with stringent requirements of factual particularity that differ substantially from the permissive notice pleadings governed solely by Chancery Rule 8(a). [21] Rule 23.1 is not satisfied by conclusory statements or mere notice pleading. On the other hand, the pleader is not required to plead evidence. [22] What the pleader must set forth are particularized factual statements that are essential to the claim. Such facts are sometimes referred to as "ultimate facts," "principal facts" or "elemental facts." [23] Nevertheless, the particularized factual statements that are required to comply with the Rule 23.1 pleading rules must also comply with the mandate of Chancery Rule 8(e) that they be "simple, concise and direct." [24] [**24] A prolix complaint larded with conclusory language, like the Complaint here, does not comply with these fundamental pleading mandates.

19 Rule 23.1 provides, in part: "The complaint shall . . . allege with particularity the efforts, if any, . . . to obtain the action the plaintiff desires from the directors . . . and the reasons for the plaintiff's failure to obtain the action or for not making the effort."
20 Rule 9(b) provides, in part: "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity."
21 Rule 8(a) provides, in part: "A pleading . . . shall contain . . . a short and plain statement of the claim showing that the pleader is entitled to relief. . . ."
22 *See Aronson, 473 A.2d at 816.*
23 Black's Law Dictionary 610-12 (7th ed. 1999); *see also* 2 James Wm. Moore et al., *Moore's Federal Practice* P9.03[1] (3d ed. 1999); 5 James Wm. Moore et al., *Moore's Federal Practice* P23.1.08[1] (3d ed. 1999).
24 This parallels the pleading rules contained in the Federal Rules of Civil Procedure. *See* 2 James Wm. Moore et al., *Moore's Federal Practice* P9.03[1][b] at 9-19 (3d ed. 1999); Deborah A. DeMott, *Shareholder Derivative Actions: Law and Practice* § 4:02, at 41 (1999 Cum. Supp.).

[**25] Chancery Rule 23.1 requires, in part, that the plaintiff must allege with particularity facts raising a reasonable doubt that the corporate action being questioned was properly the product of [*255] business judgment. [25] The rationale of Rule 23.1 is two-fold. On the one hand, it would allow a plaintiff to proceed with discovery and trial if the plaintiff complies with this rule and can articulate a reasonable basis to be entrusted with a claim that belongs to the corporation. On the other hand, the rule does not permit a stockholder to cause the corporation to expend money and resources in discovery and trial in the stockholder's quixotic pursuit of a purported corporate claim based solely on conclusions, opinions or speculation. As we stated in *Grimes v. Donald:*

> The demand requirement serves a salutary purpose. First, by requiring exhaustion of intracorporate remedies, the demand requirement invokes a species of alternative dispute resolution procedure which might avoid litigation altogether. Second, if litigation is beneficial, the corporation can control the proceedings. Third, if demand is excused or wrongfully refused, the stockholder will normally control the proceedings. [**26]
>
> The jurisprudence of *[Aronson]* and its progeny is designed to create a balanced environment which will: (1) on the one hand, deter costly, baseless suits by creating a screening mechanism to eliminate claims where there is only a suspicion expressed solely in conclusory terms; and (2) on the other hand, permit suit by a stockholder who is able to articulate particularized facts showing that there is a reasonable doubt either that (a) a majority of the board is independent for purposes of responding to the demand, or (b) the underlying transaction is protected by the business judgment rule. [26]

25 This is the so-called second prong of *Aronson,* the central focus of this case.
26 *Grimes, 673 A.2d at 1216-17* (footnotes omitted).

In setting up its analysis of the amended complaint, the Court of Chancery in this case stated that the standard by which the Complaint is to be tested is as follows: "Where under any set of facts consistent with the facts alleged in the complaint [**27] the plaintiff *would not be entitled* to judgment, the complaint *may be dismissed* as legally defective." [27] The Court attempted to paraphrase the Court of Chancery decision in *Lewis v. Vogelstein* for this formulation. The *Vogelstein* quote is that "where under any state of facts consistent with the factual allegations of the complaint the plaintiff *would be entitled* to a judgment, the complaint *may not be dismissed* as legally defective." [28]

27 *In re The Walt Disney Co. Derivative Litig., 731 A.2d at 353* (emphasis added).
28 *Lewis v. Vogelstein, Del. Ch., 699 A.2d 327, 338 (1997)* (emphasis added).

Plaintiffs argue that the formulation used by the Court of Chancery was error in that it is the opposite of the *Vogelstein* formulation. Defendants, on the other hand, argue that the formulations are identical. We need not resolve what is essentially a semantic debate. In our view, the formulation by the Court of Chancery here is confusing and unhelpful, [**28] but not reversible error, particularly in light of our *de novo* review. The issue is whether plaintiffs have alleged particularized facts creating a reasonable doubt that the actions of the defendants were protected by the business judgment rule.

Plaintiffs are entitled to all reasonable factual inferences that logically flow from the particularized facts alleged, but conclusory allegations are not considered as expressly pleaded facts or factual inferences.

Principles of Corporation Law Compared with Good Corporate Governance Practices

This is a case about whether there should be personal liability of the directors of a Delaware corporation to the corporation for lack of due care in the decisionmaking process and for waste of corporate assets. This case is not about the failure [*256] of the directors to establish and carry out ideal corporate governance practices.

All good corporate governance practices include compliance with statutory law and case law establishing fiduciary duties. But the law of corporate fiduciary duties and remedies for violation of those duties are distinct from the aspirational goals of ideal corporate governance practices. Aspirational ideals of good [**29] corporate governance practices for boards of directors that go beyond the minimal legal requirements of the corporation law are highly desirable, often tend to benefit stockholders, sometimes reduce litigation and can usually help directors avoid liability. But they are not required by the corporation law and do not define standards of liability. [29]

29 *See id. at 332*; *see also* E. Norman Veasey, *An Economic Rationale for Judicial Decisionmaking in Corporate Law, 53 Bus. Law. 681, 699-700 (1998)* (listing seven suggestions of aspirational norms for good corporate practice that are "purely precatory" and do "not foreshadow how any case should be decided," but "may be in the nature of safe harbors in certain circumstances"). For example, the Complaint quotes a *Wall Street Journal* article critical of the Board's functioning: the directors own little stock; they do not "hold a regular retreat"; they "don't meet regularly in the absence of company executives such as Mr. Eisner"; and they do not "give Mr. Eisner a written assessment of his performance" as do "89% of the nation's biggest industrial corporations." These are very desirable practices to be sure, but they are not required by the corporation law.

[**30] The inquiry here is not whether we would disdain the composition, behavior and decisions of Disney's Old Board or New Board as alleged in the Complaint if we were Disney stockholders. In the absence of a legislative mandate, [30] that determination is not for the courts. That decision is for the stockholders to make in voting for directors, urging other stockholders to reform or oust the board, or in making individual buy-sell decisions involving Disney securities. The sole issue that this Court must determine is whether the particularized facts alleged in this Complaint provide a reason to believe that the conduct of the Old Board in 1995 and the New Board in 1996 constituted a violation of their fiduciary duties.

30 *See Williams v. Geier, Del. Supr., 671 A.2d 1368, 1385 n.36 (1996)* (noting that this court will not impose requirements or exceptions that are essentially legislative because that is the province of the General Assembly and further because it would "introduce an undesirable degree of uncertainty into the corporation law"). For example, the Council of Institutional Investors, an eminently prestigious corporate governance organization, has argued in a very interesting *amicus* brief in this Court that the Disney Board should have taken steps to assure even greater independence of directors. *See also* National Association of Corporate Directors, *Report of the NACD Blue Ribbon Commission on Director Professionalism* 7-14, 37-40 (1996) (containing definitions of independence from this very influential organization and urging corporations to insist on paradigms of strengthened independence); American Law Institute, *Principles of Corporate Governance* § 3A-01 (1992) ("Composition of the Board of Publicly Held Corporations"). Many of the recommendations of the Council of Institutional Investors, the American Law Institute and the NACD are desirable but are not mandated by our law.

[**31] *Independence of the Disney Board*

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." [31] 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." [32] These prongs are in the disjunctive. Therefore, if either prong is satisfied, demand is excused. [33]

31 *Aronson, 473 A.2d at 814*; *see also id. at 816* ("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.").

32 *473 A.2d at 814.*

33 For an excellent analysis of the Delaware demand rule in this context, see 2 Dennis J. Block et al., *The Business Judgment Rule* 1467-1543 (5th ed. 1998).

[**32] [*257] In this case, the issues of disinterestedness and independence involved in the first prong of *Aronson* are whether a majority of the New Board, which presumably was in office when plaintiffs filed this action, was disinterested and independent. That is, were they incapable, due to personal interest or domination and control, of objectively evaluating a demand, if made, that the Board assert the corporation's claims that are raised by plaintiffs or otherwise remedy the alleged injury? [34] This rule is premised on the principle that a claim of the corporation should be evaluated by the board of directors to determine if pursuit of the claim is in the corporation's best interests. [35] That is the analysis the Court of Chancery brought to bear on the matter, [36] and it is that analysis we now examine to the extent necessary for appropriate appellate review.

34 It is no answer to say that demand is necessarily futile because (a) the directors "would have to sue themselves, thereby placing the conduct of the litigation in hostile hands," or (b) that they approved the underlying transaction. *See Aronson, 473 A.2d at 817-18*; *see also* Block, *supra* note 33.

[**33]

35 *See* Dennis J. Block et al., *Derivative Litigation: Current Law Versus the American Law Institute, 48 Bus. Law. 1443, 1444 (1993)* ("Courts both in and out of Delaware have ruled with near unanimity. . . . that the business judgment rule is the appropriate standard of judicial review in cases where an independent majority of a corporation's board of directors determines that litigation on behalf of the corporation will not serve the best interests of the corporation.").

36 *See In re The Walt Disney Co. Derivative Litig., 731 A.2d at 354-56*. The independence and disinterestedness of the Old Board in authorizing the Ovitz Employment Agreement and the New Board in authorizing a non-fault termination of that agreement is subsumed in the business judgment rule analysis of those issues under the second prong of *Aronson. See Aronson, 473 A.2d at 815*.

The facts supporting plaintiffs' claim that the New Board was not disinterested or independent turn on plaintiffs' central allegation that a majority of the Board was beholden to Eisner. [**34] It is not alleged that they were beholden to Ovitz. Plaintiffs' theory is that Eisner was advancing Ovitz' interests primarily because a lavish contract for Ovtiz would redound to Eisner's benefit since Eisner would thereby gain in his quest to have his own compensation increased lavishly. This theory appears to be in the nature of the old maxim that a "high tide floats all boats." But, in the end, this theory is not supported by well-pleaded facts, only conclusory allegations. Moreover, the Court of Chancery found that these allegations were illogical and counterintuitive:

> Plaintiffs' allegation that Eisner was interested in maximizing his compensation at the expense of Disney and its shareholders cannot reasonably be inferred from the facts alleged in Plaintiffs' amended complaint. At all times material to this litigation, Eisner owned several million options to purchase Disney stock. Therefore, it would not be in Eisner's economic interest to cause the Company to issue millions of additional options unnecessarily and at considerable cost. Such a gesture would not, as Plaintiffs suggest, "maximize" Eisner's own compensation package. Rather, it would dilute the value of Eisner's [**35] own very substantial holdings. Even if the impact on Eisner's option value were relatively small, such a large compensation package would, and did, draw largely negative attention to Eisner's own performance and compensation. Accordingly, no reasonable doubt can exist as to Eisner's disinterest in the approval of the Employment Agreement, as a matter of law. Similarly, the Plaintiffs have not demonstrated a reasonable doubt that Eisner was disinterested in granting Ovitz a Non-Fault Termination, thus allowing Ovitz to receive substantial severance benefits under the terms of the Employment Agreement. Nothing alleged by Plaintiffs generates a reasonable inference that Eisner would benefit personally from allowing [*258] Ovitz to leave Disney without good cause. [37]

37 *In re The Walt Disney Co. Derivative Litig., 731 A.2d at 355-56.*

The Court of Chancery held that "no reasonable doubt can exist as to Eisner's disinterest in the approval of the Employment Agreement, as a matter of law," and similarly [**36] that plaintiffs "have not demonstrated a reasonable doubt that Eisner was disinterested in granting Ovitz a Non-Fault Termination." [38] Plaintiffs challenge this conclusion, but we agree with the Court of Chancery and we affirm that holding.

38 Id.

The Complaint then proceeds to detail the various associations that each member of the New Board had with Eisner. In an alternative holding, the Court of Chancery proceeded meticulously to analyze each director's ties to Eisner to see if they could have exercised business judgment independent of Eisner. [39] Because we hold that the Complaint fails to create a reasonable doubt that Eisner was disinterested in the Ovitz Employment Agreement, we need not reach or comment on the analysis of the Court of Chancery on the independence of the other directors for this purpose. [40]

39 *See In re The Walt Disney Co. Derivative Litig., 731 A.2d at 356-61.*

40 Thus, we need not address the very interesting arguments and recommendations of the *amicus* brief filed on behalf of the Council of Institutional Investors.

[**37] In this case, therefore, that part of plaintiffs' Complaint raising the first prong of *Aronson,* even though not pressed by plaintiffs in this Court, [41] has been dismissed with prejudice. Our affirmance of that dismissal is final and dispositive of the first prong of *Aronson.* [42] We now turn to the primary issues in this case that implicate the second prong of *Aronson:* whether the Complaint sets forth particularized facts creating a reasonable doubt that the decisions of the Old Board and the New Board were protected by the business judgment rule.

41 Apparently plaintiffs, as appellants in this Court, lacked a motivation to have us review this issue at all since they do not mention it in their brief. The issue was fully briefed by the *amicus,* the Council of Institutional Investors and by the corporate defendant, Disney. Despite the irregular procedure, *see Turnbull v. Fink, Del. Supr., 644 A.2d 1322 (1999)*, we agreed to consider the issue because the deficiency was not raised by the appellees, who were not prejudiced and who fully briefed all issues before us. *See Brehm v. Eisner,* Del. Supr., No. 469, 1998, Walsh, J. (May 25, 1999) (ORDER). This departure from proper practice before this Court is a unique exception and should not be considered a precedent.

[**38]

42 This issue is not one that plaintiffs shall be permitted to relitigate if they elect to file an amended complaint setting forth particularized facts relating to the second prong of *Aronson.*

Analytical Framework for the Informational Component of Directorial Decisionmaking

Plaintiffs claim that the Court of Chancery erred when it concluded that a board of directors is "not required to be informed of every fact, but rather is required to be reasonably informed." [43] Applying that conclusion, the Court of Chancery held that the Complaint did not create a reasonable doubt that the Old Board had satisfied the requisite informational component when it approved the Ovitz contract in 1995. [44] In effect, Plaintiffs argue that being "reasonably informed" is too lax a standard to satisfy Delaware's legal test for the informational component of board decisions. They contend that the Disney directors on the Old Board did not avail themselves of all material information reasonably available in approving Ovitz' 1995 [*259] contract, and thereby violated their fiduciary duty of care. [45]

43 *In re The Walt Disney Co. Derivative Litig., 731 A.2d at 361-62.*

[**39]

44 *See id.*

45 *See Aronson, 473 A.2d at 812*; *Smith v. Van Gorkom, Del. Supr., 488 A.2d 858, 872-73 (1985).*

The "reasonably informed" language used by the Court of Chancery here may have been a short-hand attempt to paraphrase the Delaware jurisprudence that, in making business decisions, directors must consider all material information reasonably available, and that the directors' process is actionable only if grossly negligent. [46] The question is whether the trial court's formulation is consistent with our objective test of reasonableness, the test of materiality and concepts of gross negligence. We agree with the Court of Chancery that the 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 *reasonably available,* not those that are immaterial or out of the Board's reasonable reach. [47]

46 *See Aronson, 473 A.2d at 812.*

[**40]

47 Compare the American Law Institute test, which requires that a director must be informed . . . to the extent the director reasonably believes to be appropriate under the circumstances." *Principles of Corporate Governance, supra* note 29, at § 4.01(c)(2). Because this test also is based on the objective test of reasonableness, it could be argued that it is essentially synonymous with the Delaware test. But there is room to argue that the Delaware test is stricter. *See* Roswell Perkins, *ALI Corporate Governance Project in Mid-stream, 41 Bus. Law. 1195, 12 10-11 (1986).* In the end, the debate may be mostly semantic.

We conclude that the formulation of the due care test by the Court of Chancery in this case, while not necessarily inconsistent with our traditional formulation, was too cryptically stated to be a helpful precedent for future cases. Pre-suit demand will be excused in a derivative suit only if the Court of Chancery in the first instance, and this Court in its *de novo* review, conclude that the particularized facts in the complaint create a reasonable [**41] doubt that the informational component of the directors' decisionmaking process, *measured by concepts of gross negligence,* included consideration of all material information reasonably available. [48] Thus, we now apply this analytical framework to the particularized facts pleaded, juxtaposed with the presumption of regularity of the Board's process.

48 *See Aronson, 473 A.2d at 812.*

Plaintiffs' Contention that the Old Board Violated the Process Duty of Care in Approving the Ovitz Employment Agreement

Certainly in this case the economic exposure of the corporation to the payout scenarios of the Ovitz contract was material, particularly given its large size, for purposes of the directors' decisionmaking process. [49] And those dollar exposure [*260] numbers were reasonably available because the logical inference from plaintiffs' allegations is that Crystal or the New Board could have calculated the numbers. Thus, the objective tests of reasonable availability and materiality were satisfied [**42] by this Complaint. But that is not the end of the inquiry for liability purposes.

> 49 The term "material" is used in this context to mean relevant and of a magnitude to be important to directors in carrying out their fiduciary duty of care in decisionmaking. In this sense, it is distinct from the use of the term "material" in the quite different context of disclosure to stockholders in which "an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." *O'Malley v. Boris, Del. Supr., 742 A.2d 845, 850, 1999 WL 1219960*, at *4, Berger, J. (1999) (quoting *Rosenblatt v. Getty Oil Co., Del. Supr., 493 A.2d 929, 944 (1985))* (reflecting the general federal materiality standard from *TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449, 48 L. Ed. 2d 757, 96 S. Ct. 2126 (1976))*; *accord Loudon v. Archer-Daniels-Midland Co., Del. Supr., 700 A.2d 135, 143 (1997)*. One must also keep in mind that the size of executive compensation for a large public company in the current environment often involves huge numbers. This is particularly true in the entertainment industry where the enormous revenues from one "hit" movie or enormous losses from a "flop" place in perspective the compensation of executives whose genius or misjudgment, as the case may be, may have contributed substantially to the "hit" or "flop." *See* Lori B. Marino, Comment, *Executive Compensation and the Misplaced Emphasis on Increasing Shareholder Access to the Proxy, 147 U. Pa. L. Rev. 1205, 1235 (1999)* ("Executive compensation makes up such a small percentage of a firm's assets that even excessive pay packages will likely not cause a blip in a firm's stock value."); *cf. id.* (contrasting executive compensation with decisions by a company's board regarding takeovers, which have a great effect on a company's stock price).

[**43] The Court of Chancery interpreted the Complaint to allege that only Crystal (the Board's expert)--and *not the Board* itself--failed to bring to bear all the necessary information because he (Crystal) did not quantify for the Board the maximum payout to Ovitz under the non-fault termination scenario. Alternatively, the Court of Chancery reasoned that even if the Old Board failed to make the calculation, that fact does not raise a reasonable doubt of due care because *Crystal* did not consider it critical to ascertain the potential costs of Ovitz' severance package. The Court's language is as follows:

> With regard to the alleged breach of the duty of care, Plaintiffs claim that the directors were not properly informed before they adopted the Employment Agreement because they did not know the value of the compensation package offered to Ovitz. To that end, Plaintiffs offer several statements made by Graef Crystal, the financial expert who advised the Board on the Employment Agreement, including his admission that "nobody quantified the total cost of the severance package and I wish we had."
>
> The fact that *Crystal* did not quantify the potential severance benefits to Ovitz [**44] for terminating early without cause (under the terms of the Employment Agreement) does not create a reasonable inference that *the Board* failed to consider the potential cost to Disney in the event that they decided to terminate Ovitz without cause. But, even if the Board did fail to calculate the potential cost to Disney, I nevertheless think that this allegation fails to create a reasonable doubt that

the former Board exercised due care. Disney's expert did not consider an inquiry into the potential cost of Ovitz's severance benefits to be critical or relevant to the Board's consideration of the Employment Agreement. Merely because Crystal *now* regrets not having calculated the package is not reason enough to overturn the judgment of the Board *then.* It is the essence of the business judgment rule that a court will not apply 20/20 hindsight to second guess a board's decision, except "in rare cases [where] a transaction may be so egregious on its face that the board approval cannot meet the test of business judgment." Because the Board's reliance on Crystal and his decision not to fully calculate the amount of severance lack "egregiousness," this is not that rare case. [**45] I think it a correct statement of law that the duty of care is still fulfilled even if a Board does not know the exact amount of a severance payout but nonetheless is fully informed about the manner in which such a payout would be calculated. A board is not required to be informed of every fact, but rather is required to be reasonably informed. Here the Plaintiffs have failed to plead facts giving rise to a reasonable doubt that the Board, as a matter of law, was reasonably informed on this issue. [50]

50 *In re The Walt Disney Co. Derivative Litig., 731 A.2d at 361-62* (emphasis in original) (footnotes omitted).

We believe, however, that the Complaint, fairly read, charges that Crystal admitted that "nobody"--not Crystal *and* not the directors--made that calculation, although all the necessary information presumably was at hand to do so. Thus the reading given by the Court of Chancery to [*261] this aspect of the amended complaint was too restrictive because the Court's reading fails to appreciate [**46] the breadth of the allegation--*i.e.,* that neither Crystal nor the Old Board made the calculations that Crystal--the expert--now believes he should have made. Moreover, the Court's alternative analysis that "Disney's expert did not consider an inquiry into the potential costs . . . to be critical or relevant to the board's consideration" is inappropriately simplistic at the pleading stage to state a comprehensive analysis of the issue.

We regard the Court's language as harmless error, however, for the following reason. The Complaint, fairly construed, admits that the directors were advised by Crystal as an expert and that they relied on his expertise. Accordingly, the question here is whether the directors are to be "fully protected" *(i.e.,* not held liable) on the basis that they relied in good faith on a qualified expert under *Section 141(e)* of the Delaware General Corporation Law. [51] The Old Board is entitled to the presumption [52] that it exercised proper business judgment, including proper reliance on the expert. In fact, the Court of Chancery refers to the "Board's reliance on

51 *Section 141(e)* provides:

> 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.

8 Del. C. § 141(e) (emphasis added). This protection, however, is not without limitation, as in a case of corporate waste.

[**47]

52 *See Grobow, 539 A.2d at 187-88.*

Crystal and his decision not to fully calculate the amount of severance." [53] The Court's invocation here of the concept of the protection accorded directors who rely on experts, even though no reference is made to the statute itself, is on the right track, but the Court's analysis is unclear and incomplete. [54]

53 *In re The Walt Disney Co. Derivative Litig., 731 A.2d at 362.*

54 The Court of Chancery seemed, however, to key the reliance issue not to the statute but to the lack of "egregiousness," a concept that is misplaced in this context. The Court said:

> It is the essence of the business judgment rule that a court will not apply 20/20 hindsight to second guess a board's decision, except "in rare cases [where] a transaction may be so egregious on its face that the board approval cannot meet the test of business judgment." Because the Board's reliance on Crystal and his decision not to fully calculate the amount of severance lack "egregiousness," this is not that rare case. I think it a correct statement of law that the duty of care is still fulfilled even if a Board does not know the exact amount of a severance payout but nonetheless is fully informed about the manner in which such a payout would be calculated. A board is not required to be informed of every fact, but rather is required to be reasonably informed.

Id.

[**48] Although the Court of Chancery did not expressly predicate its decision on *Section 141(e)*, Crystal is presumed to be an expert on whom the Board was entitled to rely in good faith under *Section 141(e)* in order to be "fully protected." [55] Plaintiffs must rebut the presumption that the directors properly exercised their business judgment, including their good faith reliance on Crystal's expertise. What Crystal *now* believes *in hindsight* that he and the Board *should have done* in 1995 does not provide that rebuttal. That is not to say, however, that a rebuttal of the presumption of proper reliance on the expert [*262] under *Section 141(e)* cannot be pleaded consistent with Rule 23.1 in a properly framed complaint setting forth particularized facts creating reason to believe that the Old Board's conduct was grossly negligent.

> 55 The directors do, however, obliquely cite *Section 141(e)* and various Delaware cases in a footnote to their brief in this Court. *See* Ans. Br. of Defendants Below-Appellees at 18 n.10.

[**49] To survive a Rule 23.1 motion to dismiss in a due care case where an expert has advised the board in its decisionmaking process, the complaint must allege particularized facts (not conclusions) that, if proved, would show, for example, that: (a) the directors did not in fact rely on the expert; (b) their reliance was not in good faith; (c) they did not reasonably believe that the expert's advice was within the expert's professional competence; (d) the expert was not selected with reasonable care by or on behalf of the corporation, and the faulty selection process was attributable to the directors; (e) the subject matter (in this case the cost calculation) that was material and reasonably available was so obvious that the board's failure to consider it was grossly negligent regardless of the expert's advice or lack of advice; or (f) that the decision of the Board was so unconscionable as to constitute waste or fraud. [56] This Complaint includes no particular allegations of this nature, and therefore it was subject to dismissal as drafted. [57]

> 56 To be sure, directors have the power, authority and wide discretion to make decisions on executive compensation. *See 8 Del. C. § 122(5)*. As the often-cited Court of Chancery decision by Chancellor Seitz in *Saxe v. Brady* warns, there is an outer limit to that discretion, at which point a decision of the directors on executive compensation is so disproportionately large as to be unconscionable and constitute waste. *Del. Ch., 40 Del. Ch. 474, 184 A.2d 602, 610 (1962)*; *see Grimes, 673 A.2d at 1215* (noting that compensation decisions by an independent board are protected by the business judgment rule "unless the facts show that such amounts, compared with the services to be received in exchange, constitute waste or could not otherwise be the product of a valid exercise of business judgment") (citing *Saxe,* 184 A.2d at 610); *see also* Marino, *supra* note 49, at 1237-45.

[**50]

> 57 It is no excuse for plaintiffs to argue that they are unable to allege these particularized facts because they are cut off from access to discovery at the pre-suit demand stage of a derivative suit. Plaintiffs have the opportunity to use the "tools at hand" to learn facts relating to Crystal's report and the Board's consideration through an interview with Crystal or by seeking appropriate and precisely identified corporate records in a *Section 220* proceeding. *See infra* text accompanying notes 73-75.

Plaintiffs also contend that Crystal's latter-day admission is "valid and binding" on the Old Board. This argument is without merit. Crystal was the Board's expert *ex ante* for purposes of advising the directors on the Ovitz Employment Agreement. He was not their agent *ex post* to make binding admissions.

We conclude that, although the language of the Court of Chancery was flawed in formulating the proper legal test to be used and in its reading of the Complaint, that pleading, as drafted, fails to create a reasonable doubt that the Old Board's decision in approving the Ovitz Employment [**51] Agreement was protected by the business judgment rule. Plaintiffs will be provided an opportunity to replead on this issue.

Plaintiffs' Contention that the Old Board Violated "Substantive Due Care" Requirements and Committed Waste Ab Initio with Ovitz' Employment Agreement

Plaintiffs allege not only that the Old Board committed a procedural due care violation in the process of approving the Ovitz 1995 Employment Agreement but also that the Board committed a "substantive due care" violation constituting waste. They contend that the Court of Chancery erred in holding that the Complaint failed to set forth particularized facts creating a reasonable doubt that the directors' decision to enter into the Ovitz Employment Agreement was a product of the proper exercise of business judgment.

Plaintiffs' principal theory is that the 1995 Ovitz Employment Agreement [*263] was a "wasteful transaction for Disney *ab initio*" because it was structured to "incentivize" Ovitz to seek an early non-fault termination. The Court of Chancery correctly dismissed this theory as failing to meet the stringent requirements of the waste test, i.e., "'an exchange that is so one sided that no business person [**52] of ordinary, sound judgment could conclude that the corporation has received adequate consideration.'" [58] Moreover, the Court concluded that a board's decision on executive compensation is entitled to great deference. It is the essence of business judgment for a board to determine if "a 'particular individual warrant[s] large amounts of money, whether in the form of current salary or severance provisions.'" [59]

58 *In re The Walt Disney Co. Derivative Litig., 731 A.2d at 362* (quoting *Glazer v. Zapata Corp., Del. Ch., 658 A.2d 176, 183 (1993))*.

59 *Id.* (quoting *Grimes, 673 A.2d at 1215*).

Specifically, the Court of Chancery inferred from a reading of the Complaint that the Board determined it had to offer an expensive compensation package to attract Ovitz and that they determined he would be valuable to the Company. The Court also concluded that the vesting schedule of the options actually was a disincentive for Ovitz to leave Disney. [60] When [**53] he did leave pursuant to the non-fault termination, the Court noted that he left 2 million options (the "B" options) "on the table." [61] Although we agree with the conclusion of the Court of Chancery that this particular Complaint is deficient, we do not foreclose the possibility that a properly framed complaint could pass muster.

60 *See 731 A.2d at 362-63.*

61 *731 A.2d at 363*. This statement, however, is somewhat misleading in that the "B" options would not have come into being unless the employment were extended beyond the original five years. It is correct, however, that this non-fault termination cut off the possibility of Ovitz receiving those options and that those options had been a potentially valuable incentive for Ovitz to remain in Disney's employ, an incentive that Ovitz relinquished.

Plaintiffs' disagreement on appeal with the decision of the Court of Chancery is basically a quarrel with the Old Board's judgment in evaluating Ovitz' worth *vis a vis* the lavish payout to him. We agree [**54] with the analysis of the Court of Chancery that the size and structure of executive compensation are inherently matters of judgment. [62] As former Chancellor Allen stated in *Vogelstein:*

> The judicial standard for determination of corporate waste is well developed. Roughly, a waste entails 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. Most often the claim is associated with a transfer of corporate assets that serves no corporate purpose; or for which no consideration at all is received. Such a transfer is in effect a gift. If, however, there is *any substantial* consideration received by the corporation, and if there is a *good faith judgment* that in the circumstances the transaction is worthwhile, there should be no finding of waste, even if the fact finder would conclude *ex post* that the transaction was unreasonably risky. Any other rule would deter corporate boards from the optimal rational acceptance of risk, for reasons explained elsewhere. Courts are ill-fitted to attempt to weigh the "adequacy" of consideration under the waste standard or, *ex* [**55] *post,* to judge appropriate degrees of business risk. [63]

To be sure, there are outer limits, but they are confined to unconscionable cases where directors irrationally squander or give away corporate assets. Here, however, we [*264] find no error in the decision of the Court of Chancery on the waste test.

62 *See 731 A.2d at 350.*
63 *Vogelstein, 699 A.2d at 336* (emphasis in original) (citations omitted); *accord Grimes, 673 A.2d at 1214.*

As for the plaintiffs' contention that the directors failed to exercise "substantive due care," we should note that such a concept is foreign to the business judgment rule. Courts do not measure, weigh or quantify directors' judgments. We do not even decide if they are reasonable in this context. [64] Due care in the decisionmaking context is *process* due care only. Irrationality [65] is the outer limit of the business judgment rule. Irrationality may be the functional equivalent of the waste test or it may tend to show that the [**56] decision is not made in good faith, which is a key ingredient of the business judgment rule. [66]

64 *Cf. Williams v. Geier, Del. Supr., 671 A.2d 1368, 1377 (1996)* (noting the inapplicability of a reasonableness analysis in a case that "does not involve either unilateral director action in the face of a claimed threat or an act of disenfranchisement").
65 Directors' business "decisions will not be disturbed if they can be attributed to any rational business purpose." *Sinclair Oil Corp. v. Levien, Del. Supr., 280 A.2d 717, 720 (1971).*
66 The business judgment rule has been well formulated by *Aronson* and other cases. *See, e.g., Aronson, 473 A.2d at 812* ("It is a presumption that in making a business decision the directors . . . acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the corporation."). Thus, directors' decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.

[**57] *Plaintiffs' Contention that the New Board Committed Waste in Its Decision That Ovitz' Contract Should be Terminated on a "Non-Fault" Basis*

The plaintiffs contend in this Court that Ovitz resigned or committed acts of gross negligence or malfeasance that constituted grounds to terminate him for cause. In either event, they argue that the Company had no obligation to Ovitz and that the directors wasted the Company's assets by causing it to make an unnecessary and enormous payout of cash and stock options when it permitted Ovitz to terminate his employment on a "non-fault" basis. We have concluded, however, that the Complaint currently before us does not set forth particularized facts that he resigned or unarguably breached his Employment Agreement.

The Complaint does not allege facts that would show that Ovitz had, in fact, resigned before the Board acted on his non-fault termination. Plaintiffs contend, in effect, that the sum total of Ovitz' actions constituted a *de facto* resignation. But the Complaint does not allege that Ovitz had *actually* resigned. It alleges merely that he: (a) was dissatisfied with his role; (b) was underperforming; (c) was seeking and entertaining [**58] other job offers; and (d) had written to Eisner on September 5, 1996, "expressing his desire to quit." These are not particularized allegations that he resigned, either actually or constructively.

Additionally, the Complaint is internally inconsistent with plaintiffs' argument that Ovitz had resigned. The Complaint alleges that Ovitz would not actually resign before he could achieve a lucrative payout under the generous terms of his 1995 Employment Agreement. The clear inference from the Complaint is that he would lose all leverage by resigning. For example, the Complaint paraphrases Robert Slater's recent biography of Ovitz as stating that "the only reason Ovitz did not simply state outright that he quit his position at Disney was his realization that doing so would deprive him of all severance benefits" of his Employment Agreement. The Court of Chancery correctly concluded:

> As for Plaintiffs' contention that Ovitz actually or impliedly tendered his resignation before the Board approved the Non-Fault Termination, I do not believe [*265] this conclusion can reasonably be drawn from the facts alleged by Plaintiffs. While I would agree that Ovitz's September 5 letter to Eisner and his [**59] search for another job provide strong evidence of Ovitz's lack of commitment to the Company, they are not legally tantamount to a voluntary resignation. [67]

67 *In re The Walt Disney Co. Derivative Litig., 731 A.2d at 364.*

The Complaint alleges that it was waste for the Board to pay Ovitz essentially the full amount he was due on the non-fault termination basis because he should have been fired for cause. Ovitz' contract provided that he could be fired for cause only if he was grossly negligent or committed acts of malfeasance. Plaintiffs contend that ample grounds existed to fire Ovitz for cause under these terms. The Court of Chancery correctly concluded:

> The terms of the Employment Agreement limit "good cause" for terminating Ovitz's employment to gross negligence or malfeasance, or a voluntary resignation without the consent of the Company. I have reviewed the amended complaint and listened to the parties' arguments at the hearing in connection with Defendants' motion to dismiss. [**60] Still, I am unable to conclude that any of the facts alleged by Plaintiffs, even accepted as true, demonstrate that Ovitz's conduct was either grossly negligent or malfeasant during his tenure at Disney, or that Ovitz resigned voluntarily. For example, Plaintiffs allege that Ovitz sought alternative employment while he was the president of Disney. But Plaintiffs fail to explain how looking for another job constitutes gross negligence or malfeasance. The same holds true for Plaintiffs' allegation that Ovitz failed to follow Eisner's directive to meet with Director Defendant Stephen F. Bollenbach, who was then the senior executive vice president and chief financial officer of Disney. This allegation may demonstrate that Ovitz failed to become familiar with Disney's finances or that he bucked authority at Disney. However, it does not demonstrate, without more, that Ovitz was grossly negligent or committed malfeasance. None of Plaintiffs' allegations rise to the level of gross negligence or malfeasance. [68]

68 *731 A.2d at 363-64.*

[**61] Construed most favorably to plaintiffs, the facts in the Complaint (disregarding conclusory allegations) show that Ovitz' performance as president was disappointing at best, that Eisner admitted it had been a mistake to hire him, that Ovitz lacked commitment to the Company, that he performed services for his old company, and that he negotiated for other jobs (some very lucrative) while being required under the contract to devote his full time and energy to Disney.

All this shows is that the Board had *arguable* grounds to fire Ovitz for cause. But what is alleged is only an *argument--perhaps* a good one--that Ovitz' conduct constituted gross negligence or malfeasance. First, given the facts as alleged, Disney would have had to persuade a trier of fact and law of this argument in any litigated dispute with Ovitz. Second, that process of persuasion could involve expensive litigation, distraction of executive time and company resources, lost opportunity costs, more bad publicity and an outcome that was uncertain at best and, at worst, could have resulted in damages against the Company.

The Complaint, in sum, contends that the Board committed waste by agreeing to the very lucrative [**62] payout to Ovitz under the non-fault termination provision because it had no obligation to him, thus taking the Board's decision outside the protection of the business judgment rule. Construed most favorably to plaintiffs, the Complaint contends that, by reason of the New Board's available arguments of resignation and good cause, it had the leverage [*266] to negotiate Ovitz down to a more reasonable payout than that guaranteed by his Employment Agreement. But the Complaint fails on its face to meet the waste test because it does not allege with particularity facts tending to show that no reasonable business person would have made the decision that the New Board made under these circumstances.

We agree with the conclusion of the Court of Chancery:

> The Board made a business decision to grant Ovitz a Non-Fault Termination. Plaintiffs may disagree with the Board's judgment as to how this matter should have been handled. But where, as here, there is no reasonable doubt as to the disinterest of or absence of fraud by the Board, mere disagreement cannot serve as grounds for imposing liability based on alleged breaches of fiduciary duty and waste. There is no allegation that the Board did not [**63] consider the pertinent issues surrounding Ovitz's termination. Plaintiffs' sole argument appears to be that they do not agree with the course of action taken by the Board regarding Ovitz's separation from Disney. This will not suffice to create a reasonable doubt that the Board's decision to grant Ovitz a Non-Fault Termination was the product of an exercise of business judgment. As demand is not excused as to Plaintiffs' claims in connection with the current Board's decision to grant Ovitz's Non-Fault Termination, these claims must be dismissed. [69]

To rule otherwise would invite courts to become super-directors, measuring matters of degree in business decisionmaking and executive compensation. Such a rule would run counter to the foundation of our jurisprudence.

69 *In re The Walt Disney Co. Derivative Litig., 731 A.2d at 364* (footnote omitted).

Nevertheless, plaintiffs will have another opportunity--if they are able to do so consistent with Chancery Rule 11 [70]--to file a short [**64] and plain statement [71] alleging particularized facts creating a reasonable doubt that the New Board's decision regarding the Ovitz non-fault termination was protected by the business judgment rule.

70 Rule 11(b) provides, in part, that subject to sanctions for violating the rule, an attorney "by presenting to the Court . . . a [signed] pleading . . . is certifying that to the best of the [attorney's] knowledge, information and belief, formed after an inquiry reasonable under the circumstances . . . the allegations and other factual contentions have evidentiary support or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery."

71 *See* Ct. Ch. R. 8(a).

No Discovery Permitted; Books and Records May be Available

Plaintiffs complain, in effect, that the system of requiring a stockholder to plead particularized facts in a derivative suit is basically unfair because the Court will not permit discovery under [**65] Chancery Rules 26-37 to marshal the facts necessary to establish that pre-suit demand is excused. [72] This is a common complaint, one that is echoed in the *amicus* brief of the Council of Institutional Investors on this appeal. But this argument has been answered by this Court on several occasions.

72 *See Levine, 591 A.2d at 208-210.*

Plaintiffs may well have the "tools at hand" to develop the necessary facts for pleading purposes. [73] For example, plaintiffs may seek relevant books and records of the corporation under *Section 220* of the Delaware General Corporation Law, [74] if they can ultimately bear the burden of showing a proper purpose and make specific and discrete identification, with rifled precision, of the documents sought. Further, [*267] they must establish that each category of books and records is essential to the accomplishment of their articulated purpose for the inspection. [75] We do not presume to direct the Court of Chancery how it should decide any proceeding under *Section* [**66] *220*. From a timing perspective, however, we note that such a proceeding is a summary one that should be managed expeditiously.

73 *See Grimes, 673 A.2d at 1216 n.11, 1218*; *Scattered Corp., 701 A.2d at 78*; *Rales v. Blasband, Del. Supr., 634 A.2d 927, 935 n.10 (1993).*
74 *8 Del. C. § 220*; *see* note 57 *supra.*
75 *See Security First Corp. v. U.S. Die Casting & Dev. Corp., Del. Supr., 687 A.2d 563, 567-569 (1997)* (noting that "it is well established that investigation of mismanagement is a proper purpose for a *Section 220* books and records inspection" but that a party needs to show, by a preponderance of the evidence, that there is a legitimate chance that their reason for suspecting mismanagement is credible--a "threshold [that] may be satisfied . . . through documents, logic, testimony or otherwise"); *see also* DeMott, *supra* note 24, § 4:15, at 90.

Conclusion

One can understand why Disney stockholders [**67] would be upset with such an extraordinarily lucrative compensation agreement and termination payout awarded a company president who served for only a little over a year and who underperformed to the extent alleged. That said, there is a very large--though not insurmountable--burden on stockholders who believe they should pursue the remedy of a derivative suit instead of selling their stock or seeking to reform or oust these directors from office.

Delaware has pleading rules and an extensive judicial gloss on those rules that must be met in order for a stockholder to pursue the derivative remedy. Sound policy supports these rules, as we have noted. This Complaint, which is a blunderbuss of a mostly conclusory pleading, does not meet that burden, and it was properly dismissed.

The order of the Court of Chancery dismissing the Complaint was set forth in three paragraphs. [76] Each paragraph stated that certain counts were dismissed. That dismissal operates as an adjudication on the merits. [77] That is, the dismissal is with prejudice as to all counts. To the extent that plaintiffs have appealed the order of the Court of Chancery, we affirm that dismissal in all respects, except that [**68] paragraph 1 of the order is affirmed in part, reversed in part and remanded.

76 *See In re The Walt Disney Co. Derivative Litig., 731 A.2d at 380.*
77 *See* Ct. Ch. R. 41(b).

The portion of paragraph 1 that dismissed "plaintiffs claims for breach of fiduciary duty and waste, as set forth in Counts I and II of the amended complaint . . . for failure to make a demand under Court of Chancery Rule 23.1," is reversed only to the extent that the dismissal ordered by the Court of Chancery was with prejudice. [78] Because of the unusual nature of this case and the rulings in this opinion, the interests of justice require that the dismissal ordered in paragraph 1 of the Order of the Court of Chancery shall be without prejudice. Accordingly, we remand to the Court of Chancery to permit plaintiffs to file an amended complaint in accordance with the rulings of this Court as set forth in this opinion.

78 Compare *Malone v. Brincat, Del. Supr., 722 A.2d 5, 14 (1998)*, where we similarly affirmed a dismissal but reversed to the extent that the dismissal was with prejudice, thus permitting plaintiff to replead.

[**69]

CONCUR BY: HARTNETT

CONCUR

HARTNETT, Justice, concurring:

I agree that the complaint leaves much to be desired and that plaintiffs be given an opportunity to file an amended complaint. In my view, however, the present complaint is adequate as to some of the asserted claims, if only barely so.

Chancery Rules 23.1 and 12(b)(6) are predicated on the Federal Rules of Civil Procedure. The federal precedents therefore carry great weight. [79]

79 *See Scott v. Kay, Del. Supr., 233 A.2d 52 (1967).*

[*268] Rule 23.1 does not abrogate Rule 12(b)(6), and therefore, in order for the defendants to have obtained a dismissal for failure to state a claim upon which relief can be granted under Rule 12(b)(6), it must have appeared "with reasonable certainty that the plaintiffs would not have been entitled to the relief sought under any set of facts which could be proven to support the action." [80] Moreover, as is true in other contexts, the plaintiffs' well-pleaded factual allegations must be taken as true and the complaint [**70] has to be read in the light most favorable to the plaintiffs. [81] The reason for Rule 23.1 is judicial economy. It is not intended to preclude a judicial inquiry where the pleaded facts, if true, and any inferences that may be drawn from them, in the light most favorable to the plaintiffs, show the likelihood of misconduct by the directors. Because of the absence of a precise formula in the Rule for pleading compliance with the demand requirement, the sufficiency of a complaint under Rule 23.1 is determined on the basis of the facts of each case. [82]

80 *Rabkin v. Philip A. Hunt Chemical Corp., Del. Supr., 498 A.2d 1099, 1104 (1985).*

81 *See* 7C Charles Alan Wright et al., *Federal Practice and Procedure: Federal Rules of Civil Procedure Rules 23.1 to 25* § 1836 (2d ed. 1986) (citing *Mayflower Hotel Stockholders Protective Comm. v. Mayflower Hotel Corp., D.C. Cir., 84 U.S. App. D.C. 275, 173 F.2d 416 (1949)*; *Overfield v. Pennroad Corp.,* 3d. Cir., *113 F.2d 6 (1940)*; *Citrin v. Greater New York Indus., Inc., S.D.N.Y., 79 F. Supp. 692 (1948)*; and *Issner v. Aldrich, D. Del., 254 F. Supp. 696 (1966)).*

[**71]

82 See id. at § 1871.

I agree that the complaint does not create a reasonable doubt as to the disinterestedness or independence of the Board. In my opinion, however, from the totality of the factual allegations in the complaint, a reasonable doubt that the business judgment rule precludes judicial inquiry already exists as to some of the other claims, such as whether the directors were aware of the total cost of Eisner's compensation package when they approved it or whether Ovitz had actually resigned before he struck his termination deal.

Plaintiffs must not be held to a too-high standard of pleading because they face an almost impossible burden when they must plead facts with particularity and the facts are not public knowledge. Brushing aside technicalities, the issue here is whether this suit should have been dismissed by the Court of Chancery at this stage of the litigation without any discovery or whether the allegations in the complaint were sufficient to justify at least some discovery. In my opinion, the complaint already sufficiently alleges facts to warrant some limited discovery [**72] as to some of the claims.

In re Cray Inc. Derivative Litig.,
431 F. Supp. 2d 1114 (W.D. Wash., 2006)

Positive
As of: Feb 17, 2012

IN RE CRAY INC. DERIVATIVE LITIGATION; This document relates to: ALL ACTIONS

No. C05-1016Z

UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF WASHINGTON

431 F. Supp. 2d 1114; 2006 U.S. Dist. LEXIS 27182; Fed. Sec. L. Rep. (CCH) P93,870

April 27, 2006, Decided
April 28, 2006, Filed

COUNSEL: [**1] For Dominick Loriggio, on behalf of himself and all others similarly situated, Plaintiff: Adam R Gonnelli, Nadeem Faruqi, FARUQI & FARUQI, NEW YORK, NY; Clifford A Cantor, SAMMAMISH, WA.

For Vasant Butala, derivatively, on behalf of Nominal, Defendant, CRAY, INC, Plaintiff: Clifford A Cantor, SAMMAMISH, WA; John G Emerson, EMERSON POYNTER, SEATTLE, WA; Stuart W Emmons, W Todd Ver Weire, William B Federman, FEDERMAN & SHERWOOD, OKLAHOMA CITY, OK.

For James E Rottsolk, Peter J Ungaro, David R Kieffer, Scott J Poteracki, Kenneth W Johnson, Burton J Smith, Kenneth W Kennedy, Jr, Stephen C Kiely, Daniel C Regis, Sally G Narodick, Frank L Lederman, John B Jones, Jr, Steven C Richards, Defendants: Alfred Arthur Day, STOEL RIVES (WA), SEATTLE, WA; Lois Omenn Rosenbaum, STOEL RIVES, PORTLAND, OR.

For Cray Incorporated, a Washington corporation, Defendant: Christian N Oldham, Rudy Albert Englund, Brian J Meenaghan, LANE POWELL PC (SEA), SEATTLE, WA;

JUDGES: THOMAS S. ZILLY, United States District Judge.

OPINION BY: THOMAS S. ZILLY

OPINION

[*1116] ORDER

This matter comes before the Court on motions to dismiss by nominal Defendant Cray Incorporated ("Cray") pursuant to *FED. R. CIV. P. 12(b)(6)* [**2] for failure to comply with the pre-litigation demand requirement in *RCW 23B.07.400*, docket no. 18, and by the Individual Defendants [1] for failure to properly plead fraud pursuant to *FED. R. CIV. P. 9(b)* and failure to state claims upon which relief can be granted pursuant to *FED. R. CIV. P. 12(b)(6)*, docket no. 16. [2] Having reviewed the motions to dismiss, Plaintiffs' opposition briefs, docket nos. 22 and 23, the reply briefs, docket nos. 25 and 27, and all supporting declarations and exhibits, and having heard argument on March 28, 2006, the Court now enters the following Order.

1 The "Individual Defendants" are James E. Rottsolk, Peter J. Ungaro, David R. Kieffer, Scott J. Poteracki, Kenneth W. Johnson, Burton J. Smith, Kenneth W. Kennedy, Jr., Stephen C. Kiely, Daniel C. Regis, Sally G. Narodick, Frank L. Lederman, John B. Jones, Jr., and Stephen C. Richards.

2 In their motion to dismiss, the Individual Defendants join in Cray's motion to dismiss for failure to comply with the demand requirement. Docket no. 18, at 1.

[**3] **BACKGROUND**

This shareholder derivative action brings claims for breach of fiduciary duties, abuse of control, gross mismanagement, waste of corporate assets, and unjust enrichment. Verified Amended Derivative Complaint ("VADC"), docket no. 9, [*1117] P 1. Plaintiffs allege that these violations occurred from July 31, 2003, to the filing of the VADC on October 13, 2005 ("Relevant Period"). Id. P 1. Plaintiffs are shareholders of Cray who owned, and continue to own, shares of Cray's common stock. Id. PP 11-12.

As alleged by Plaintiffs, "Cray is engaged in the design, development, marketing and support of high-performance computer systems, commonly known as supercomputers." Id. P 2. Cray is incorporated and maintains its principal place of business in Washington State. Id. P 13. Generally, Plaintiffs allege that Cray's officers and directors "knowingly misrepresented both the dynamics of Cray's business model and the Company's internal controls with regard to its financial reporting process." Id. P 3. More specifically, Plaintiffs allege that "[o]n March 16, 2005, Cray revealed that, commensurate with its Sarbanes-Oxley activities, it expected to document [**4] material weaknesses in its system of internal controls and also expected to report that these controls were ineffective." Id. P 5. As a result, Plaintiffs allege that on March 17, 2005, Cray's stock lost 25.9% of its value. Id. Finally, Plaintiffs allege that on May 9, 2005, Cray publicly revealed that it failed to include an auditor's opinion on management's assessment of internal control over financial reporting, and Cray reported revenue results that were adversely impacted by faulty internal controls and practices causing Cray's stock to drop another 35.6% by May 12, 2005. Id. P 6.

Cray has a nine member Board of Directors. The Individual Defendants serving on the Board of Directors include Rottsolk, Smith, Kennedy, Kiely, Regis, Narodick, Richards, Lederman, and Jones. Plaintiffs bring claims against each member of Cray's Board for conduct during the Relevant Period. VADC P 1. Plaintiffs also bring claims against Ungaro, Kiefer, Poteracki, and Johnson in their capacity as officers of Cray. VADC PP 16-19. Facts relevant to the Individual Defendants are as follows:

Rottsolk

Rottsolk is the Chairman and CEO of Cray and has been a member of the Board of Directors [**5] since Cray was founded in 1987. Rottsolk also served as Cray's President from March 2002 until March 7, 2005. Plaintiffs allege that Rottsolk knew of Cray's adverse non-public information from internal documents and conversations with others and participated in the issuance of false or misleading statements. During the Relevant Period, Rottsolk sold 79,980 shares of Cray stock for proceeds of $ 960,710. Id. PP 14, 119(a).

Smith

Smith is a member of the Board of Directors and an employee of Cray. Id. PP 14, 119(d). Plaintiffs allege that Smith knew of Cray's adverse non-public information from internal documents and conversations with others and participated in the issuance of false or misleading statements. During the Relevant Period, Smith sold 49,548 shares of Cray stock for proceeds of $ 539,052. Id. P 15.

Kennedy

Kennedy is a member of Cray's Board of Directors. Plaintiffs allege that Kennedy knew of Cray's adverse non-public information from internal documents and conversations with others and participated in the issuance of false or misleading statements. During the Relevant Period, Kennedy sold 900 shares of Cray stock for proceeds of $ 10,404. [**6] Id. P 20.

Kiely

Kiely is a member of Cray's Board of Directors. Plaintiffs allege that Kiely knew of Cray's adverse non-public information from internal documents and conversations with others and participated in [*1118] the issuance of false or misleading statements. Id. P 21.

Regis

Regis is a member of Cray's Board of Directors. Plaintiffs allege that Regis knew of Cray's adverse non-public information from internal documents and conversations with others and participated in the issuance of false or misleading statements. During the Relevant Period, Regis sold 31,999 shares of Cray stock for proceeds of $ 212,185. Id. PP 22, 115.

Narodick

Narodick is a member of Cray's Board of Directors. Plaintiffs allege that Narodick knew of Cray's adverse non-public information from internal documents and conversations with others and participated in the issuance of false or misleading statements. Id. P 23.

Richards

Richards is a member of Cray's Board of Directors. Plaintiffs allege that Richards knew of Cray's adverse non-public information from internal documents and conversations with others and participated in the issuance of false or misleading [**7] statements. Id. P 24.

Lederman

Lederman is a member of Cray's Board of Directors. Plaintiffs allege that Lederman knew of Cray's adverse non-public information from internal documents and conversations with others and participated in the issuance of false or misleading statements. Id. P 25.

Jones

Jones is a member of Cray's Board of Directors. Plaintiffs allege that Jones knew of Cray's adverse non-public information from internal documents and conversations with others and participated in the issuance of false or misleading statements. Id. P 26.

Ungaro

Ungaro was President of Cray during the Relevant Period. Plaintiffs allege that Ungaro knew of Cray's adverse non-public information from internal documents and conversations with others and participated in the issuance of false or misleading statements. Id. P 16.

Kiefer

Kiefer was Sr. Vice President of Cray at times during the Relevant Period. Plaintiffs allege that Kiefer knew of Cray's adverse non-public information from internal documents and conversations with others and participated in the issuance of false or misleading statements. Id. P 17.

Poteracki

Poteracki [**8] was Sr. Vice President of Finance and Chief Financial Officer of Cray at times during the Relevant Period. Plaintiffs allege that Poteracki knew of Cray's adverse non-public information from internal documents and conversations with others and participated in the issuance of false or misleading statements. Id. P 18.

Johnson

Johnson was General Counsel, Secretary, and CFO of Cray at times during the Relevant Period. Plaintiffs allege that Johnson knew of Cray's adverse non-public information from internal documents and conversations with others and participated in the issuance of false or misleading statements. Id. P 19.

DISCUSSION

I. Cray's Motion to Dismiss for Failure to Comply with the Demand Requirement

A. Legal Standards

1. Motion to Dismiss

As with all motions to dismiss, allegations of material fact are taken as true and construed in the light most favorable to [*1119] the nonmoving party. *Smith v. Jackson, 84 F.3d 1213, 1217 (9th Cir. 1996)*. However, conclusory allegations of law and unwarranted inferences are insufficient to defeat a motion to dismiss. *Associated Gen. Contractors v. Metro. Water Dist. of So. Cal., 159 F.3d 1178, 1181 (9th Cir. 1998).* [**9]

2. Governing Law for Shareholder Demand Requirement

Shareholder derivative actions must comply with *FED. R. CIV. P. 23.1*, which states in relevant part as follows: "The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority . . . and the reasons for the plaintiff's failure to obtain the action or for not making the effort." *Rule 23.1* is related to the substantive requirement that plaintiffs in shareholder derivative suits must first demand that the corporation take the action that the plaintiffs seek to enforce through the suit. See *Kamen v. Kemper Fin. Servs., 500 U.S. 90, 96, 111 S. Ct. 1711, 114 L. Ed. 2d 152 (1991)* (*Rule 23.1* "clearly contemplates both the demand requirement and the possibility that demand may be excused, [but] it does not create a demand requirement of any particular dimension.").

Because the substantive demand requirement is established by state law, courts must apply the law of the forum state-in this case, Washington State. See *Erie R.R. Co. v. Tompkins, 304 U.S. 64, 78, 58 S. Ct. 817, 82 L. Ed. 1188 (1938)*. Washington [**10] State sets forth its own procedural demand requirement for shareholder derivative actions in *RCW 23B.07.400(2)*, which provides as follows:

> A complaint in a proceeding brought in the right of a corporation must be verified and *allege with particularity the demand made, if any, to obtain action by the board of directors and either that the demand was refused or ignored or why a demand was not made.* Whether or not a demand for action was made, if the corporation commences an investigation of the charges made in the demand or com-

> plaint, the court may stay any proceeding until the investigation is completed.

(Emphasis added).

The parties in this case agree that Washington State courts have not interpreted or applied this *procedural* demand requirement, nor have they specifically adopted an underlying *substantive* demand requirement. As a result, both parties rely heavily on case law from other jurisdictions, including the relatively well-developed body of law from Delaware. [3] The "substantive" demand requirement for Delaware is found in Delaware's common law. "[T]he right of a stockholder to prosecute a derivative suit is limited [**11] to situations where the stockholder has demanded that the directors pursue the corporate claim and they have wrongfully refused to do so or where demand is excused because the directors are incapable of making an impartial decision regarding such litigation." *Rales v. Blasband, 634 A.2d 927, 932 (Del. 1993)* (noting the connection between this substantive requirement and the procedural requirement in Chancery Court *Rule 23.1*). The underlying purpose of this requirement is based on the fundamental principle that the "directors of a corporation and not its shareholders manage the [*1120] business and affairs of the corporation" and the "decision to bring a law suit or to refrain from litigating a claim on behalf of a corporation is a decision concerning the management of the corporation." *Levine v. Smith, 591 A.2d 194, 200 (Del. 1991)*, overruled on other grounds by *Brehm v. Eisner, 746 A.2d 244, 253 n.13 (Del. 2000)*.

3 Delaware has adopted a procedural demand requirement, which is found in Delaware Chancery Court *Rule 23.1*, as follows:

> The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort.

[**12] Although relying heavily on Delaware law in their analysis, Plaintiffs suggest that the Court should not necessarily rely on such law but instead look to the plain language of *RCW 23B.07.400(2)* and a two-page unpublished case from the Middle District of Tennessee discussing Tennessee's procedural demand requirement statute, which is identical to the Washington State statute. See *In re Direct General Corp. Sec. Litig., 2005 U.S. Dist. LEXIS 16405, 2005 WL 1895638 (M.D. Term. August 3, 2005)*. The Direct General Court's analysis of the demand requirement was extremely limited, finding "that the allegations of the Verified Complaint are sufficient to excuse the demand otherwise required under Tennessee law" and that the plaintiffs had "shown that the decision-makers' interests and independence herein are sufficiently compromised by the actual allegations against them to excuse demand." *2005 U.S. Dist. LEXIS 16405, [WL] at *1*. The single Tennessee state law case relied upon by Direct General cites extensively to Delaware demand requirement and business judgment rule cases. See *Lewis v. Boyd, 838 S.W.2d 215, 222 (Tenn. App. 1992)*, (citing *Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984)* [**13] and *Levine, 591 A.2d at 212*, regarding interestedness and independence). Thus, Direct General does not provide support for Plaintiffs' contention that Washington State courts would deviate from the long-held corporate law standards of Delaware, nor does it provide any analysis that is useful in disposing of this motion to dismiss.

Rather than simply rely on Direct General as Plaintiffs suggest, this Court must attempt to "predict how the highest court of the state would decide the case if presented with the case today." See *Boland v. Engle, 113 F.3d 706, 710 (7th Cir. 1997)*. The Boland Court noted that this analysis may involve the consideration of relevant authority of other jurisdictions that have addressed the issue. *Id. at 711-12* (noting that "Delaware corporate law is undoubtedly persuasive authority" but concluding that it is not necessarily dispositive). Ultimately, the Boland Court found the trend towards narrowing the exceptions to the demand requirement persuasive and held that Boland's failure to make a demand was not excused. *Id. at 713-14*. In this Case, *RCW 23B.07.400(2)* [**14] strongly implies the existence of a substantive demand requirement in Washington State as does the underlying policy rational (i.e., business decisions are within the province of the Board of Directors and a shareholder demand is a business decision). Accordingly, the Court concludes that the Washington State Supreme Court would likely adopt the substantive demand requirement and apply a similar, if not the same, exception for futility as that employed in Delaware.

B. Shareholder Demand Requirement and the Futility Exception

As described by the Supreme Court of Delaware, "the right of a stockholder to prosecute a derivative suit is limited to situations where the stockholder has demanded that the directors pursue the corporate claim and they have wrongfully refused to do so or where demand is excused because the directors are incapable of making an impartial decision regarding such litigation." *Rales v. Blasband, 634 A.2d at 932.* Plaintiffs acknowledge that no demand was submitted to Cray's Board of Directors in this case. VADC P 119. Accordingly, dismissal is required unless Plaintiffs' failure to comply with the demand requirement was excused under the [*1121] so-called [**15] "futility" exception. See *Rales, 634 A.2d at 933-34.*

Where, as in this case, the plaintiffs in a derivative suit do not challenge any specific decision of the board, courts must "examine whether the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations." *Id. at 934.* [4] Courts must look to the complaint and 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." Id. (emphasis added). As one court described it, "the entire review is factual in nature." *In re Cendant Corp. Derivative Litig., 189 F.R.D. 117, 128 (D. N.J. 1999)* (citing *Aronson, 473 A.2d at 814*). The inquiry requires courts to look to the totality of the circumstances in assessing whether a complaint creates a "reasonable doubt" concerning the board's independence or disinterestedness:

> Terms like reasonable doubt, [**16] for example, help guide judgment but, are not scientific. In making the required judgment no single factor-such as receipt of directorial compensation; family or social relationships; approval of the transaction attacked; or other relationships with the corporation (e.g., attorney or banker)-may itself be dispositive in any particular case. Rather the question is whether the accumulation of all factors creates the reasonable doubt to which Aronson refers.

4

In cases where the plaintiff challenges a specific transaction, the demand requirement may be excused where the plaintiff can show that the transaction was not a product of a valid exercise of the defendants' business judgment. See *Aronson, 473 A.2d at 814*. Here, Plaintiffs do not suggest that this prong of Aronson is applicable.

Harris v. Carter, 582 A.2d 222, 229 (Del. Ch. Ct. 1990). "[T]he concept of reasonable doubt is akin to the concept that the stockholder has a reasonable belief that the board [**17] lacks independence." *Grimes v. Donald, 673 A.2d 1207, 1217 n. 17 (Del. 1996)*, overruled on other grounds by *Brehm v. Eisner, 746 A.2d 244, 253 n.13 (Del. 2000).*

Based on these standards, Plaintiffs' failure to make a demand is excused for futility only if a majority (five) of the members of Cray's Board of Directors, as constituted at the time of filing the VADC, were either "interested" or "lacked independence." Although the Plaintiffs allege 16 separate reasons why a majority of the members of Cray's Board were either interested or lacked independence (meaning a demand on Cray would have been a "futile, wasteful and useless act"), Plaintiffs discuss only four of these allegations in their opposition to Defendants' demand requirement motion. See VADC P 119(a), (c)-(e); Pls.' Opp., at 11-15. The Court limits its analysis of Plaintiffs' futility allegations to only those that Plaintiffs support with argument. [5]

5 Even a cursory review of the remaining allegations reveals that they are generic and conclusory under the "interested" and "independent" standards discussed below. See PP 119(b) (allegation that current directors are not independent of compensation committee), (f) (allegation that directors breached fiduciary duties), (g) (generic allegation of inter-related familiar, business, professional and personal relationships), (h) (generic allegation of knowledge of and/or benefits from wrongdoing), (i) (generic allegation of participation in and/or approval of wrongdoing), (j) (generic allegation that directors would be forced to sue themselves), (k) (repeated allegation of fiduciary duty violations), (1) (generic allegation that Board authorized and/or permitted false statements), (m) (allegation that suit by current directors would "likely expose" directors and officers to further violations of securities laws), (n) (allegation that Cray will be exposed to further losses), (o) (allegation that allowing derivative suit to move forward would expose directors to liability in the class action suits), (p) (allegation that directors may face uninsured liability).

[**18] [*1122] **1. Interested Board Members**

The Rales Court succinctly described the "interest" considerations as follows: "A director is considered interested where he or she will receive a personal financial benefit that is not equally shared by the stockholders. Directorial interest also exists where a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders." *634*

A.2d at 936. However, "the mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge . . . [the] disinterestedness of directors." *In re Sagent Tech., Inc., Derivative Litig., 278 F. Supp. 2d 1079, 1089 (N.D. Cal. 2003)* (quoting Aronson). In other words, "[a] plaintiff may not bootstrap allegations of futility by pleading merely that the directors participated in the challenged transaction or that they would be reluctant to sue themselves." Id. (citations omitted).

In Sagent, plaintiffs alleged that a demand was futile because three of the six board members were either interested or lacked independence. *278 F. Supp. 2d 1079, 1088 (N.D. Cal. 2003).* [**19] One member, Zicker, was allegedly interested because he sold common stock for more than $ 1.3 million in proceeds. *Id. 1088-89*. Plaintiffs alleged that Zicker did so while "in possession of material, adverse nonpublic information." Id. The Sagent Court concluded that this generic allegation was insufficient to demonstrate "a substantial likelihood" that Zicker would be liable for insider trading. *Id. at 1089*. Additionally, the plaintiffs in Sagent alleged that the members of Sagent's Audit Committee "failed to establish and maintain adequate internal accounting controls and to ensure that the company's financial statements were based on accurate information." *Id. at 1084-85*. However, they apparently did not allege that this failure rendered the audit committee interested.

At the time Plaintiffs filed this derivative suit, the members of Cray's Board of Directors included Rottsolk, Smith, Jones, Kennedy, Kiely, Lederman, Narodick, Regis, and Richards. Plaintiffs' opposition brief relies on only two allegations to demonstrate interestedness: (1) Regis, Richards, Narodick, and Lederman are interested because they are members [**20] of Cray's Audit Committee ("Audit Committee Directors") (VADC P 119(e)); and (2) Rottsolk, Smith, Kennedy, and Regis are interested because they sold Cray stock during the Relevant Period ("Selling Directors") (VADC P 119(a)). [6] Pls.' Opp., docket no. 22, at 12-15. Because Plaintiffs must demonstrate that a total of five members were interested or lacked independence, the demand requirement is only excused if they establish that one group or the other is interested *and* there is at least one additional director who was either interested or who lacked independence (for a total of five). The Court turns now to an examination of the allegedly interested directors.

6 Plaintiffs allege that Johnson and Poteracki sold stock during the Relevant Period. VADC P 115. However, those Defendants were not directors when this action commenced.

a. Audit Committee Directors

According to Cray's 2005 Proxy, Cray's Audit Committee "assists the Board of Directors in fulfilling its responsibility for oversight of" [**21] the following: "[1] the quality and integrity of [Cray's] accounting and financial reporting processes and the audits of [Cray's] financial statements; [2] [*1123] the qualifications and independence of the public auditing firm engaged to issue an audit report on [Cray's] financial statements; [3] the performance of [Cray's] systems of internal controls, disclosure controls and internal audit functions, and [4] [Cray's] procedures for legal and regulatory compliance, risk assessment and business conduct standards." VADC P 29(A). Plaintiffs allege that these duties required the Audit Committee to review and discuss financial reporting and accounting policies with management and auditors, review and approve SEC filings in advance, oversee disagreements between management and auditors, and recommend whether financial statements should be included in the 10-K Reports. Id.

In their opposition brief, Plaintiffs argue that three cases support their contention that Cray's Audit Committee Directors are interested under the Rales test. [7] *Cendant, 189 F.R.D. 117*; *In re Lernout & Hauspie Sec. Litig., 286 B.R. 33 (D. Mass. 2002)*; *In re Oxford Health Plans, Inc. Sec. Litig., 192 F.R.D. 111 (S.D.N.Y. 2000)*. [**22] First, Plaintiffs state that the Cendant Court "found demand to be futile in part because it was the Audit Committee's responsibility to catch and correct the accounting irregularities." Resp. Br. at 13. This interpretation of Cendant is mistaken. Plaintiffs cite the "Background" section of the Cendant Court's Order, which noted that the Audit Committee was "specifically informed" that its income was overstated prior to the date Cendant publicly announced that information and, while in possession of this information, several members of the Audit Committee sold a total of 1.8 million shares of Cendant stock in the months before the announcement. *189 F.R.D. at 125*; Pls.' Opp., at 13 n.14. However, the "Demand" section of the Cendant Court's analysis is devoid of any suggestion that the Audit Committee members were interested merely because they were on the Audit Committee. *Id. at 128-29* (citing instead the benefits directors received from transactions, the sale of millions of shares of stock by directors while in possession of adverse information, and the "significant personal liability" directors faced from a pending class action suit). In this [**23] case, the VADC alleges only that the Audit Committee "recommended that the Board include the improper financial statements and publish the improper and misleading press releases throughout the Relevant Period" and that such actions breached the Audit Committee's fiduciary duties. VADC P 119(e). Cendant provides no helpful analysis as to these demand futility allegations.

7

At argument, Plaintiffs' counsel stated that they also relied on *In re Caremark Int'l, Inc., Derivative Litig., 698 A.2d 959 (1996)*, to support the argument that the Audit Committee is "interested." Caremark was discussed in Plaintiffs' brief with regard to the exculpatory provisions in Cray's bylaws and was not discussed in the "Audit Committee" section of Plaintiffs' brief. See Pls.' Opp., at 12-13, 15-16. In any event, Caremark is also discussed below.

Second, Lernout is inapposite as it provides no analysis of the demand requirement and addressed only a motion to dismiss for failure to allege facts [**24] sufficient to state claims for breach of fiduciary duties. Lernout did not apply the "interestedness" standard established in Rales and, in fact, involved class action claims under *Section 10(b)* of the Securities Exchange Act rather than a derivative action. *286 B.R. at 37-38*.

Finally, the Oxford Court offered a lengthy recitation of the demand futility standards and proceeded to conclude demand was excused without any discussion of which specific directors were interested or lacked independence. *192 F.R.D. at 115-18* (concluding that it "appears unnecessary., to address the issue of the [*1124] independence or disinterestedness of the Directors individually"). Instead, the Oxford Court looked generally to the insider trading allegations. *Id. at 117-18*. Contrary to Plaintiffs' suggestion, Oxford is devoid of any discussion regarding the interestedness of the Audit Committee but merely states generally, and without citation, that knowledge of another's improper insider trading is enough to demonstrate interestedness. Oxford does not support Plaintiffs' contention that the Audit Committee Directors are interested by virtue of [**25] their place on the Audit Committee.

Plaintiffs' additional reliance on Caremark is also misplaced. Caremark did not address demand futility, but only stated the liability standard for certain breaches of the duty of care. *698 A.2d at 970* (director's obligation includes a duty to attempt in *good faith* to assure that a corporate information and reporting system exists and failure to do so may, in theory, render a director liable for losses caused by non-compliance). The Caremark Court held that "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." *Id. at 971*. The Court described such a claim as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment" and noted that, even if the harm to the corporation was caused by a violation of the criminal law, it is not necessarily enough to create a breach of fiduciary duty. *Id. at 967, 972*. To demonstrate that the Audit Committee is [**26] interested as the result of a possible Caremark claim, Plaintiffs must provide "particularized factual allegations" that the members face a "materially detrimental impact" if the claim were to proceed. See *Rales, 634 A.2d at 934, 936*. The "mere threat" of liability under a Caremark claim is not enough. *Sagent, 278 F. Supp. 2d at 1089*. Although the VADC alleges broadly that Cray was "virtually devoid of internal controls, processes and procedures in every area of the finance and accounting departments," Plaintiffs have not provided "particularized factual allegations" suggesting that (assuming this characterization is true for purposes of the motion) it was the result of a "sustained or systematic failure" by the Audit Committee. See VADC 119(e).

In sum, Plaintiffs' "demand futility" cases do not stand for the proposition that a committee assigned the general oversight responsibility of the activities underlying a derivative complaint (e.g., establishing accounting controls and guarding against irregularities) *is per se* "interested." Nor have Plaintiffs adequately alleged facts that suggest a substantial likelihood of liability under [**27] a Caremark duty of care claim. Plaintiffs must allege facts that state "with particularity" the manner in which a given director is interested. See *RCW 23B.07.400(2)*. The mere threat of personal liability alone is insufficient. *Sagent, 278 F. Supp. 2d at 1089*. Plaintiffs' generic allegation regarding the Audit Committee Directors fails to demonstrate that those Directors are interested.

b. Insider Sales

The VADC alleges that the Selling Directors include Rottsolk, Smith, Regis, and Kennedy. VADC P 119(a). In its motion to dismiss, Cray contends that (1) Kennedy was an outside director presumed to have no information about day-to-day company affairs, and (2) Kennedy's one sale occurred in August 2003, which, while in the Relevant Period, was before the FY 2004 issues Plaintiffs rely upon. In response, Plaintiffs apparently abandon the allegation that Kennedy is interested as a result of his single stock sale during the [*1125] Relevant Period. See Pls.' Opp., at 14 (no discussion of Kennedy). Accordingly, the Selling Directors, for purposes of this analysis, include only Rottsolk, Smith, and Regis.

The VADC alleges that the [**28] Selling Directors were privy to the adverse, non-public information regarding Cray's accounting systems when they sold shares of Cray stock during the Relevant Period. VADC P 119(a). The Selling Directors engaged in at least nine separate sales during the Relevant Period. Id. P 115 (Sales Schedule). [8]

8 Plaintiffs' schedule of stock sales omits Individual Defendant Smith. Id. at P 115. Plaintiffs allege that Smith sold 49,548 shares for a total of $ 539,052 but do not provide the number of trades or dates of each trade. Id. at P 119(a)(ii).

In support of their argument that the Selling Directors were interested, Plaintiffs rely on a single unpublished opinion from the Delaware Chancery Court. See *Zimmerman v. Braddock (Zimmerman II), 2005 Del. Ch. Lexis 135 (Del. Ch. 2005)*. In Zimmerman II, nominal defendant Priceline licensed its technology to a separate privately-held company, WebHouse, in return for royalties. *Id. at *8*. In the derivative action, the plaintiff alleged [**29] that Priceline's management knew that WebHouse was losing $ 5 million a week and having technical problems causing the website to crash. *Id. at *9*. In spite of these problems, Priceline's management continued to publicly tout the prospects of the technology and its relationship with WebHouse. *Id. at *10*. During this period, three of Priceline's directors sold approximately $ 248 million worth of Priceline's stock in just 45 days. *Id. at *11 n.21*. In determining whether these three directors were interested for purposes of the demand futility analysis, the Delaware Chancery Court reasoned as follows:

> A reasonable inference from the Plaintiff's allegations is that the Selling Defendants had knowledge -- directly and by imputation -- of Priceline and WebHouse's problems. In addition, it is a reasonable inference that the public was not aware of Priceline's true predicament because its problems -- even if they had been partially disclosed -- were likely overshadowed by the public hyperbole of Priceline's executives.
>
> . . .
>
> When the sheer size of the trades (collectively, approximately $ 248 million dollars) is combined with the Plaintiff's well-pled allegations [**30] of insider trading culpability, the Selling Defendants, for motion to dismiss purposes, can be viewed as facing substantial personal liability even though the materiality of the trades (or the consequences of an action challenging them) to the Selling Defendants has not been specifically pled.
>
> . . .
>
> The question with regard to demand futility is whether the trading directors could impartially consider a shareholder's demand upon the corporation to pursue a claim against them based on their trades. In light of the allegations in the Second Amended Complaint and the value of the Selling Defendants' trades, it is a reasonable inference that the Selling Defendants would be personally and significantly concerned about, and opposed to, any such demand and, thus, interested in whether the Priceline Board would pursue a claim based on their trades.

*Id. at *32-35*. Also, in *Zimmerman* [*1126] *v. Braddock (Zimmerman I), 2002 Del. Ch. LEXIS 145, *8 n.64*, the selling defendants did not even contest the fact that they were interested as a result of the $ 248 million in stock sales, which was likely a consideration for the Zimmerman II Court. *2005 Del. Ch. LEXIS 135 at *29*.

In this case, Plaintiffs contend [**31] that the Selling Directors were privy to inside information concerning "the complete absence of the Company's internal controls and the difficulties Cray was encountering producing and qualifying its new products" as a result of their positions as CEO (Rottsolk), employee (Smith), and Chairman of Cray's Audit Committee (Regis). Pls.' Opp., at 14. Plaintiffs cite no other allegations in the VADC that state what specific information Rottsolk, Smith, and Regis knew, or when they would have become aware, of such information in relation to each stock sale.

Cray argues that Plaintiffs' insider trading claims do not demonstrate "interestedness" because (1) Regis was (like Kennedy) an outside director, (2) Plaintiffs' allegations are conclusory and insufficient under the case law, and (3) the sales by Rottsolk and Smith were made pursuant to *Rule 10b-5* plans, which provides an affirmative defense. First, Cray notes that Regis was an outside director during the entire Relevant Period and that the law presumes that outside directors are not responsible for false or misleading information under the "group published information" rule. See *Decker v. GlenFed, Inc. (In re GlenFed, Inc., Sec. Litig.), 60 F.3d 591, 593 (9th Cir. 1995)*. [**32] In GlenFed, the Ninth Circuit held that "[m]erely because the complaint identifies a corporation's outside directors, various committee assignments, and generic responsibilities for every committee" does not mean such outside directors are responsible for information published on behalf of the group. Id. Plaintiffs do not directly respond to this argument and appear to rely only on the fact that Regis was the Chairman of Cray's Audit Committee.

Second, Cray contends that at least two cases applying Delaware law, Sagent and *Guttman v. Huang, 823 A.2d 492 (Del. Ch. Ct. 2003)*, have held that similar insider trading claims were insufficient to demonstrate interestedness. In Sagent, the plaintiffs alleged that Zicker "sold 80,000 shares of Sagent common stock while in the possession of material, adverse, non-public information," reaping a $ 1.3 million profit. *278 F. Supp. 2d at 1088*. The Sagent Court concluded that the director was not interested because the complaint contained no allegation that the director was in possession of any particular material adverse information when he sold Sagent stock. *Id. at 1089*. Similarly, [**33] in Guttman, the complaint alleged that "each of the defendants who sold during the contested period was in possession of material, non-public information and traded to his personal advantage using that information." *823 A.2d at 496*. The complaint also stated that "[e]ach of the defendants was in a position to know of the improper accounting practices engaged in by NVIDIA" and "[e]ach of the defendants engaged in trades shortly after NVIDIA released a financial statement that was later restated." *Id. at 496-97*. The Guttman Court concluded that these allegations were "wholly conclusory" and did not include "well-pled, particularized allegations of fact detailing the precise roles that these directors played at the company, the information that would have come to their attention in those roles, and any indication as to why they would have perceived the accounting irregularities." *Id. at 503*.

Finally, Cray contends that the trades by Rottsolk and Smith are subject to an [*1127] affirmative defense because those trades were effectuated under *10b-5* plans that automatically dictated the amount and timing of the sales. For example, Rottsolk's [**34] scheduled sales included 15,000 shares each in August, September, October, and November 2003, and January 2004. VADC P 115. In response, Plaintiffs argue that a ruling on this affirmative defense would only be appropriate in a summary judgment motion after the case has been developed factually through discovery. Plaintiffs are correct that the Court may not consider affirmative defenses at this juncture, particularly where Defendants have not yet filed an Answer to the VADC.

While the interestedness determination for insider sales is not entirely clear, the cases support Cray's contention that the Plaintiffs' allegations are insufficient. Both *Sagent* and *Guttman* analyzed nearly-identical allegations regarding insider sales and found those allegations conclusory and insufficient to demonstrate interestedness. In contrast, the more recent unpublished opinion in Zimmerman II held that similar allegations were sufficient to demonstrate interestedness. However, the Zimmerman II Court gave significant weight to the "sheer size of the trades (collectively, approximately $ 248 million dollars)," all of which occurred in 45 days. *2005 Del. Ch. Lexis 135 at *11,* [**35] *33-35*. That volume of trading is absent from this case, where the Selling Defendants sold a total of 161,527 shares of Cray stock for approximately $ 1.71 million in proceeds over a 16-month period. See VADC PP 115, 119(a) (sales occurred from August 2003 to December 2004). As a result, the weight of authority analogous to this case supports Defendants' argument and the Court concludes that the Selling Directors were not interested. [9]

9 The Court also notes that, for the reasons discussed in Part II.B below, common law insider trading claims are not available in Washington State. Because the Selling Directors are not subject to personal liability for derivative insider trading claims, the sufficiency of the "interestedness" futility allegation is further diminished.

2. Independence of Board Members

The Rales Court described the "independence" considerations as follows:

> [I]ndependence means that a director's decision is based on the corporate merits of the subject before the board [**36] rather than extraneous considerations or influences. To establish a lack of independence, [plaintiff] must show that the directors are beholden to the [interested directors] or so under their influence that their discretion would be sterilized.

634 A.2d at 936 (quotations and citations omitted). In Texlon Corp. v. Myerson, the Delaware Supreme Court elaborated on this standard, stating as follows:

> A controlled director is one who is dominated by another party, whether through close personal or familial relationship or through force of will. A director may also be deemed "controlled" if he or she is beholden to the allegedly controlling entity, as when the entity has the direct or indirect unilateral power to decide whether the director continues to receive a benefit upon which the director is so dependent or is of such subjective material importance that its threatened loss might create a reason to question whether the director is able to consider the corporate merits of the challenged transaction objectively.

802 A.2d 257, 264 (Del. 2002).

In a single paragraph of argument, Plaintiffs contend that two members of Cray's Board, [**37] Rottsolk and Smith, are not independent. Pls.' Opp., at 11-12 (arguing Rottsolk and Smith are not independent [*1128] because they rely on substantial income from Cray as employees). Plaintiffs are correct. In Rales, the Court found that two members of the board (Sherman, the CEO, and Ehrlich, the President of a related company) lacked independence from two controlling directors where they received large salaries from the companies and, therefore, it could be inferred that they were beholden. *634 A.2d at 937.* [10] Additionally, Defendants do not respond to Plaintiffs' argument that Rottsolk and Smith lack independence and, at argument, Defendants' counsel all but conceded that the Delaware cases hold as such. Therefore, the Court presumes that the argument has merit and concludes that Rottsolk and Smith are "interested" for purposes of this motion.

10

But see *Sagent, 278 F. Supp. 2d at 1089* (board members do not lack independence based solely on their positions and the monetary compensation they received in connection with their duties as employee and consultant for the company). However, the Sagent Court relied only on a pre-Rales case from Delaware for this proposition and, therefore, does not provide a helpful analysis. See id. (citing *Grobow v. Perot, 539 A.2d 180, 188 (Del. 1988)).*

[**38] **3. Plaintiffs have not Established that Demand was Futile**

Under the demand futility analysis, Plaintiffs must demonstrate through the allegations contained in the VADC that a majority (five) of the members of Cray's Board of Directors are either interested or lack independence. *Rales, 634 A.2d at 933-34.* Plaintiffs have failed to make such a showing. The relevant case law does not hold that a director is interested merely by virtue of sitting on an Audit Committee while the corporation faces accounting and audit irregularities. Similarly, the weight of authority suggests that Rottsolk, Smith, and Regis are not interested as a result of having sold shares of Cray stock during the Relevant Period. Both Sagent and Guttman specifically held that insider sales such as those at issue here were insufficient, and the lone, unpublished case cited by Plaintiffs is distinguishable to the extent that the proceeds in this case ($ 1.71 million) are vastly disproportionate to Zimmerman, where the Court noted the "sheer size of the trades" ($ 248 million). Finally, the only directors who lack independence are Rottsolk and Smith. [11] Accordingly, the Court GRANTS [**39] Defendants' motion to dismiss for failure to comply with the pre-litigation demand requirement.

11 The Court notes that even if the Selling Directors were interested, Plaintiffs fail to demonstrate that a majority of Cray's Board is impartial because Rottsolk and Smith are in both groups.

II. Individual Defendants' Motion to Dismiss [12]

12 The motion to dismiss for failure to adequately plead demand futility is also GRANTED as to the Individual Defendants, who incorporate that argument by reference into their motion to dismiss. The Court will also consider the Individual Defendants' separate motion to dismiss.

In addition to joining Cray's motion to dismiss for failure to comply with the demand requirement, the Individual Defendants move separately to dismiss the VADC for failure to comply with the pleading requirements [**40] in *Rule 9(b)*, and failure to state claims upon which relief can be granted under *Rule 12(b)(6)*. First, the Individual Defendants contend that the VADC alleges a "unified course of fraudulent conduct," requiring Plaintiffs to state those fraud allegations with particularity. Second, the Individual Defendants argue that Plaintiffs' two claims relating to insider trading may not be brought in a derivative action. See VADC PP 120-24 (Count [*1129] I: Breach of Fiduciary Duty for Misappropriate Information), 145-47 (Count VI: Unjust Enrichment). Third, the Individual Defendants contend that Plaintiffs' claims for breach of fiduciary duties, abuse of control, gross mismanagement, and waste (Counts II, III, IV, and V, respectively) must be dismissed because Plaintiffs fail to allege any cognizable claim for damages. Finally, the Individual Defendants contend that Plaintiffs' claim for corporate waste must also be dismissed for failure to allege facts sufficient to state a claim.

A. Failure to Plead Fraud Under *Federal Rule of Civil Procedure 9(b)*

Under *FED. R. CIV. P. 9(b)*, "[i]n all averments of fraud or [**41] mistake, the circumstances constituting fraud or mistake shall be stated with particularity." In general, *Rule 9(b)* requires fraud allegations to include "the who, what, when, where, and how of the misconduct charged." *Vess v. CIBA-Geigy Corp., USA, 317 F.3d 1097, 1106 (9th Cir. 2003)* (quotations omitted). The Ninth Circuit has distinguished between cases in which fraud allegations form the entire basis for a claim and cases in which there is both fraudulent and non-fraudulent conduct underlying a claim:

> In some cases, the plaintiff may allege a unified course of fraudulent conduct and

> rely entirely on that course of conduct as the basis of a claim. In that event, the claim is said to be "grounded in fraud" or to "sound in fraud," and the pleading of that claim as a whole must satisfy the particularity requirement of *Rule 9(b)*.
>
> . . .
>
> In other cases, however, a plaintiff may choose not to allege a unified course of fraudulent conduct in support of a claim, but rather to allege some fraudulent and some non-fraudulent conduct. In such cases, only the allegations of fraud are subject to *Rule 9(b)*'s heightened pleading requirement.

Id. at 1103-04 [**42] (citations omitted).

Here, the parties' dispute centers on whether any or all of Plaintiffs' claims are "grounded in fraud" such that they are entirely subject to *Rule 9(b)* or whether the fraud allegations may be addressed separately. The Individual Defendants argue that each claim is grounded in fraud because Plaintiffs incorporate by reference allegations of misrepresentation and concealment. See VADC PP 3, 4, 7, 41-42 (alleging knowing misrepresentations, concealment of facts, misleading of analysts, and conspiracy). The Individual Defendants contend that these allegations are conclusory and fail to allege what was false or misleading about the statements, which directors and officers knew they were misleading, and when they knew it.

In response, Plaintiffs first argue that a number of their claims do not rely on allegations of fraud. In particular, Plaintiffs refer to their claims for (1) breach of the fiduciary duties of good faith and due care, (2) gross mismanagement, and (3) waste. These claims are based in part upon allegations that the Individual Defendants failed to fulfill a duty to implement effective internal controls over Cray's financial reporting. See VADC [**43] PP 125-130 (breach of fiduciary duty of care and good faith), 136-140 (gross mismanagement), 141-144 (waste). This argument has merit. Plaintiffs allege that the Individual Defendants "abandoned and abdicated their responsibilities and fiduciary duties with regard to prudently managing the assets and business of Cray" and failed "to conduct proper supervision." Id. PP 137, 142. These allegations and the claims they support do not rely on or involve fraud. Under the distinction described in Vess, the breach of duty of care, mismanagement, and waste claims are not subject to *Rule 9(b)* and do not fail in their [*1130] entirety as the Individual Defendants contend.

Second, Plaintiffs argue that those claims dependant on averments of fraud may also stand because the VADC satisfies the "particularity" requirement of *Rule 9(b)*. This argument is not well taken. In support of their position that they sufficiently alleged the "who, what, where, when, and how"of the fraud allegations, Plaintiffs simply cite to paragraphs 55, 63, 66-67, 75, 81, 93, 99, and 100 of the VADC, without further explanation. However, these allegations are largely conclusory and redundant. Paragraphs 55, 63, 66-67, 75, [**44] and 81 simply offer repeated citations to Cray's 10Q quarterly public disclosures, which each state (with some minor variation) in relevant part as follows:

> Based on the evaluation, our principal executive and financial officers each concluded that, as of the date of the evaluation, our disclosure controls and procedures were effective in providing reasonable assurance that material information relating to Cray and our consolidated subsidiaries is made known to management, including during the period when we prepare our periodic SEC reports.

Id. at P 55. The VADC alleges only that, in fact, Cray "did not have sufficient internal controls to ensure either that revenue was properly recognized or that financial information was accurately reported." Id. at P 56. Plaintiffs do not explain why or when Cray's CEO and CFO stopped concluding that Cray's procedures were effective, nor do they state how or when the other Individual Defendants would have learned of this information. Similarly, paragraphs 93, 99, and 100 merely cite Cray's disclosure that it expected to, and ultimately did, identify material weaknesses in its internal controls and accounting procedures. [**45] The VADC fails to explain how these disclosures, which are apparently pled to demonstrate that the earlier statements were false, establish that the Individual Defendants knew the earlier statements were false when made.

Finally, Plaintiffs argue that much of the evidence related to the fraud allegations is in the hands of the Individual Defendants, essentially seeking to excuse the generality of the VADC until they can obtain such evidence through discovery. See *U.S. ex. rel. Lee v. Smithkline Beecham, Inc., 245 F.3d 1048, 1052 (9th Cir. 2001)* ("*Rule 9(b)* may be relaxed to permit discovery in a limited class of corporate fraud cases where the evidence of fraud is within a defendant's exclusive possession."), overruled on other ground by *Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1575 (9th Cir. 1990)*. However, the cases allowing for a relaxed application of *Rule 9(b)* continue to require significant particularity in the pleading. See, e.g., *Wool v. Tandem Computers, Inc., 818 F.2d 1433, 1440 (9th Cir. 1987)* (fraud allegations are "very precise" and specify "the exact dollar amount of each alleged overstatement, and the [**46] manner in which such representations were false and misleading"); *Fed. Sav. and Loan Ins. Corp. v. Musacchio, 695 F. Supp. 1053, 1058-59 (N.D. Cal. 1988)* ("In virtually every instance in which fraud is alleged the plaintiffs have set forth the time, place and manner of the allegedly fraudulent acts."). No such precision or specificity is present in the VADC. Thus, the Court also GRANTS the Individual Defendants' motion to dismiss the fraud allegations for failure to comply with *Rule 9(b)* and dismisses those claims without prejudice. [13]

> 13 The claims based in fraud include Count I (breach of fiduciary duty of loyalty and good faith for insider selling), Count II (breach of fiduciary duty of loyalty and good faith for improperly misrepresenting Cray's financial statements), part of Count V (waste caused by improper public statements, financial results and prospectus), and Count VI (unjust enrichment for insider selling on the basis of misrepresented financial information).

[*1131] **B. Insider Trading** [**47] **Claims (Counts I and VI) Under *Federal Rule of Civil Procedure 12(b)(6)***

A motion to dismiss for failure to state a claim under *FED. R. CIV. P. 12(b)(6)* may be granted only where it appears beyond a reasonable doubt that the plaintiff can prove no set of facts that would entitle the plaintiff to relief. *Conley v. Gibson, 355 U.S. 41, 45-46, 78 S. Ct. 99, 2 L. Ed. 2d 80 (1957)*. Allegations of material fact are taken as true and construed in the light most favorable to the nonmoving party. *Smith v. Jackson, 84 F.3d 1213, 1217 (9th Cir. 1996)*. However, conclusory allegations of law and unwarranted inferences are insufficient to defeat a motion to dismiss. *Associated Gen. Contractors v. Metro. Water Dist. of So. Cal., 159 F.3d 1178, 1181 (9th Cir. 1998)*.

The Individual Defendants raise four arguments in support of their motion to dismiss the insider trading claims (Counts I and VI) for failure to state a claim: (1) not all of the Individual Defendants sold stock during the relevant period and those that did not should be dismissed as to the insider trading claims; (2) several of the [**48] Selling Defendants sold pursuant to *10b-5* plans, which provides an affirmative defense; (3) several of the Selling Defendants *purchased* and continued to hold shares during the Relevant Period; and (4) there is no common law derivative cause of action for insider trading because Cray sustained no damages. Defs.' Mot. at 6-9.

The Individual Defendants' first three arguments are not well developed and are without merit in the context of a *12(b)(6)* motion to dismiss. First, the VADC refers to the "Insider Selling Defendants" in Count I and the "defendants" in Count VI. See VADC PP 120-124, 145-147. Plaintiffs specify which Individual Defendants sold Cray stock during the Relevant Period. Id. P 115. [14] Thus, under the minimal notice pleading requirement of *Rule 8(a)*, the VADC adequately identifies the Individual Defendants at issue in Counts I and VI. Second, the *10b-5* argument is, as the Individual Defendants acknowledge, an affirmative defense. The Individual Defendants have filed no Answer to the VADC and, therefore, alleged no affirmative defenses. The Court will not dismiss the insider sales claims on the basis of a yet-to-be-pled affirmative defense, particularly where [**49] the Individual Defendants bear the burden of proof. See T. HAZEN, THE LAW OF SECURITIES REGULATION § 12.17 (5th ed. 2002) (noting that courts require the defendant to demonstrate that stock sales were made pursuant to a *10b-5* plan). Third, the Individual Defendants do not support their argument that Smith, Johnson, Rottsolk and Poteraki should be dismissed because they purchased and held additional shares during the Relevant Period. The Individual Defendants cite no authority for the proposition that a defendant's purchase of stock during a period of allegedly unlawful insider sales entitles them to dismissal.

> 14 Plaintiffs have, however, mistakenly omitted Defendant Smith from this schedule, but they name Smith as a Selling Defendant in paragraphs 15 and 119(a).

The more closely contested issue is whether a common law derivative claim for insider selling even exists. The Individual Defendants cite two cases holding that such claims are not available and a leading corporate law treatise stating that a [**50] majority of courts are in agreement. See *Freeman v. Decio, 584 F.2d 186, 192-95 (7th Cir. 1978)* (claim dismissed because (1) no damages to corporation and (2) defendants would be subject to double liability [*1132] given availability of *Rule 10b-5* claims); *Frankel v. Slotkin, 795 F. Supp. 76, 79-80 (E.D.N.Y. 1992)* (claim dismissed for lack of actual damage to the corporation); 3A WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1174 (perm. ed. 2002) ("[M]ost courts considering the issue have rejected a common law corporate cause of action against directors and officers for insider trading"). The Individual Defendants also note that Washington State generally requires a showing of damages for breach of fiduciary duty and unjust enrichment claims. See *Interlake Porsche Audi, Inc. v. Bucholz, 45 Wn. App. 502, 509, 728 P.2d 597 (1986)* (showing of proximate causation of loss sustained by corporation required); *Bailie Communications, Ltd. v. Trend Bus. Sys., Inc., 61 Wn. App. 151, 159, 810 P.2d 12 (1991)* (unjust enrichment claim requires showing defendants enriched themselves at the expense of the corporation).

In response, [**51] Plaintiffs rely heavily on *Brophy v. Cities Service Company, 31 Del. Ch. 241, 70 A.2d 5, 8 (Del. Ch. 1949)*, which held that "[i]n equity, when the breach of a confidential relation by an employee is relied on and an accounting for any resulting profits is sought, loss to the corporation need not be charged in the complaint." See also *Diamond v. Oreamuno, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78, 83 (1969)* (relying on Brophy in holding that there may be an insider trading claim); *Walton v. Morgan Stanley & Co., Inc., 623 F.2d 796, 798 (2d Cir. 1980)* (stating that Delaware courts have "consistently followed" Brophy's holding that a breach of fiduciary duty is actionable absent an injury without analyzing Brophy's continued viability after the implementation of *10b-5* liability). In Brophy, the plaintiff alleged that the insider defendant had knowledge of the corporation's plan to buy back its own stock on certain prearranged dates. *70 A.2d at 6.* The plaintiff further alleged that the defendant breached a duty of trust to the corporation by purchasing shares of the corporation's stock for himself just before the buy-back and then selling the shares after [**52] the buy-back for a profit. Id. Plaintiffs' reliance on Brophy is misplaced. In Freeman, the Seventh Circuit examined the continued viability of Brophy in 1978 and reasoned that allowing derivative common law claims for insider trading would create the problem of double liability because a statutory remedy was available under *Rule 10b-5. 584 F.2d at 195-96.* The Freeman Court also distinguished Brophy on the grounds that, at least implicitly, the Brophy Court recognized that the corporation did suffer potential harm in becoming a competitor in the market for its own stock with the insider defendant who purchased shares contemporaneously. *Id. at 194.*

Plaintiffs also cite an inapposite section of Fletcher's treatise on corporations, which is inconsistent with the section relating specifically to the insider trading cases cited above. See Pls.' Opp., at 14 (citing FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS at § 888). Finally, Plaintiffs cite the Zimmerman II Court's conclusion that the plaintiff had adequately pled an insider trading claim where defendants sold approximately $ 248 million in Priceline stock with [**53] the knowledge that Priceline's business relationship with WebHouse was not succeeding. *2005 Del Ch. Lexis 135 at *8 n.84 (2005)* (unpublished).

The Individual Defendants' argument with regard to the unavailability of insider trading derivative claims has merit. The Court finds persuasive the Seventh Circuit's reasoning that *Brophy* is no longer relevant in this context because it was decided well before private causes of action were available to individual shareholders under *Rule 10b-5*. There is also no dispute that Washington State case law [*1133] acknowledges the general requirement that damages are an essential element of derivative claims for breach of fiduciary duties and unjust enrichment. Thus, although it is an open question, the Court also concludes that the Washington State courts would decline to adopt a common law derivative claim for insider trading where there is no allegation of damage to the nominal defendant corporation.

The Court GRANTS the Individual Defendants' motion to dismiss Counts I (breach of fiduciary duties by insider selling defendants) and VI (unjust enrichment) of the VADC for this reason as well.

C. Failure to Adequately Plead Damages [**54] **(Counts II-V)**

The Individual Defendants contend that Counts II (breach of fiduciary duties), III (abuse of control), IV (gross mismanagement) and V (corporate waste) must be dismissed because the VADC fails to allege any recoverable damages. Counts II through IV simply state that Cray has "sustained significant damages." VADC PP 129, 133, 138. Count V alleges that the Individual Defendants caused Cray to waste corporate assets by "paying incentive based bonuses to certain of its executive officers and incur [sic] potentially millions of dollars of legal liability and/or legal costs to defend defendants' unlawful actions." Id. P 142. Plaintiffs' opposition brief suggests that these claims are based on allegations that Cray sustained damages in the form of (1) costs incurred to carry out internal investigations of, and defend against, potential legal liability from the pending class action lawsuit, and (2) harm to Cray's corporate image and good will that impairs Cray's ability to raise equity capital or debt. Id. PP 38-39, 104. The Individual Defendants maintain that these damage allegations are speculative and unrecoverable.

1. Costs of Investigating [**55] **and Defending Class Action**

The Individual Defendants rely on several cases holding that legal costs and potential legal liability arising out of a separate class action suit are not recoverable damages in a derivative action. See Defs.' Mot., at 10. For example, in In re Symbol Technologies Securities Litigation, the complaint alleged as damages that the corporation might be "caused to pay amounts with regard to the claims asserted in the Class Action, or [] caused to pay any legal fees and incidental expenses in connection with defending such claims." *762 F. Supp. 510, 516 (E.D.N.Y. 1991).* The District Court in Symbol deemed such damages unrecoverable because they were contingent on the outcome of a class action suit in which no judgment had been entered or settlement reached. Id. The Individual Defendants provide four other unpublished district court cases applying the same reasoning. See *Dollens v. Zionts, 2002 U.S. Dist. LEXIS 13511, 2002 WL 1632261 *9 (N.D. Ill. 2002)*; *In re United Telecomms., Inc., Sec. Litigation, 1993 U.S. Dist. LEXIS 4749, 1993 WL 100202 *3 (D. Kan. 1993)*; *Daisy Sys. Corp. v. Finegold, 1988 U.S. Dist. LEXIS 16765, 1988 WL 166235 *4 (N.D. Cal. 1988)*; [**56] *Falkenberg v. Baldwin, 1977 U.S. Dist. LEXIS 15456, 1977 WL 1025 *4 (S.D.N.Y. 1977)*.

In response, Plaintiffs cite only a single unpublished case attached as a slip opinion to their Response brief. See Mehlenbacher v. Jitaru, Case No. 04-cv-1118-Orl-22KRS (M.D. Fl. June 6, 2005). In Mehlenbacher, the plaintiff brought an indemnity and contribution claim alleging damages for legal costs incurred by "the SEC investigation, the securities fraud class actions, and the internal investigations of the Company." Slip Op. at 10. The class action had been voluntarily dismissed without payment of settlement. Id. at 9. Without discussion or citation to analogous cases, the District Court in Mehlenbacher simply concluded that "Count II may not [*1134] be a model of pleading, but it does pass muster under the liberal *Fed. R. Civ. P. 8(a)* standard." Id. at 10. Mehlenbacher is not instructive due to its lack of analysis or support. In contrast, Symbol Technologies, Dollens, United Telecommunications, Daisy Systems, and Falkenberg each held that derivative claims are foreclosed when they merely allege damages based on the potential costs of investigating, defending, [**57] or satisfying a judgment or settlement for what might be unlawful conduct. The Court concludes that Plaintiffs' damage allegations based on potential costs of the class action suits are insufficient to state a claim for relief.

2. Loss of Goodwill and Increased Financing Costs

The Individual Defendants argue that Plaintiffs cannot recover damages based on allegations of lost goodwill and a "liar's discount" that will potentially increase the costs of obtaining financing. VADC PP 39, 104, 142. Again, the Individual Defendants rely on Symbol Technologies and similar cases which dismissed claims for such damages. *762 F. Supp. at 517* (allegation that defendants undermined the company's credibility in the marketplace was "boilerplate" and insufficient to withstand motion to dismiss). See also *United Telecomms., 1993 U.S. Dist. LEXIS 4749, 1993 WL 100202 at *2*; *Dollens, 2002 U.S. Dist. LEXIS 13511, 2002 WL 1632261 at *9*.

In response, Plaintiffs cite only the unpublished Cement-Lock v. Gas Technology Institute, 2005 WL 2420374 at *13 (N.D. Ill. 2002), in which the plaintiff alleged the following damages:

> (1) misappropriation of millions of dollars in grant money, [**58] which prevented the development of the Technology and results in the future loss of profits from the licensing of the Technology; (2) *harm to Cement-Lock Group's business reputation*; (3) lost business opportunities to market the Technology to other individuals, corporations, or governmental entities, including Taiwan, Hong Kong, and China; and (4) devaluation of Cement-Lock Group's intellectual property by wasted years in the lifespan of certain patents and confusion and infringement on the Technology's service mark and trademark.

(Emphasis added). With reference to all of these allegations, the Cement-Lock Court stated only: "Such damages are neither speculative nor remote. Under the common law, concrete injury to business reputation will satisfy the injury element of standing." Id.

While there is some inconsistency in the case law (i.e., Symbol Technologies, United Telecommunications, and Dollens versus Cement-Lock), the weight of authority suggests that lost goodwill and business reputation damage allegations must be more than speculative and conclusory. Moreover, Cement-Lock is in agreement to a degree, requiring "concrete" injury to a corporation's [**59] business reputation. Here, Plaintiffs bring only a single allegation that specifies any present damage to Cray. VADC P 104 (alleging that "the fees, interest rates and terms" of a June 1, 2005, credit agreement "were far less favorable than those that would have been available to a well managed company with established and fully functioning internal financial controls"). This allegation is conclusory, failing to identify the fees, interest rate or terms, or to provide any explanation as to how the credit agreement was unfavorable. Accordingly, the Court concludes that Counts II through V fail to identify recoverable damages for loss of goodwill or business reputation and GRANTS the Individual Defendants' motion to dismiss without prejudice for this reason as well.

D. Failure to Allege Waste of Corporate Assets (Count V)

Finally, the Individual Defendants contend that Plaintiffs' claim for [*1135] waste of corporate assets (Count V) should also be dismissed for failure to state a claim under *Rule 12(b)(6)*. Corporate waste is defined as "an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing [**60] to trade." *Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997)*. In this case, Plaintiffs allege that the Individual Defendants caused Cray to engage in corporate waste "by paying incentive based bonuses to certain of its executive officers and incur [sic] potentially millions of dollars of legal liability and/or legal costs to defend defendants' unlawful actions." VADC P 142. The Individual Defendants argue that this claim must fail because (1) there is no allegation the bonuses were made without consideration or constituted a gift, and (2) there is no allegation that the costs associated with defending the pending legal actions are egregious or irrational. See *Lewis, 699 A.2d at 336* (no corporate waste where any substantial consideration was received by the corporation); *White v. Panic, 783 A.2d 543, 554 n.36 (Del. 2001)* (corporate waste claim requires plaintiff to show (and by implication allege) that the board's decision was egregious and irrational). Plaintiffs provide no opposition to this argument. Because the corporate waste allegation is unsupported and there is no opposition from the Plaintiffs, the Court GRANTS the Individual [**61] Defendants' motion to dismiss Count V without prejudice.

CONCLUSION

For the reasons stated above, the Court rules as follows:

The joint motion by Cray and the Individual Defendants to dismiss for failure to comply with the pre-litigation demand requirement, docket no. 18, is GRANTED and the VADC is DISMISSED WITHOUT PREJUDICE.

The Individual Defendants' motion to dismiss for failure to comply with *Rule 9(b)*, docket no. 16, is GRANTED IN PART and DENIED IN PART. The motion is GRANTED as to specific allegations of fraud and misrepresentation and those claims are DISMISSED WITHOUT PREJUDICE. The motion is DENIED as to the request to dismiss Counts I through VI in their entirety.

The Individual Defendants' motion to dismiss Counts I and VI for failure to state breach of fiduciary duty and unjust enrichment claims on the basis of insider selling, docket no. 16, is GRANTED. Counts I and VI are DISMISSED WITH PREJUDICE.

The Individual Defendants' motion to dismiss Counts II through V, docket no. 16, is GRANTED. Counts II through V are DISMISSED WITHOUT PREJUDICE.

IT IS SO ORDERED.

DATED this 27th day of April, 2006.

s/ Thomas S. Zilly

United [**62] States District Judge

Surowitz v. Hilton Hotels Corp.,
383 U.S. 363 (U.S. 1966)

SUROWITZ v. HILTON HOTELS CORP. ET AL.

No. 161

SUPREME COURT OF THE UNITED STATES

383 U.S. 363; 86 S. Ct. 845; 15 L. Ed. 2d 807; 1966 U.S. LEXIS 2989; 10 Fed. R. Serv. 2d (Callaghan) 678

January 20, 1966, Argued
March 7, 1966, Decided

PRIOR HISTORY: CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

DISPOSITION: *342 F.2d 596*, reversed and remanded.

SUMMARY:

In the United States District Court for the Northern District of Illinois, a corporate stockholder filed a complaint containing detailed allegations of fraud by the officers and directors of the corporation. Pursuant to *Rule 23(b) of the Federal Rules of Civil Procedure*, requiring verification of complaints in stockholders' derivative suits, the plaintiff verified the complaint. Over the plaintiff's protest and without being required to file an answer, the defendants were granted a motion to require the plaintiff to submit herself to an oral examination by the defendants' counsel. During such examination, the plaintiff indicated that she did not understand the complaint at all, that she did not know about and could not explain the allegations in the complaint, and that in signing the verification she had merely relied on what her son-in-law had explained to her about the facts of the case. The defendants thereupon moved to dismiss the complaint. In response to this motion, affidavits were filed by the plaintiff's attorney and by the plaintiff's son-in-law, alleging that the plaintiff was a Polish immigrant with a very limited English vocabulary and practically no formal education; that her son-in-law, a professional investment advisor, had used over $ 2,000 of her money to purchase some stock in the defendant corporation for her; that after the corporation had declined to pay its dividend, she sought her son-in-law's advice and was advised by him that he had investigated the corporation and had found that the management had wrongfully damaged the corporation; and that she verified the complaint on the basis of her faith that her son-in-law had correctly advised her that the statements in the complaint were either true or to the best of his knowledge he believed them to be true. Despite these affidavits, the District Court, holding that the plaintiff's verification was false and that she had therefore not complied with *Rule 23(b)*, dismissed the case with prejudice. The Court of Appeals for the Seventh Circuit affirmed. (*342 F2d 596*.)

On certiorari, the United States Supreme Court reversed and remanded the case to the District Court for trial on the merits. In an opinion by Black, J., expressing the views of six members of the Court, it was held that in view of the purpose of *Rule 23(b)* and the circumstances of the instant case, the Rule did not justify dismissal.

Harlan, J., concurred on the ground that the affidavit by the plaintiff's attorney constituted a sufficient verification to comply with *Rule 23(b)*.

Warren, Ch. J., and Fortas, J., did not participate.

LAWYERS' EDITION HEADNOTES:

[***LEdHN1]

PLEADING §7

stockholder's suit -- verification --

Headnote:[1]

Rule 23(b) of the Federal Rules of Civil Procedure, requiring verification of complaints in stockholders' derivative suits, is not intended to bar derivative suits, but is designed to discourage "strike suits" by people who might be interested in getting quick dollars by making charges without regard to their truth so as to coerce corporate managers to settle worthless claims in order to get rid of them.

[***LEdHN2]

PLEADING §7

stockholder's suit -- verification --

Headnote:[2]

Rule 23(b) of the Federal Rules of Civil Procedure, requiring verification of complaints in stockholders' derivative suits, does not justify dismissal of a complaint alleging fraudulent conduct in violation of federal securities laws, where the verification is based on advice received by the plaintiff rather than on her own knowledge, but where the action, instead of being a "strike suit" or anything akin to it, involves charges founded on reasonable beliefs growing out of careful investigation.

[***LEdHN3]

COURT §1

Federal Rules of Civil Procedure -- purpose --

Headnote:[3]

The basic purpose of the Federal Rules of Civil Procedure is to administer justice through fair trials, not through summary dismissals.

[***LEdHN4]

COURT §1

Federal Rules of Civil Procedure -- purpose --

Headnote:[4]

The Federal Rules of Civil Procedure are designed in large part to get away from some of the old procedural boobytraps which common-law pleaders could set to prevent unsophisticated litigants from ever having their day in court.

[***LEdHN5]

COURT §1

civil procedure -- adjudication on merits --

Headnote:[5]

Rules of civil procedure not only permit, but should as nearly as possible guarantee, that bona fide complaints be carried to an adjudication on the merits.

SYLLABUS

Petitioner, a stockholder in Hilton Hotels Corporation, brought this action on behalf of herself and other stockholders charging the corporation's officers and directors with fraud. The 60-odd-page complaint was signed by petitioner's counsel in compliance with *Rule 11 of the Federal Rules of Civil Procedure.* Pursuant to *Rule 23 (b)* the complaint was verified by petitioner, who stated that some of the allegations were true and that "on information and belief" she thought the others were true. In an oral examination by respondents' counsel, petitioner, an immigrant with practically no formal education and limited knowledge of the English language, showed that she did not understand the complaint and that in signing the verification she relied on her son-in-law's explanation of the facts. Respondents then moved to dismiss the complaint on the ground that it was a sham and that petitioner was not a proper party plaintiff. Petitioner's counsel filed two affidavits, one by himself and the other by petitioner's son-in-law, an investment advisor, demonstrating that extensive investigation had preceded the filing of the complaint. Despite the affidavits the District Court dismissed the suit with prejudice on the ground that petitioner's affidavit was false and a sham. The Court of Appeals affirmed although noting that "many of the material allegations of the complaint are obviously true and cannot be refuted." *Held*:

1. While *Rule 23 (b)* was adopted and has served to discourage "strike suits" based on worthless claims, it was not written to bar derivative suits which have played an important part in protecting stockholders from management frauds. P. 371.

2. The record here discloses that this is not a strike suit, but a suit by a small stockholder who, to protect her investment, acted in good faith on the basis of advice by her counsel and financial advisor son-in-law. Pp. 371-372.

3. The purpose of the Federal Rules is to administer justice through fair trials and *Rule 23* cannot be construed as compelling dismissal of cases like this where the record shows grave fraud charges based on reasonable beliefs growing out of careful investigation. P. 373.

COUNSEL: Richard F. Watt argued the cause for petitioner. With him on the brief were Sidney M. Davis, Walter J. Rockler and Lionel G. Gross.

Samuel W. Block argued the cause for respondents. On the brief for Hilton Hotels Corp. were Leslie Hodson, Don H. Reuben and Lawrence Gunnels. With Mr. Block on the brief for the individual respondents were Albert E. Jenner, Jr., Keith F. Bode, William J. Friedman and Stanley R. Zax.

JUDGES: Black, Douglas, Clark, Harlan, Brennan, Stewart, White; Warren and Fortas took no part in the consideration or decision of this case.

OPINION BY: BLACK

OPINION

[***808] [**846] [*364] MR. JUSTICE BLACK delivered the opinion of the Court.

Petitioner, Dora Surowitz, a stockholder in Hilton Hotels Corporation, brought this action in a United States District Court on behalf of herself and other stockholders [***809] charging that the officers and directors of the corporation had defrauded it of several million dollars by illegal devices and schemes designed to cheat the corporation and enrich the individual defendants. The acts charged, if true, would constitute frauds of the grossest kind against the corporation, and would be in violation of the Securities [**847] Act of 1933, [1] the Securities Exchange Act of 1934, [2] and the Delaware General Corporation Law. [3] Summarily stated, the detailed complaint, which takes up over 60 printed pages, charges first that defendants conceived and carried out a deceptive plan under which the Hilton Hotels Corporation through a formal "offer" mailed to all the stockholders, purchased from them some 300,000 shares of its outstanding common [*365] stock, that these defendants manipulated the stock's market price to an artificially high level and then at this inflated price sold some 100,000 shares of their own stock to the corporation, and that the effect of this offer and purchase was to reduce the corporation's working capital more than $ 8,000,000 at a time when its financial condition was weak, and the funds were badly needed to run the corporation's business. The second deceptive scheme charged in the complaint was that the same defendants, all of whom were stockholders of the Hilton Credit Corporation, caused the Hilton Hotels Corporation to purchase, also at an artificially high price, more than a million shares of Hilton Credit Corporation stock, paying about $ 3,441,000 for it, of which over $ 2,000,000 was personally received by the defendants. The complaint was signed by counsel for Mrs. Surowitz in compliance with *Rule 11 of the Federal Rules of Civil Procedure* which provides that "The signature of an attorney constitutes a certificate by him that he has read the pleading; that to the best of his knowledge, information, and belief there is good ground to support it; and that it is not interposed for delay." Also pursuant to *Rule 23 (b)* of the Federal Rules, the complaint was verified by Mrs. Surowitz, the petitioner, who stated that some of the allegations in the complaint were true and that she "on information and belief" thought that all the other allegations were true.

1 48 Stat. 74, as amended, *15 U. S. C. § 77a et seq. (1964 ed.).*

2 48 Stat. 881, as amended, *15 U. S. C. § 78a et seq. (1964 ed.).*

3 *Del. Code Ann. Tit. 8, § 101 et seq.* (1953 ed.).

So far as the language of the complaint and of Mrs. Surowitz's verification was concerned, both were in strict compliance with the provisions of *Rule 23 (b)* which states that a shareholder's complaint in a secondary action must contain certain averments and be verified by the plaintiff. [4] Notwithstanding [***810] the sufficiency [*366] of the complaint and verification under *Rule 23 (b)*, however, the court, without requiring defendants to file an answer and over petitioner's protest, granted defendants' motion to require Mrs. Surowtz to submit herseof to an oral examination by the defendants' counsel. In this examination Mrs. Surowitz showed in her answers to questions that she did not understand the complaint at all, that she could not explain the statements made in the complaint, that she had a very small degree of knowledge as to what the lawsuit was about, that she did not know any of the defendants by name, that she did not know the nature of their alleged misconduct, and in fact that in signing the verification she had merely relied on what her son-in-law had explained to her about the facts in [**848] the case. On the basis of this examination, defendants moved to dismiss the complaint, alleging that "1. It is a sham pleading, and 2. Plaintiff, Dora Surowitz, is not a proper party plaintiff . . . ." In response, Mrs. Surowitz's lawyer, in an effort to cure whatever infirmity the court might possibly find in Mrs. Surowitz's verification in light of her deposition, filed two affidavits which shed much additional light on an extensive investigation which had preceded the filing of the complaint. Despite these affidavits the District Judge dismissed the case holding that Mrs. Surowitz's affidavit was "false," that [*367] being wholly false it was a nullity, that being a nullity it was as though no affidavit had been made in compliance with *Rule 23*, that being false the affidavit was a "sham" and *Rule 23 (b)* required that he dismiss her case, and he did so, "with prejudice."

4 "(b) *Secondary Action by Shareholders.* In an action brought to enforce a secondary right on the part of one or more shareholders in an association, incorporated or unincorporated, because the association refuses to enforce rights which may properly be asserted by it, the complaint shall be verified by oath and shall aver (1) that the plaintiff was a shareholder at the time of the transaction of which he complains or that his share thereafter devolved on him by operation of law and (2) that the action is not a collusive one to confer on a court of the United States jurisdiction of any action of which it would not otherwise have jurisdiction. The complaint shall also set forth with particularity the efforts of the plaintiff to secure from the managing directors or trustees and, if necessary, from the shareholders such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort."

The Court of Appeals affirmed the District Court's dismissal, saying in part:

"We can only conclude, as did the court below, that plaintiff's verification of the complaint was false because she swore to the verity of alleged facts of which she was wholly ignorant." *342 F.2d, at 606.*

The Court of Appeals reached its conclusion that the case must be dismissed under *Rule 23 (b)* and Rule 41 (b) despite the fact that the charges made against the defendants were viewed as very serious and grave charges of fraud and that "many of the material allegations of the complaint are obviously true and cannot be refuted." *342 F.2d, at 607.* We cannot agree with either of the courts below and reverse their judgments. We do not find it necessary in reversing, however, to consider all the numerous arguments made by respondents based on the origin, history and utility of *Rule 23*, and of derivative causes of action and class suits. No matter how much weight we give to the function of the Rule and of class action proceedings in protecting corporate management against so-called "nuisance" or "strike suits," we hold that the Rule cannot justify dismissal of this case on the record shown here.

At the time the District Court dismissed and the Court of Appeals approved, there were pending before those courts not merely the complaint, the verified statements by counsel and by Mrs. Surowitz, and the deposition of Mrs. Surowitz, but, as noted above, two affidavits, one signed by Mrs. Surowitz's attorney in this case, Mr. [*368] Walter J. Rockler, and the other signed by her son-in-law, Mr. Irving Brilliant, had been submitted in response to the [***811] defendants' motion that the complaint be dismissed. These affidavits, as well as Mrs. Surowitz's deposition, are a part of the record before us here and we shall now state the facts as they are illuminated by these affidavits.

Mrs. Surowitz, the plaintiff and petitioner here, is a Polish immigrant with a very limited English vocabulary and practically no formal education. For many years she has worked as a seamstress in New York where by reason of frugality she saved enough money to buy some thousands of dollars worth of stocks. She was of course not able to select stocks for herself with any degree of assurance of their value. Under these circumstances she had to receive advice and counsel and quite naturally she went to her son-in-law, Irving Brilliant. Mr. Brilliant had graduated from the Harvard Law School, possessed a master's degree in economics from Columbia University, was a professional investment advisor, and in addition to his degrees and his financial acumen, he wore a Phi Beta Kappa key. In 1957, six years before this litigation began, he bought some stock for his mother-in-law in the Hilton Hotels Corporation, paying a little more than $ 2,000 of her own money for it. He evidently had confidence in that corporation because by 1960 he had purchased for his wife, his deceased mother's [**849] estate, a trust fund created for his children, and Mrs. Surowitz some 2,350 shares of the corporation's common stock, at a cost of about $ 45,000 in addition to one of the corporation's $ 10,000 debentures.

About December 1962, Mrs. Surowitz received through the mails a notice from the Hilton Hotels Corporation announcing its plan to purchase a large amount of its own stock. Because she wanted it explained to her, she took the notice to Mr. Brilliant. Apparently disturbed [*369] by it, he straightway set out to make an investigation. Shortly thereafter he went to Chicago, Illinois, where Hilton Hotels has its home office and talked the matter over with Mr. Rockler. Mr. Brilliant and Mr. Rockler had been friends for many years, apparently ever since both of them served as a part of the legal staff representing the United States in the Nuremberg trials. The two decided to investigate further, and for a number of months both pursued whatever avenues of information that were open to them. By August of 1963 on the basis of their investigation, both of them had reached the conclusion that the time had come to do something about the matter. In the meantime the value of the corporation's stock had declined steadily, and in August the corporation failed to pay its usual dividend. In October, while a complaint was being prepared charging defendants with fraud and multiple violations of the federal securities acts and state law, Mr. Rockler met with defendants' lawyers. This conference, instead of producing an understanding, merely provided Mr. Brilliant and Mr. Rockler with information, not previously available to them, which increased their grave suspicions about the corporation's stock purchase and its management. For instance it was learned at this meeting that at the time of the stock purchase the president and chairman of the board of Hilton Hotels Corporation had purchased for an unusually high price over 100,000 shares of the corporation's stock from several trusts established by a vice president and director of the corporation. Finally, in December, or almost exactly one year after [***812] the corporation had submitted its questionable offer to purchase stock from its shareholders, this complaint was filed charging the defendants with creating and participating in a fraudulent scheme which had taken millions of dollars out of the corporation's treasury and transferred the money to the defendants' pockets.

[*370] Soon after these investigations began Rockler prepared a letter for Mrs. Surowitz to send to the corporation protesting the alleged fraudulent scheme. Mr. Brilliant, her son-in-law, took the communication to Mrs. Surowitz, explained it to her, and she signed it. Later, in August 1963, when the corporation declined to pay its dividend, Mrs. Surowitz, who had purchased the stock for the specific purpose of gaining a source of income, was sufficiently disturbed to seek Mr. Brilliant's counsel. He explained to her that he and Mr. Rockler were of the opinion that the corporation's management had wrongfully damaged the corporation, and together at that time Mrs. Surowitz and her son-in-law discussed the matter of her bringing this suit. When, on the basis of this conversation, Mrs. Surowitz stated that she agreed that suit be filed in her name, Mr. Rockler prepared a formal complaint which he mailed to Mr. Brilliant. Mr. Brilliant then, according to both his affidavit and Mrs. Surowitz's testimony, read and explained the complaint to his mother-in-law before she verified it. Her limited education and her small knowledge about any of the English language, except the most ordinarily used words, probably is sufficient guarantee that the courts below were right in finding that she did not understand any of the legal relationships or comprehend any of the business transactions described in the complaint. She did know, however, that she had put over $ 2,000 of her hard-earned money into Hilton Hotels stock, that she was not [**850] getting her dividends, and that her son-in-law who had looked into the matter thought that something was wrong. She also knew that her son-in-law was qualified to help her and she trusted him. It is difficult to believe that anyone could be shocked or harmed in any way when, in the light of all these circumstances, Mrs. Surowitz verified the complaint, not on the basis of her own knowledge and understanding, but in the faith that her [*371] son-in-law had correctly advised her either that the statements in the complaint were true or to the best of his knowledge he believed them to be true.

[***LEdHR1] [1]We assume it may be possible that there can be circumstances under which a district court could stop all proceedings in a derivative cause of action, relieve the defendants from filing an answer to charges of fraud, and conduct a pre-trial investigation to determine whether the plaintiff had falsely sworn either that the facts alleged in the complaint were true or that he had information which led him to believe they were true. And conceivably such a pre-trial investigation might possibly reveal facts surrounding the verification of the complaint which could justify dismissal of the complaint with prejudice. However, here we need not consider the question of whether, if ever, Federal *Rule 23 (b)* might call for such summary action. Certainly it cannot justify the court's summary dismissal in this case. *Rule 23 (b)* was not written in order to bar derivative suits. Unquestionably it was originally adopted and has served since in part as a means to discourage [***813] "strike suits" by people who might be interested in getting quick dollars by making charges without regard to their truth so as to coerce corporate managers to settle worthless claims in order to get rid of them. On the other hand, however, derivative suits have played a rather important role in protecting shareholders of corporations from the designing schemes and wiles of insiders who are willing to betray their company's interests in order to enrich themselves. And it is not easy to conceive of anyone more in need of protection against such schemes than little investors like Mrs. Surowitz.

[***LEdHR2] [2]When the record of this case is reviewed in the light of the purpose of *Rule 23 (b)*'s verification requirement, there emerges the plain, inescapable fact that this is not a strike suit or anything akin to it. Mrs. Surowitz was [*372] not interested in anything but her own investment made with her own money. Moreover, there is not one iota of evidence that Mr. Brilliant, her son-in-law and counselor, sought to do the corporation any injury in this litigation. In fact his purchases for the benefit of his family of more than $ 50,000 of securities in the corporation, including a $ 10,000 debenture, all made years before this suit was brought, manifest confidence in the corporation, not a desire to harm it in any way. The Court of Appeals in affirming the District Court's dismissal, however, indicated that whether Mrs. Surowitz and her counselors acted in good faith and whether the charges they made were truthful were irrelevant once Mrs. Surowitz demonstrated in her oral testimony that she knew nothing about the content of the suit. That court said:

"Those affidavits reveal that substantial and diligent investigation by Brilliant, Rockler and others preceded the filing of this complaint. . . . Neither affidavit, however, does anything, if anything could be done, to offset plaintiff's positive disavowal of any relevant knowledge or information other than the fact of her stock ownership." *342 F.2d, at 607.*

In fact the opinion of the Court of Appeals indicates in several places that a woman like Mrs. Surowitz, who is uneducated generally and illiterate in economic matters, could never under any circumstances be a plaintiff in a derivative [**851] suit brought in the federal courts to protect her stock interests. [5]

> 5 Consider, for example, these three excerpts taken from separate paragraphs in the Court of Appeals' opinion:
>
> "We have considered all arguments advanced by the plaintiff. We have considered the record in the light of plaintiff's limited grasp of the English language and the intricacies of corporate finance. We have considered the peculiar position of a plaintiff in a suit such as this as, principally, the instrument through which the judicial machinery is set in motion. It is not unreasonable to state as a minimum requirement that the plaintiff have general knowledge of the acts of which she complains and the connection of the defendants to those acts which she alleges. We conclude that any lesser requirement would make the verification provision farcical.
>
> ....
>
> "But if the verification provision of the Rule is to have any real meaning, it requires that a plaintiff must have knowledge of his own position and relationship to the suit, of the official identity of the parties against whom the suit is brought and general knowledge of the wrongful acts which he alleges as a foundation for his complaint.
>
> ....
>
> "We think the court below correctly held that a pleading governed by *Rule 23 (b)* is sham when it clearly appears that the ostensible verification is a mere formality without knowledgeable or informative comprehension in the party plaintiff whose verification gives it the breath of life. That breath is not instilled by the reading of words to that plaintiff which she obviously did not understand." *342 F.2d, at 608, 606*, and 607-608.

[*373] [***814] [***LEdHR3] [3] [***LEdHR4] [4] [***LEdHR5] [5]We cannot construe *Rule 23* or any other one of the Federal Rules as compelling courts to summarily dismiss, without any answer or argument at all, cases like this where grave charges of fraud are shown by the record to be based on reasonable beliefs growing out of careful investigation. The basic purpose of the Federal Rules is to administer justice through fair trials, not through summary dismissals as necessary as they may be on occasion. These rules were designed in large part to get away from some of the old procedural booby traps which common-law pleaders could set to prevent unsophisticated litigants from ever having their day in court. If rules of procedure work as they should in an honest and fair judicial system, they not only permit, but should as nearly as possible guarantee that bona fide complaints be carried to an adjudication on the merits. *Rule 23 (b)*, like the other civil rules, was written to further, not defeat the ends of justice. The serious fraud charged here, [*374] which of course has not been proven, is clearly in that class of deceitful conduct which the federal securities laws were largely passed to prohibit and protect against. There is, moreover, not one word or one line of actual evidence in this record indicating that there has been any collusive conduct or trickery by those who filed this suit except through intimations and insinuations without any support from anything any witness has said. The dismissal of this case was error. It has now been practically three years since the complaint was filed and as yet none of the defendants have even been compelled to admit or deny the wrongdoings charged. They should be. The cause is reversed and remanded to the District Court for trial on the merits.

Reversed and remanded.

Mr. JUSTICE FORTAS took no part in the decision of this case.

THE CHIEF JUSTICE took no part in the consideration or decision of this case.

CONCUR BY: HARLAN

CONCUR

Mr. JUSTICE HARLAN, concurring.

Rule 23 (b) directs that in a derivative suit "the complaint shall be verified by oath" but nothing dictates that the verification be that of the plaintiff shareholder. See *Bosc v. 39 Broadway, Inc., 80 F.Supp. 825.* In the present circumstances, it seems to me the [**852] affidavit of Walter J. Rockler, counsel for Mrs. Surowitz, amounts to an adequate verification by counsel, which I think is permitted by a reasonable interpretation of the Rule at least in cases such as this. On this premise, I agree with the decision of the Court.

REFERENCES

Pleading and verification requirements in stockholders' derivative suits in federal courts

Annotation References:

Civil action by private person under 10(b) of Securities Exchange Act of 1934 (*15 USC 78j(b)*). *37 ALR2d 649.*

Motive as affecting stockholders' right to maintain suit against corporation or officer, other than to inspect books. 67 ALR 1470.