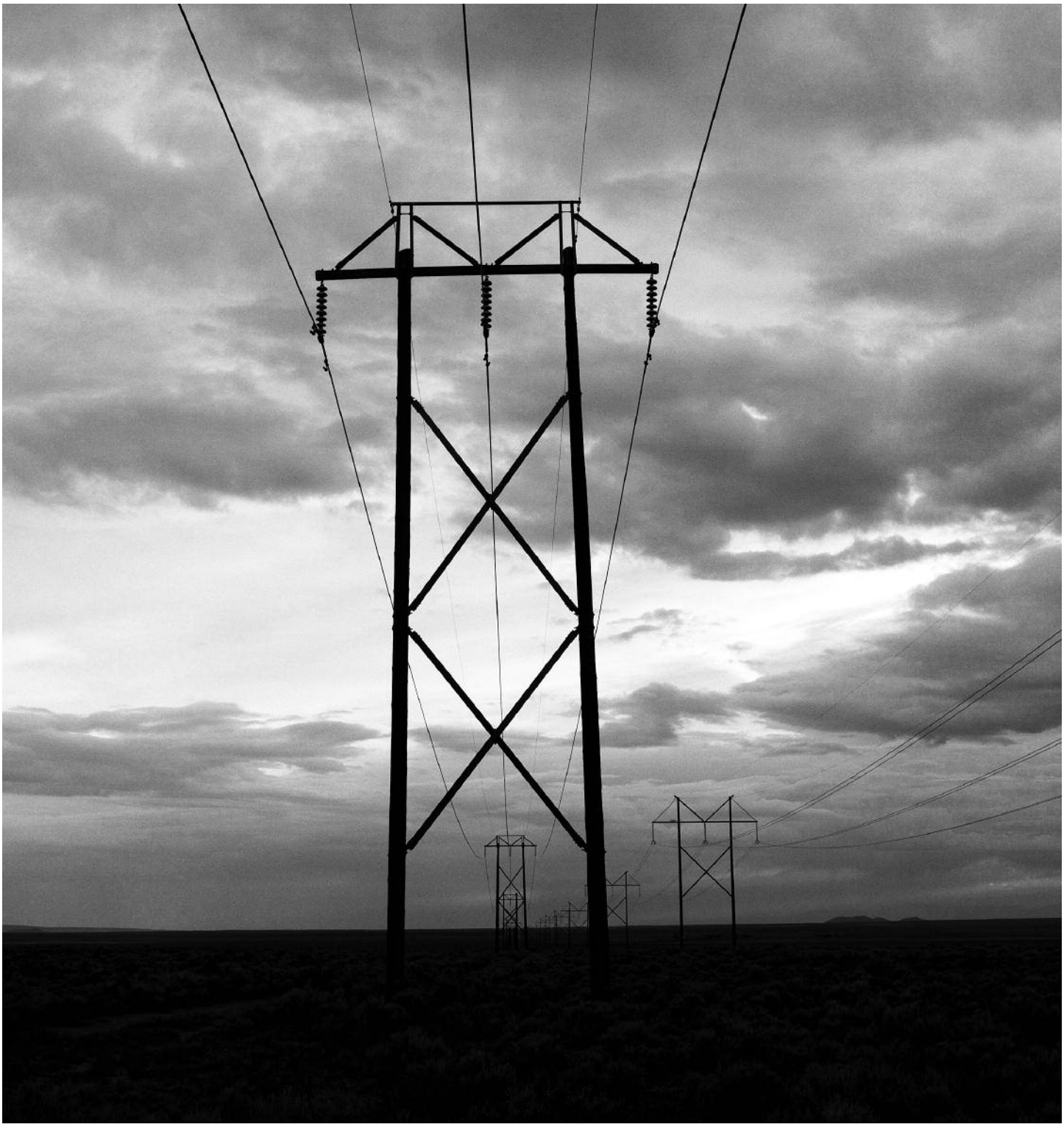
TEXAS BUSINESS LITIGATION JOURNAL



Business Torts

Delaware Fiduciary Duty Law

SPRING 2007 ▪ Volume 29 ▪ Number 2

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SECTION OFFICERS and COUNCIL MEMBERS

COVER: West Texas Power. Photograph by Larry Gustafson, Dallas.

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Dear Section Members:

The articles in the *Journal's* spring edition are excellent. Thanks to Todd Murray, Everett New, Bill Katz, Moses Cage, Lauren Burke, John McFarland, and Greg Huffman for their hard work. Their labors are to your benefit. I also again thank Larry Gustafson for the cover photograph. Most importantly, I want to thank Michael Ferrill for his efforts in editing *Texas Business Litigation Journal*. Mike has been the Journal's editor for some time, and his efforts on behalf of the Section deserve praise and compensation. In fact, I am hereby doubling his compensation from the Section. (Unfortunately for Mike, zero times two still equals zero.)

Although I commend all the articles to your reading, I particularly want to discuss McFarland's short article, *The End of the Arbitration Era*. Arbitration is a critically important means of resolving disputes between parties, and reaffirms the rights of parties to craft, by contract, their relationships with one another. As Section members have a particular interest in complex business litigation, it is important that we understand both the strengths and weaknesses of this dispute-resolution tool.

As Mike Ferrill and I have noted before, the Journal is always on the lookout for articles. Please see Mike's note on the next page for information on how to submit original articles. Also, remember the Journal is also open to reprinting articles that would benefit section members.

The Section's annual breakfast and business meeting will be held on Friday morning, June 22, in conjunction with the State Bar Convention in San Antonio. I hope you are able to attend to learn more about the Section, partake in a meal with other Section members, and hear an excellent program on ethics and business litigation from Professor Marc Steinberg of SMU's Dedman School of Law.

Service on the Section's Council is an honor, but it also involves work. I want to encourage you to consider whether your interests and schedule would permit you to give something back to the Bar through serving a three-year term on the Council. If so, please send an e-mail indicating your interest, along with an attached resume or other biographical materials, to the three members of the Council's Nominations Committee, Todd Murray (Carrington, Coleman, Sloman & Blumenthal, Dallas), Tom Malaone (El Paso Corportation, Houston) and Bill Pakalka (Fulbright & Jaworski, Houston). Their e-mail addresses are on the Section's website, at http://www.tablit.org/officers.shtml. Because of publishing schedules, time is of the essence in responding if you are interested.

The June meeting closes out my year as Chairman of the Section. I am honored to have served as your Chairman, and to have served with the other members of the Council. Their wisdom, expertise, and willingness to take time from their schedules for the Section are amazing.

Sincerely,
Justice Jim Moseley
Section Chair
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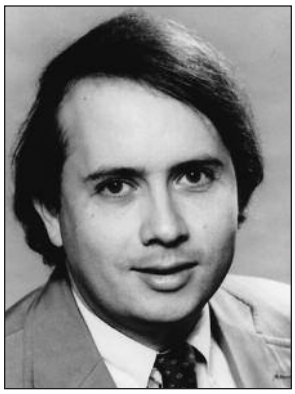
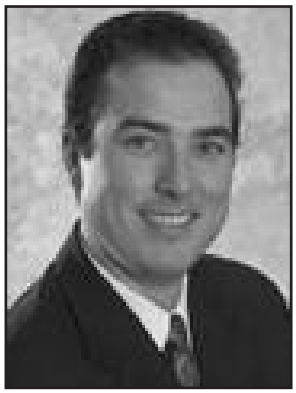
FROM ▪ THE ▪ EDITOR



This issue of the Journal features the annual survey articles on business torts and Delaware fiduciary duty law, and an article taking a fresh look at the pros and cons of arbitration.

As always, we solicit written contributions to the Journal. We currently have commitments for annual survey articles on antitrust, securities, RICO, business torts, class actions, D&O and expert witness developments. If you have an idea for a survey article in another area of business litigation, or an article focusing on a particular aspect of or development in the law (even if it falls within one of the broad survey categories), contact me at 112 E. Pecan, Suite 1800, San Antonio, Texas 78205 (210) 554-5282; (210) 226-8395 (fax), amferril@coxsmith.com.

A. Michael Ferrill
Editor



2006 Update of Delaware Fiduciary Duty Law

By Todd A. Murray and Everett New [1]

The Delaware courts issued a number of opinions dealing with fiduciary duties during 2006. Significant issues this year included the distinction between the duty of care and the duty of good faith, section 102(b)(7) exculpatory provisions, to whom the fiduciary duties of the directors of a subsidiary corporation are owed, fiduciary duties to minority shareholders in merger transactions, the line between direct and derivative claims, and demand futility. Leading off the survey for the second year in a row (and included for the third year in a row), is an opinion in the Walt Disney Company litigation.

In re Walt Disney Company Derivative Litigation[2]

This opinion dealt with the litigation surrounding the severance package paid to Walt Disney Company's former President Michael Ovitz upon his departure from the company. This year, the Supreme Court of Delaware had the opportunity to review the Court of Chancery's decision to dismiss the breach of fiduciary duty claims against several of the directors and officers of the company. Finding that the Court of Chancery committed no reversible errors, the Delaware Supreme Court affirmed its decision.

Following a recitation of the facts of Ovitz' hiring, tenure, and firing, the Supreme Court summarized the plaintiffs' claims of error.[3] The court broke the alleged errors into two categories: (1) those related to the contention that the Disney defendants breached their fiduciary duties to act with due care and in good faith by approving Ovitz' employment agreement, especially its non-fault termination severance clause; and (2) those related to the contention "that Ovitz breached his fiduciary duties of care and loyalty to Disney by (i) negotiating for and accepting the [non-fault termination] severance provisions of [his employment agreement], and (ii) negotiating a full [non-fault termination] payout in connection with his termination."[4]

First, the Supreme Court addressed the two alleged grounds for error regarding the Chancellor's rejection of the plaintiffs' claims against Ovitz. The plaintiff took issue with the Court of Chancery's ruling that Ovitz owed no fiduciary duty to Disney when negotiating his employment agreement.[5] Reviewing this contention, the Supreme Court stated that the question was procedurally barred from review because it was not presented to the trial court, and that even if it had been presented, it lacked legal and factual merit. Furthermore, the fact that the employment agreement was not finalized until two months after Ovitz' employment began was not material because the critical terms of the agreement were already in place.[6] The plaintiff also took issue with the Court of Chancery's rulings that Ovitz committed no breach of fiduciary duty by: (i) accepting the non-fault termination payment, and (ii) not convening a board meeting to consider terminating himself for cause. The Supreme Court also rejected these arguments because Ovitz took no part in the decision to terminate himself or whether that termination would be for cause, and did not breach a duty by failing to convene a board meeting to consider whether his termination should be for cause.[7]

Next, the Supreme Court addressed the allegation that the Court of Chancery committed reversible error by ruling that the Disney defendants did not breach their fiduciary duties to act with due care or in good faith. Taking these two duties in turn, the Supreme Court first reviewed the claimed errors related to the duty of care rulings.[8]

The plaintiffs claimed that the Chancery Court erred by: (i) separating the questions of whether the plaintiffs established either gross negligence or a lack of good faith by a preponderance of the evidence, (ii) deciding that Ovitz' employment agreement did not have to be approved by the whole board, (iii) deciding breaches of the duty of care on an individual director basis instead of by the board collectively, (iv) holding that the compensation committee's approval of the non-fault provisions of Ovitz' employment agreement was not a breach of the duty of care, and (v) finding that the election of Ovitz as Disney's president was not a breach of the duty of care by those directors who were not part of the compensation committee.[9]

The Supreme Court rejected these contentions in turn, ruling that: (i) the Court of Chancery was not required "to consider only evidence of lack of due care (i.e. gross negligence) in determining whether the business judgment rule presumptions have been

rebutted," (ii) Delaware law expressly allows a board to delegate decisions such as compensation to board committees; therefore, the whole board did not need to approve Ovitz' employment agreement, (iii) the plaintiffs' "about-face" from their Court of Chancery argument on whether breaches of the duty of care should be analyzed director-by-director or for the board as a whole made the argument unfairly presented, and no resulting prejudice from the Chancellor's approach was identified, (iv) the Court of Chancery's determination that the compensation committee was adequately informed when it approved Ovitz' agreement was supported by the record, and (iv) the directors who elected Ovitz to Disney's presidency were well informed and were not grossly negligent.[10]

Having reviewed the plaintiffs' arguments related to the duty of care and finding no reversible error, the Supreme Court addressed the plaintiffs' arguments related to the fiduciary duty to act in good faith, strongly reinforcing the business judgment rule. The plaintiffs' first argument was that the Court of Chancery's definition of bad faith was substantively erroneous and was also changed between its 2003 and 2005 decisions in the case. The Supreme Court disagreed, finding no substantive error or practical difference between the definitions as used.[11] Furthermore, the plaintiffs contended that the Supreme Court should "treat a failure to exercise due care as a failure to act in good faith."[12] The court declined to do so, tacitly pointing out that even if it were to conflate the two duties, the outcome of this case would be no different because the plaintiffs could not satisfy the very test they proposed. The court continued, acknowledging that duty to act in good faith jurisprudence "is not a well-developed area of [Delaware] corporate fiduciary law."[13] Accordingly, the court decided to address whether the Court of Chancery's standard for bad faith—"intentional dereliction of duty, a conscious disregard for one's responsibilities"—was legally correct.[14]

In making the determination, the Supreme Court identified three categories of fiduciary behavior that were candidates for the "bad faith" label: (i) "subjective bad faith," which is "fiduciary conduct motivated by an actual intent to do harm," (ii) "lack of due care," which is "fiduciary action taken solely by reason of gross negligence and without any malevolent intent," and (iii) a middle of the road version, which is what the Chancellor's definition, "intentional dereliction of duty, a conscious disregard for one's responsibilities," was meant to embrace.[15] Applying these categories to the case at hand, the Supreme Court discounted the first category because no conduct violative of that definition was alleged. As to the second category, the Supreme Court agreed with the Chancellor that the plaintiffs failed to establish gross negligence, adding that:

> grossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith. The conduct that is the subject of due care may overlap with the conduct that comes within the rubric of good faith in a psychological sense, but from a legal standpoint those duties are and must remain quite distinct.[16]

Bolstering its opinion, the Supreme Court pointed to the fact that the Delaware General Assembly had addressed the distinction between a failure to exercise due care (gross negligence) and bad faith in Delaware General Corporate Law section 102(b)(7), and 8 Delaware Code section 145, both of which deal with exculpation clauses. As the court summarized, "under Delaware statutory law a director or officer of a corporation can be indemnified for liability (and litigation expenses) incurred by reason of a violation of the duty of care, but not for a violation of the duty to act in good faith."[17]

As for the third category of behavior that qualified for the bad faith label, the Supreme Court asked, and answered affirmatively, whether the intentional dereliction/conscious disregard conduct was properly treated as non-indemnifiable, non-exculpable conduct in violation of the duty to act in good faith.[18] The court gave two reasons for its affirmative answer: (1) fiduciary misconduct is not limited to disloyalty or gross negligence, and (2) the legislature has recognized the middle ground of misconduct between subjective bad faith and gross negligence.[19] As the court saw it, the first reason encompasses cases in which the directors have no conflicting self-interest but nonetheless "engage in misconduct that is more culpable than simple inattention or failure to be informed of all facts material to the decision." The duty to act in good faith, according to the court, addresses these violations where the fiduciary conduct "is qualitatively more culpable than gross negligence," but "does not involve disloyalty."[20]

The second reason given by the court was based on what it described as the legislature's acknowledgment of the intermediate category of fiduciary misconduct in Delaware General Corporation Law section 102(b)(7)(ii).[21] That section denies exculpation for "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law," which, as the court viewed it, showed that the legislature distinguished between knowing violations of the law or intentional misconduct and acts not in good faith. According to the court, "the statute exculpates directors only for conduct amounting to gross negligence, [therefore,] the statutory denial of exculpation for 'acts ... not in good faith' must encompass the intermediate category of misconduct captured by the Chancellor's definition of bad faith."[22]

After discussing the subtleties between the fiduciary duty to act with due care and the fiduciary duty to act in good faith, the Supreme Court made short shrift of the plaintiffs' final claims. For the claims arising from the payment of the non-fault termination severance pay, the court held that Disney's board was not required to act to terminate Ovitz. For the determination to terminate Ovitz without cause, the court held that it was not a violation of fiduciary duty. Finally, the court held that the board was entitled to rely on the opinion of the chairman and general counsel that Ovitz could not be fired for cause, and that the decision to approve Ovitz's employment agreement did not constitute corporate waste.[23]

In the end, the Delaware Supreme Court affirmed the judgment of the Court of Chancery without change.

Stone v. Ritter

In addition to altering fiduciary duty jurisprudence regarding the concept of the duty of good faith, this case also had the distinction of having been dealt with by both the Delaware Chancery Court and Delaware Supreme Court in 2006. In January, the Court of Chancery dismissed the complaint for failure to make demand or adequately plead demand futility.[24] In November, the Delaware Supreme Court affirmed that decision, holding that the duty of good faith is not an independent claim but rather is a component of the duty of loyalty, and altering the analysis of *Caremark* claims for breach of the duty of oversight to require proof that the directors knew they were not discharging their fiduciary duties.[25]

After conducting a search of the corporation's books and records that failed to turn up any facts supporting their allegations, the plaintiffs nonetheless filed this derivative action against 15 current and former directors of AmSouth Bancorporation ("AmSouth"), alleging that they breached their fiduciary duties by failing to guard against violations of the Bank Secrecy Act ("BSA") and anti-money laundering regulations through the implementation of sufficient internal controls.[26] The underlying violations of the BSA and anti-money laundering regulations were uncovered through a federal investigation into a ponzi scheme which resulted in AmSouth being fined $50 million based on findings that its employees failed to file suspicious activity reports as required by law and that its internal controls lacked the coordination necessary to comply with the BSA and federal regulations.[27]

The court noted that the plaintiffs failed to make demand on the AmSouth board prior to filing suit. In order to justify their failure to make demand, the plaintiffs first contended that the directors were not independent or disinterested because they faced a substantial likelihood of liability for their breach.[28] The court quickly rejected this argument, noting the complete lack of facts tying the defendants to the violations or red flags that should have alerted them. The plaintiffs then argued that the defendants "failed to exercise any business judgment and failed to make any good faith attempt to fulfill [their] fiduciary duties."[29] The court discounted this argument as well, recognizing that unlike the *Disney* case in which a board failed to carefully consider material presented to it, no facts were pled in this case that showed the board was ever made aware of the inadequacy of the company's internal controls.[30]

The Chancery Court acknowledged that AmSouth's controls were clearly inadequate, but found no connection between that lack of controls and the plaintiffs' failure to make the required demand on the board. In light of that failure and the plaintiffs' failure to sufficiently plead demand futility, the court dismissed the complaint with prejudice.

Revisiting the demand futility analysis in its review, the Delaware Supreme Court noted that AmSouth had a section 102(b)(7) exculpatory provision, which relieved directors from liability for a breach of the duty of care, thus requiring directors' liability to be based on breach of either the duty of good faith or the duty of loyalty.[31] The court then recounted the evolution of the *Caremark* standard for "assessing a director's potential personal liability for failing to act in good faith in discharging his or her oversight responsibilities."[32] Taking this concept one step further, the court reasoned that:

> failure to act in good faith is not conduct that results, ipso facto, in the direct imposition of fiduciary liability. The failure to act in good faith may result in liability because the requirement to act in good faith 'is a subsidiary element[,]' i.e., a condition, 'of the fundamental duty of loyalty.'

The Supreme Court further held that "the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty;" in fact, the "duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest [but] also encompasses cases where the fiduciary fails to act in good faith."[33] In other words, imposing liability for director oversight liability requires a showing that either the directors failed to implement controls or reporting systems or consciously failed to monitor or oversee an implemented control system, *and* "that the directors knew they were not discharging their fiduciary obligations."[34]

Having established these rules, the court applied them to the case at hand, finding that the AmSouth board fulfilled its fiduciary duties when it "received and approved relevant policies and procedures, delegated to certain employees and departments the responsibility for filing [suspicious activity reports] and monitoring compliance, and exercised oversight by relying on periodic reports from them."[35] In light of this finding, the court affirmed the Court of Chancery's dismissal of the complaint with prejudice.

In re Scott Acquisition Corp.[36]

This bankruptcy case considered to whom the directors and officers of a subsidiary corporation owe their fiduciary duties.

Scotty's Inc. is a wholly owned subsidiary of Scott Acquisition Corp. At the behest of its primary creditor, Scotty's entered into sale-and-leaseback agreements on some of its choice real estate. Some of the agreements were with entities controlled by its directors and officers.[37] The director and officer controlled entities paid less than fair market value for the properties, although Scotty's received no more favorable treatment than it would have from independent third parties.[38] Scotty's also borrowed money from some of its directors and officers at rates of 11% or greater which were paid in full. Furthermore, after Scotty's filed its bankruptcy petition the directors chose to reduce the liability limit on the directors and officers' insurance policy from $5 million to $2 million.[39]

After Scotty's filed bankruptcy, the trustee filed suit against the directors and officers alleging, among other things, that they

breached their fiduciary duties and aided and abetted breaches of their fiduciary duties. The defendants moved to dismiss the claims for failure to state a claim upon which relief can be granted, and argued that the trustee lacked standing.[40] In support of their arguments, the defendants relied on S*outhwest Holdings, L.L.C. v. Kohlberg & Co. (In re Southwest Supermarkets, L.L.C.)*, arguing that in the case of a wholly-owned subsidiary, its officers and directors owed their fiduciary duties solely to the parent corporation and not to the subsidiary.[41] The bankruptcy court found the argument absurd, noting that there was "no basis for the principle . . . that the directors of an insolvent subsidiary can, with impunity, permit it to be plundered for the benefit of its parent corporation."[42] The court further supported its holding by acknowledging that under Delaware law, directors owe fiduciary duties to the creditors of an insolvent corporation, that those duties are typically derivative of the duties owed to the subsidiary corporation, and therefore that if the creditors are owed a fiduciary duty, then "the subsidiary itself must also be owed such a duty."[43]

Having held that directors of an insolvent subsidiary corporation owe fiduciary duties to the subsidiary and its creditors, the bankruptcy court then briefly addressed the plaintiff's aiding and abetting claims, finding that the allegations, when read in the light most favorable to the non-moving party, stated a claim sufficient to survive a motion to dismiss. Similarly, as to the trustee's standing to bring the action, the court noted that the alleged claims were derivative in nature and could be brought by any creditor; therefore the trustee was a proper person to bring the claims because the trustee "may pursue the interests of the bankruptcy estate and derivatively the interests of its creditors."[44]

In re J.P. Morgan Chase & Co. Shareholder Litigation[45]

This Delaware Supreme Court case dealt with allegations of breach of fiduciary duty against the CEO of J.P Morgan Chase & Co. ("JPMC") by its shareholders, related to JPMC's merger with Bank One. The class action complaint alleged false statements in the proxy statement issued in connection with the merger, and a breach of fiduciary duty by the officers for approving a merger at an allegedly unnecessary 14% premium.

Although the merger was approved by over 99 percent of the votes cast, the plaintiffs pursued their claims based on a single New York Times article which reported that, only days before the merger closed, Bank One's CEO offered to sell Bank One to JPMC at no premium if he, rather than JPMC's CEO, was appointed CEO of the combined entity.[46] The plaintiff sought to recover for the shareholder class the $7 billion JPMC allegedly overpaid for Bank One because JPMC could have purchased Bank One for no premium by appointing Bank One's CEO as CEO of the merged entity.[47] Essentially, the plaintiffs' argued that JPMC's directors breached their fiduciary duties by obtaining shareholder approval through a materially misleading proxy statement that did not disclose the no-premium offer.

The Chancery Court dismissed the complaint, holding that the claim of overpayment was a derivative claim, the plaintiffs failed to make a pre-suit demand, and the failure to disclose allegation failed to state a claim upon which relief could be granted because it did not allege a compensable harm to the class.[48] The court concluded that the damages from the disclosure violation were identical to the damages allegedly suffered by JPMC in the claim for overpayment, both of which were derivative in nature.

The plaintiff stockholders appealed the dismissal of the claim for failure to disclose, arguing that a violation of the duty of disclosure alone automatically entitled them to damages as a matter of law under the rationale adopted by the Delaware Supreme Court in *In re Tri-Star Pictures, Inc*.[49] The court was not swayed by the argument, stating that under Delaware law there is not "a per se rule of damages for breach of the fiduciary duty of disclosure."[50] The court reiterated its holding in *Loudon v. Archer-Daniels-Midland Co*. that *Tri-Star* stood "only for the narrow proposition that where directors have breached their disclosure duties in a corporate transaction that has in turn caused impairment to the economic or voting rights of stockholders," nominal damages are appropriate.[51] Here, the court continued, the Chancellor correctly found no such impairment because the only injury claimed was the corporation's loss of the opportunity to acquire Bank One on more favorable terms—the greater number of stockholders and outstanding shares was not the "injury to voting interests described in *Tri-Star*."[52]

Because the JPMC-Bank One merger was a transaction between two independent entities, not a transaction between a corporation and its controlling stockholder, the court held that *Tri-Star* did not apply and affirmed the Court of Chancery.

ATR-Kim Eng Financial Corp. v. Araneta[53]

In one of its first opportunities to apply the holding in *Stone v. Ritter*, the Delaware Court of Chancery addressed a blatant violation of fiduciary duties in this fact-intensive case. Here, a minority shareholder filed suit against the majority shareholder for liquidating the corporation's assets by transferring the assets to his family, and against two other directors for failing to oversee and prevent the looting.[54] The Chancery Court agreed with the plaintiff that the actions violated the directors' and majority shareholder's fiduciary duties owed to the corporation and the minority shareholders.

In reaching this decision, the court applied the necessary conditions for director oversight liability from *Caremark* as articulated in *Stone*:

> (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of

liability requires a showing that the directors knew that they were not discharging their fiduciary obligations.[55]

Because the directors thought of themselves as mere employees of the majority shareholder and did nothing but stand by and watch as the majority shareholder liquidated the company to the detriment of the minority shareholders, the court felt that they breached their obligation to protect the interests of the company and its stockholders.[56] Furthermore, the court stated, the directors' behavior did not show a lapse in judgment or attention, but rather demonstrated a faithless approach to the obligations of their positions through a choice of total fealty to a particular stockholder.[57]

Finding that the directors and majority shareholder had violated their fiduciary duties, the court awarded the minority stockholder his initial investment plus 25% interest per year compounded monthly, plus costs and fees. The court then took the unusual step of making the three jointly and severely liable for the damages, because of the directors' willingness to serve their employer at the cost of intentionally abandoning their fiduciary duties to the company and minority shareholder. As a final note, the court pointed out that the majority shareholder "should be required to make [the directors] whole," and that the director defendants, therefore, should be able to seek recovery from him for whatever amount they pay. Going further, however, the court stated that because the director defendants acted as mere tools and contributed to the harm "public policy might limit their ability to seek indemnification from their 'boss.'"[58]

Gentile v. Rossette[59]

In a continuation of a case reported in last year's summary, the former stockholders of SinglePoint Financial, Inc. appealed the Chancery Court's grant of summary judgment on claims of breach of fiduciary duty in favor of SinglePoint's former CEO and directors.[60] Concluding that the claims could be brought either directly or derivatively, the Delaware Supreme Court reversed the Court of Chancery and remanded the case.

The plaintiffs alleged that Rossette, the former CEO (and controlling stockholder), engaged in a self-dealing transaction by converting over $3 million in promissory notes representing money he leant to SinglePoint into SinglePoint common stock worth substantially more than $3 million.[61] The conversion reduced the minority shareholder's interest in SinglePoint from 38.81% to 6.51% and increased Rossette's interest to 93.49%.[62] These transactions were approved by SinglePoint's board, which included Rossette and defendant Douglas Bachelor. Rossette and Bachelor obtained stockholder authorization to issue the additional stock required to complete the exchange, but did not disclose the purpose of the stock issuance.[63] Two months after the exchange, Rossette negotiated a merger between SinglePoint and Cofiniti, its only competitor. As part of that transaction, Rossette received a put agreement whereby Cofiniti would purchase some of the shares granted to Rossette for $1.8 million, one year after the merger. No other stockholders received similar treatment.[64] In reaction, the minority shareholders filed suit against Rossette and Bachelor. The Court of Chancery granted the defendants' motion for summary judgment and dismissed the suit, finding that the plaintiffs' claims were derivative in nature and, therefore, the merger with Cofiniti destroyed their standing to bring the claims. The plaintiffs appealed.

The Supreme Court first isolated the two aspects of the plaintiffs' claims: (1) allegations that that the corporation overpaid for the forgiveness of debt, and (2) allegations that the minority shareholders lost substantial portions of the voting power and cash value of their stock. As the court recognized, the first related to damages to the corporation and any recovery would benefit the corporation, making those claims derivative.[65] The second injury was direct to the stockholders who, as a result of the actions, lost economic value and voting power in direct proportion to the benefits to the controlling shareholder. In such cases, the minority stockholder has a direct claim against the controlling shareholder.[66]

In remanding the action, the court also pointed out that applying Delaware law in this fashion fit "within the analytical framework mandated by *Tooley*," and "as a practical matter, the only claim available after Cofiniti was liquidated [was] a direct action by Plaintiffs."[67]

Gesoff v. IIC Industries Inc.[68]

In an opinion that recapped Delaware courts' "entire fairness" cases and provided a discussion of 8 Del. C. § 102(b)(7), the Delaware Court of Chancery determined that the corporate merger underlying the case was not the product of fair dealing and did not result in a fair price, but nonetheless exculpated the sole independent board member who approved the merger.

CP Holdings, an English holding company, decided to take its Delaware subsidiary IIC Industries private because, among other things, the costs and exposure to U.S. taxes and regulations outweighed the benefits.[69] Intending to increase its 80% stake in IIC to at least 90% in order to take advantage of Delaware's short form merger law, CP began putting together a tender offer for the remaining IIC shares. As part of the process, CP conferred with Jesup & Lamont ("J&L"), a small investment bank, and Samuel Ottensoser, a U.S. lawyer, both of whom were later retained by IIC's one member special committee to advise him on this very transaction.[70]

The CP board met and authorized a tender offer to the IIC board at $13.00 per share. The IIC board appointed a special committee to review the offer, but only Alfred Simon was independent and able to serve, making him the sole member of the Special Committee (the "Committee"). The Committee was tasked with reviewing the tender offer and preparing a recommendation to the shareholders and board as to IIC's position on the offer.[71] Although IIC's grant of authority to the Committee was broad, in

reality the Committee's choices for counsel and financial advisor were basically dictated by CP. Thus, the Committee retained J&L and Ottensoser. J&L did not tell the Committee of its relationship with CP, and Ottensoser assured the Committee that there was no conflict with him advising both CP and the Committee.[72]

As further color, the opinion recounted an email exchange between CP and Ottensoser outlining CP's manipulative negotiation plan:

> CP would first make a "lowish bid" to the board of IIC, which would respond by hiring Jesup & Lamont, named specifically, to evaluate the bid. Jesup & Lamont was then expected to recommend a bid that was a "bit higher." CP would meet the new price, Jesup & Lamont would approve it, and the door would then open for CP to make its tender offer for the shares of IIC.[73]

Ottensoser responded that this was indeed the process. The negotiation process unfolded in exactly this pattern with CP offering $10.00 per share (significantly less than the CP authorized $13.00 per share), J&P valuing IIC for the Committee, CP offering $10.50 per share, and the parties agreeing to that amount. During this process J&P continued to communicate with CP, going so far as to report to members of CP's board on the Committee's position and minimum offer requirements.[74] The Committee then announced its recommendation of the tender offer to the stockholders.

Notwithstanding the Committee's endorsement, the tender offer failed to bring in the necessary shares to get CP's ownership to the 90% mark required for a short form merger.[75] Although this prevented a short form merger, CP decided to continue the merger under a long form version with the same $10.50 per share offer. The Committee recommended the merger to the full board without further investigation or an additional fairness opinion. IIC's full board and CP, IIC's majority stockholder, subsequently approved the merger.[76] The plaintiffs challenged the merger, contending that it was the product of unfair dealing and that the $10.50 per share was an unfair price.

Because well established law provides that a long form merger between a parent and subsidiary invokes the entire fairness standard of review, the court examined the transaction to determine whether it involved fair dealing and a fair price.[77] Regarding fair dealing, the court noted that the question depended on the quality of negotiations between CP and the Committee. Because the Committee consisted of only one board member and was not empowered to veto the transaction or to select its own independent counsel and financial advisor, the court concluded that the process did not resemble an arms-length transaction and, therefore, was not objectively fair.[78] Similarly, the court found that the evidence admitted at trial failed to support any argument that the transaction price was fair. Having determined that the transaction was unfair, the court performed an extensive analysis to determine the appropriate remedy, arriving at a price of $14.30 per share.[79]

Finally, the court addressed defendant Simon's contention that IIC's Delaware Code section 102(b)(7) exculpated him from liability. Section 102(b)(7) clauses exculpate directors for all breaches of fiduciary duty other than "for breach of the duty of loyalty, failure to act in good faith, intentional misconduct, and certain other violations."[80] Because Simon did not directly benefit from the transaction, was not conflicted in the transaction, and did not conspire in the scheme to eliminate the minority shareholders, the court held that he was exculpated under the clause.

David B. Shaev Profit Sharing Account v. Armstrong[81]

In this case, the Chancery Court addressed the defense of demand futility and helped to clarify what a plaintiff must plead for claims of breach of fiduciary duty to withstand a motion to dismiss for failure to make demand.

The claims in this case arose out of the Enron and Worldcom litigation. Shareholders in Citigroup, Inc. filed a derivative suit claiming the directors knew or should have known about allegedly fraudulent relationships between Citigroup and the two corporations.[82] An almost identical case, *In re Citigroup Inc. Shareholders Litigation*, had been filed two years earlier but had been dismissed for failure to make demand with an admonition of the plaintiffs for failure to complete a section 220 books and records review prior to bringing suit. In the present case, however, the plaintiff (who was represented by the same lawyers as the plaintiffs in *In re Citigroup*), complied with section 220 and then brought a narrower complaint based on the director's alleged failure to detect and stop the improper transactions between Citigroup and Enron and Worldcom.[83] This complaint focused on the fact that Citigroup's board never saw "one scrap of paper" regarding the "massive fraud that Citigroup management caused Citigroup to engage in with Enron," and had no functional monitoring system in place to monitor likely conflicts of interest that arose with Citigroup's acquisition of Salomon Smith Barney.[84]

Prior to bringing suit, the plaintiffs did not make demand on Citigroup; therefore, they must have pled facts showing that such demand would be futile. Generally, demand futility is decided based on whether "a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment."[85] In cases in which there is no transaction to test against the business judgment rule, as was the case in *In re Caremark Int'l Inc. Derivative Litigation*, the court must decide whether "the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that . . . the board of directors

could have properly exercised its independent and disinterested business judgment in responding to a demand."[86]

Under this "*Caremark*" type of claim, the plaintiffs could withstand a motion to dismiss for failure to make demand by showing that the directors were not disinterested or independent, that the board utterly failed to exercise oversight, or that the directors were conscious that they weren't doing their job and ignored red flags indicating misconduct. The court noted, however, that no exception to demand existed based on allegations "that directors bear liability where a concededly well-constituted oversight mechanism, having received no specific indications of misconduct, failed to discover fraud."[87] Accepting in principle that liability could exist when a director remained ignorant of a large fraud occurring in plain sight, the Chancery Court found that the facts of the case did not present such a case and granted the defendants' motion to dismiss.

In re Transamerica Airlines, Inc.[88]

The Delaware Court of Chancery reviewed plaintiff Akande's motion for leave to file a third amended complaint, which added claims for breach of fiduciary duty, concluding that the amendment should be allowed because, despite the defendant's arguments, the addition would not be futile under Court of Chancery Rule 15.

Rule 15 provides, among other things, that a party may amend its pleading with leave of the court, which "shall be freely given when justice so requires."[89] The motion may be denied if the amendment would be futile because it would not survive a motion to dismiss for failure to make demand or state a claim.

Akande received a judgment in a Nigerian court against Transamerica Airlines, Inc., based on a contract claim. Prior to the issuance of the Nigerian judgment, however, Transamerica had filed a certificate of dissolution in accordance with Delaware law. Akande sought, by means of this present action, to enforce the Nigerian judgment against the now defunct Transamerica and its former directors.[90] Having already filed an initial complaint and an amended complaint, Akande filed a motion for leave to file a third amended complaint to add claims of breach of fiduciary duty by the Transamerica directors.[91] Because Transamerica was insolvent at the time it filed its certificate of dissolution, the directors owed a fiduciary duty to the company's creditors as well as its shareholders. Akande claimed that the directors breached that duty by failing to provide for his claim. Responding to the motion to amend, Transamerica (and the new director defendants) argued that the amendment would be futile because the claims were barred by the statute of limitations.[92]

In weighing the arguments, the court examined whether Transamerica's directors breached their fiduciary duties by failing to comply with Delaware's statutory dissolution procedures.[93] The purpose of the dissolution procedures is to provide a mechanism to afford fair treatment to foreseeable future, yet unknown, claimants of a dissolved corporation, while providing corporate directors with a mechanism that will both permit distributions upon corporate dissolution and avoid risk that a future corporate claimant will, at a later time, be able to establish that such a distribution was in violation of a duty owed to the corporation's creditors on dissolution.[94]

The court noted that the law provides two procedures for a company upon dissolution. The first is an elective procedure in which the corporation gives notice of the dissolution to all known claimants against the corporation, including those with claims pending in a proceeding to which the corporation is a party.[95] Here, the court noted that the defendants admitted that they did not give Akande notice of the dissolution and found that Akande pled sufficient facts, which if proven, could show that Transamerica knew about the Nigerian action. Therefore, under this procedure, the amendment would not be futile.[96]

The second dissolution procedure is a default procedure whereby a dissolved corporation that fails to follow the first procedure must make provisions sufficient to satisfy any claim that the corporation knows about or reasonably should know about that could arise within ten years from the date of dissolution.[97] Akande's complaint alleged that Transamerica made no such provisions. The court agreed, concluding that the breach of fiduciary duty claim would not be futile under that procedure either.

Because neither of the statutory procedures were followed by Transamerica, the court granted Akande's motion to amend to add claims for breach of fiduciary duty.

Canadian Commercial Workers Industry Pension Plan v. Alden[98]

Canadian Commercial Workers Industry Pension Plan ("CCWIPP") filed this derivative action against nominal defendant Case Financial, Inc. and against four of its former directors and officers. The litigation arose after substantially all the assets of Case were sold.[99] After two of the former directors settled the claims against them, the remaining directors filed motions to dismiss which the Court of Chancery granted in part and denied in part.

CCWIPP's claims against the two remaining defendants, Alden and Bibicoff, included (1) breach of the duty of loyalty and corporate waste, and (2) breach of the duty of oversight (a *Caremark claim*).[100] The breach of the duty of loyalty claim against Alden was based on his alleged receipt of stock options in violation of his agreement with Case and his alleged use of Case employees and property to run his own separate business. The breach of loyalty claim against Bibicoff was premised on his alleged improper transfer of accounts receivable to a separate entity he owned, and usurpation of other corporate opportunities.[101] The *Caremark*/breach of the duty of oversight claims were based on alleged failures by both Alden and Bibicoff to prevent the alleged breaches of duty by one another and their alleged failure to follow Case's internal policies.[102]

Alden argued in his motion to dismiss that the Caremark claims against him were extinguished by a broad mutual release between Case and Alden, citing 8 Del. C. § 102(b)(7), and that the plaintiff was an inadequate derivative representative, citing Chancery Rule 23.1.[103] Bibicoff's motion to dismiss argued that Case failed to make an adequate investigation into the claims before assigning them to CCWIPP for prosecution and that the *Caremark* claim failed to state a claim upon which relief could be granted.[104]

The court first addressed the implications of Alden's waiver, noting that the release did not discharge him from criminal acts and that CCWIPP alleged acts that might be criminal in support of the breach of the duty of loyalty claim, but not in support of the *Caremark* duty to oversee claim.[105] Thus, the court stated it would dismiss the *Caremark* claim against Alden but allow the claims for breach of the duty of loyalty to continue because of the crime exception to the waiver.

Next, the court reviewed CCWIPP's *Caremark* claim allegations, describing them as "exceedingly general," and "conclusory."[106] The court further rejected CCWIPP's allegation that the defendants failed to oversee each others' activities, reasoning that "neither logic nor precedent suggests [Alden] had a separate enforceable duty to oversee his own actions," and furthermore, "directors of Delaware corporations generally have no duty to monitor the personal affairs of other directors and officers."[107] Similarly, the court held that despite the fact that Alden was a CPA and Bibicoff was an attorney, Delaware law does not hold either to a higher standard of care in the duty of oversight context.[108] In light of these failures, the court dismissed CCWIPP's *Caremark* claims against both of the defendants.

Alden's claim that CCWIPP was an inadequate derivative plaintiff also failed because Alden had not shown a substantial likelihood that CCWIPP was not acting in the best interests of Case stockholders.[109] Likewise, Case's decision to allow CCWIPP to prosecute the claims a mere three days after CCWIPP made demand on Case's board was not a "*per se* insufficient" time for the Case board to fulfill its duties.[110]

Thus, the court dismissed the claims against both defendants for the failure to state a *Caremark* claim, but allowed the other claims to stand.

Superior Vision Services, Inc. v. ReliaStar Life Insurance Co.[111]

An interesting twist on the typical fiduciary duty case, this case involved claims by the company against one of its shareholders. Superior Vision Services, Inc. asked the Delaware Court of Chancery to declare that its shareholder ReliaStar Life Insurance Co. breached its fiduciary duties to Superior, that ReliaStar breached its covenant of good faith and fair dealing, and that Superior was entitled to pay dividends in contravention of an agreement between the Superior board and its shareholders. The court rejected Superior's claims and dismissed the complaint.

Although Superior had entered into an agreement with its shareholders prohibiting it from paying dividends, a provision in the agreement allowed for waiver of the prohibition if the waiver was approved by written consent of investors owning at least two thirds of the outstanding shares.[112] ReliaStar owned 44% of Superior and refused to consent to payment of dividends, despite the fact that the entire board and all remaining shareholders approved the payment. Superior sought declaratory relief and ReliaStar moved to dismiss, arguing that Superior lacked standing and that the complaint failed to state a claim upon which relief could be granted. Further, ReliaStar contended that it was not a controlling stockholder of Superior and therefore owed no fiduciary duty to Superior, that even if it was a controlling stockholder it owed no duty to Superior, and that its conduct violated no fiduciary duties.[113]

As to the standing argument, the court noted that although other shareholders who were denied their dividends by ReliaStar's actions would be the logical plaintiffs, Superior still had standing because it alleged direct harm caused by ReliaStar's thwarting of the policies adopted by Superior's board of directors.[114] The court then addressed the "remarkably unconventional" cause of action for breach of fiduciary duty brought by the corporation against its shareholder, noting that shareholders owe fiduciary duties to the company only if they occupy the status of majority or controlling shareholder. Here, ReliaStar was not a majority shareholder because it owned only 44% of Superior; therefore, it owed fiduciary duties to Superior only if it was a controlling shareholder. The court found that ReliaStar failed to meet this requirement as well because it exercised its power to thwart the board based on contract rights, not by influencing or controlling the board or its members.[115] In fact, as the court stated, the board took the action it saw fit by approving the dividends in the first place.

Vice Chancellor Noble then disposed of the remaining claim for breach of the covenant of good faith and fair dealing, pointing out that "imposing an obligation on a contracting party through a covenant of good faith and fair dealing is a cautious enterprise and should be rare."[116] Under the agreement at issue, ReliaStar had an unqualified right to refrain from consenting to the waiver, and the covenant of good faith and fair dealing does not require otherwise.

Blue Chip Capital Fund II Limited Partnership v. Tubergen[117]

This case provided the Chancery Court an opportunity to examine the interplay between contract and breach of fiduciary duty claims. In the end, the court dismissed the breach of fiduciary duty claims, deciding that they were secondary to the contract-based claims.

Underlying this suit was the sale of substantially all of the assets of HCS Infusion Services, Inc. Upon completion of the sale, HCS distributed the proceeds primarily to the holders of a class of preferred stock that included the company's controller.[118] The minority stockholder, Blue Chip Capital Fund II Limited Partnership, filed a derivative suit and a direct suit against the directors

for breach of fiduciary duty and against HCS for breach of contract based on the alleged breach of an implied covenant of good faith and fair dealing.[119] Because the claim that the board breached its fiduciary duty in interpreting the contract was basically the same as the contract claim that the board failed to interpret the contract in good faith, the court found that "the fiduciary duty claims [were] superfluous."[120] Furthermore, according to the court, the rights of preferred shareholders were generally governed by contract law and allowing the two claims to co-exist would undermine the primacy of contract law.

However, to allay the risk that the corporate assets would be inadequate, the court dismissed the fiduciary duty claims without prejudice.

Kosseff v. Ciocia[121]

In this decision, the Chancery Court Master denied a motion to dismiss claims of breach of fiduciary duty related to a hastily-entered agreement to settle a proxy contest. The agreement resulted in the resignation of the CEO, enlarged the board from six to nine members, and appointed three additional board members who were backers of the proxy solicitation.[122] In exchange, the CEO received the right to buy up to a quarter of the business of the company at a reduced price. Kosseff, a shareholder in the company, filed this derivative suit to challenge the agreement as a violation of the director's fiduciary duties.[123]

In denying the motion to dismiss, the Master noted that the plaintiff did not make demand on the board, but concluded that, as applied to the three newly appointed board members, a demand to rescind the agreement was "the quintessence of futility" because it would in effect "request that the directors . . . rescind[] an Agreement to which they owe their tenure on the board."[124] As to the remaining six board members, the Master found that three were interested in the transaction and the other three were independent. The approval of the three independent directors was not, however, sufficient to warrant dismissal of the complaint because the fact that the agreement was reached in less than three days without independent advisers or a special committee raised a reasonable doubt that the three acted without "good faith and due care."[125]

Oliver v. Boston University[126]

This extensive opinion dealt with claims by former minority shareholders in Seragen, Inc., a biotechnology company. The minority shareholders contended that Boston University, Seragen's controlling shareholder, and seven individuals, including six of Seragen's directors (three of whom were closely affiliated with BU), violated their fiduciary duties in the approval of various financial transactions, including the merger of Seragen with Ligand Pharmaceuticals, Inc.. The Court of Chancery agreed, holding the three affiliated directors and BU jointly and severally liable for $4,809,245 in damages, plus interest.[127]

BU owned a controlling interest in Seragen and, along with other directors and affiliates, entered into a series of transactions that provided Seragen with capital in exchange for additional equity or other contractual rights.[128] Despite these efforts, Seragen continued to have extensive financial problems because it had no product in the marketplace. Eventually, Seragen agreed to a merger with Ligand for approximately $70 million, conditioned upon no more than 10% of the common shares seeking appraisal.[129] The $70 million was insufficient to cover all of Seragen's debts and obligations. The defendants negotiated amongst themselves to divide the proceeds, considering the minority shareholders only to the extent necessary to decide the minimum amount that would have to be diverted to those shareholders to avoid the exercise of appraisal rights by more than 10% of the common shares.[130] The resulting agreement (the "Accord") was reached without any procedures to ensure that it was fair and without the input of the minority shareholders.

The consummation of the merger was followed shortly by this lawsuit alleging direct and derivative claims, including breach of fiduciary duty claims against BU and the three closely affiliated directors.[131] Applying the entire fairness standard because the majority of the Seragen board was interested or lacked independence, the court found that the transaction was not the product of fair dealing or a fair price. As the court stated, "the Defendants failed to demonstrate that the merger allocation was entirely fair because not only was there no process to ensure its fairness, but also because the price assigned . . . was unfair."[132]

Notably, the court pointed out that Seragen's directors should have included the value of derivative claims that existed at the time of the merger in allocating the proceeds of the merger.[133] This allocation, according to the court, should have been based on the derivative claims known to the directors under a standard of inquiry notice—when they "become[] aware of facts sufficient to put a person of ordinary intelligence and prudence on inquiry which, if pursued, would lead to the discovery of injury."[134]

Having found that the breach of the duty of loyalty claims had merit, the court turned to the claims for failure to disclose, dilution of the minority shareholders' voting power, and aiding and abetting of the breaches of fiduciary duty by a BU trustee. As to the failure to disclose claims, the court looked for an omission of a fact that was material from the objective standpoint of a reasonable investor.[135] Finding none, the court dismissed the claims. With regard to the dilution of voting power claims, the court found that the issued shares that could potentially have diluted the voting power were either lacking in voting rights or were never converted to voting shares, thus no dilution occurred.[136] And finally, the court found that the transaction upon which the aiding and abetting claim was premised failed; therefore, the aiding and abetting claim could not stand.[137]

North American Catholic Educational Programming Foundation, Inc. v. Gheewalla[138]

The North American Catholic Educational Programming Foundation, Inc. ("NACEPF") brought this suit against Clearwire Holdings, Inc. alleging, among others, direct claims for breach of fiduciary duties against Clearwire's directors.[139] The Court of Chancery concluded that creditors may not bring a direct claim for breach of fiduciary duty based on the theory that the corporation was in the zone of insolvency.

Clearwire was incorporated for the purpose of providing wireless internet access through radio wavelengths regulated and licensed by the FCC (called "spectrums").[140] Clearwire entered into agreements with NACEPF and others under which Clearwire would obtain licenses for spectrums as they became available. When the wireless spectrum market collapsed, Clearwire began settling potential claims with its creditors. NACEPF refused to settle its claims and filed this suit when Clearwire effectively went out of business.[141] NACEPF alleged that while Clearwire was insolvent or within the zone of insolvency, its directors failed to preserve Clearwire's assets for the benefit of Clearwire's creditors when it became apparent that Clearwire would need to be liquidated. The defendants moved to dismiss the action, contending that the court lacked jurisdiction over them and that NACEPF failed to state a claim upon which relief could be granted.[142]

Jurisdiction over the defendants was premised on 10 Del. C. § 3114, which grants jurisdiction over directors of Delaware corporations for claims related to acts performed in their capacity as a director—if the claim fails, then jurisdiction is lacking.[143] In light of this jurisdictional premise, the court reviewed NACEPF's allegations to determine if the defendants were correct in arguing that the allegations failed to state a claim. Therefore, according to the court, the question was "whether a corporation's creditors may assert direct claims against directors for breach of fiduciary duties when the corporation is insolvent or in the zone of insolvency."[144]

Here, the court answered that question in the negative, based on a two step inquiry: (1) whether the creditor has sufficiently pleaded that it is entitled to payment which is currently or imminently due, and if so, (2) whether a direct claim "implicating invidious conduct . . . has been properly pleaded."[145] As the court concluded, NACEPF failed to allege that it was entitled to payment that was clearly and immediately due. Further compelling this conclusion was the court's awareness of other protections which exist to protect creditors, including those in their negotiated contracts and security instruments, the common law implied covenant of good faith and fair dealing, and bankruptcy and fraudulent conveyance laws.[146]

Having found NACEPF's claims insufficient, the court dismissed the suit, thus rejecting the jurisdictional allegations in the process.

Khanna v. McMinn[147]

This case dealt with a number of issues that often arise when fiduciary duty claims are alleged, including what constitutes demand, whether certain allegations support demand futility, application of the business judgment rule, aiding and abetting, sufficiency of pleadings, waiver of privilege, and the adequacy of class representatives. In the end, the Court of Chancery dismissed eight of the plaintiffs' ten claims, found one of the three class representatives inadequate, and unsealed the record because of waiver of privilege.[148]

The initial plaintiff in this case, Dhruv Khanna, was formerly general counsel and an executive vice president of nominal defendant Covad Communications Group, Inc.[149] After being removed from his position amid allegations of sexual harassment, Khanna sent a letter to the board outlining alleged breaches of fiduciary duty and demanding certain benefits for himself including his appointment to the board as vice chairman with a 15 year contract, reappointment as an executive vice president, commensurate compensation, and formal exoneration of all allegations against him.[150] When Covad failed to accede to his demands, Khanna initiated this lawsuit alleging class and derivative claims against members of Covad's board for breaches of fiduciary duty related to numerous transactions, including some with Crosspoint Venture Partners, L.P., which also was named as a defendant.[151] Almost a year after filing his complaint, Khanna was joined as putative class representative by two other shareholders.

The complaint sought redress for (1) allowing the vestment of the chairman of the board's founders' shares when the requirements were not met, (2) permitting two board members to form a competitor company, (3) investing corporate funds in the competing company, (4) acquiring a failing company (which led to Covad's bankruptcy) to rescue an investor's business, (5) settling claims by the acquired company on less than ideal terms, and (6) investing in, and paying to divest, another company of one of the directors.[152] In addition to these allegations, the complaint alleged that the defendants failed to disclose material information in proxy statements. The defendants moved to dismiss the claims, to disqualify Khanna, and to seal portions of the record and complaint.

First, the court examined the demand and demand futility arguments. Noting that a demand must identify the alleged wrongdoers and their alleged wrongful action, as well as the action the shareholder wants the board to take, the court rejected the defendants' argument that Khanna's letter constituted a demand and that by making demand Khanna had conceded the disinterestedness and independence of the board.[153] Instead, the court concluded that Khanna's letter did not constitute a demand because the actions he sought the board to take all related to his removal from Covad. Additionally, the court pointed out that although the board formed a special committee that investigated the claims and concluded litigation was not warranted (thus apparently taking Khanna's letter

as a demand), "the Board's interpretation of what the letter represented [did] not control the court's determination of whether it was a demand."[154]

With regard to demand futility, the court found that the plaintiffs failed to plead with particularity facts sufficient to create a reasonable doubt as to the reasonableness and disinterestedness of at least half of Covad's board under the first prong of *Aronson* and *Rales*.[155] The court did, however, find that the plaintiffs' allegations created a reasonable doubt that some of the challenged transactions were the product of a valid exercise of business judgment, thus satisfying the second prong of the disjunctive *Aronson* demand futility test.[156]

Second, the court addressed allegations that Crosspoint aided and abetted some of Covad's fiduciaries. According to the court, allegations of aiding and abetting must show: (1) a fiduciary relationship, (2) a breach of the relationship, (3) a knowing participation in that breach by the defendant, and (4) damages proximately caused by the breach. Here, the primary issue was whether Crosspoint knowingly participated in the alleged breaches by the fiduciaries. In the court's opinion, Crosspoint's knowing participation was sufficiently brought into question by allegations that a board member who was general and managing partner of Crosspoint and on Covad's compensation committee lobbied and persuaded Covad's CEO to take the actions at issue.[157]

Third, the court addressed the plaintiffs' claims of *respondeat superior* liability against Crosspoint, which the court dismissed because they fell short of the pleading bar. Likewise, the court was not persuaded by the plaintiffs' disclosure claims under the doctrine of laches and the remaining disclosure claims, dismissing them for failure to state a claim.[158]

Fourth, the court examined the defendants' motion to give certain allegations confidential treatment. Because the defendants had waived the attorney-client privilege with respect to the portions of the complaint at issue during a prior section 220 trial, the court denied the request and concluded that strong policy reasons in favor of a public record outweighed the "sensitive information" in the complaint.[159]

Fifth, the court addressed the defendants' contention that Khanna and the other plaintiffs were unqualified to serve as class representatives. As to Khanna, the court agreed that his previous representation of Covad on matters substantially related to the challenged transactions and the substantial likelihood that Khanna was bringing the action as a result of Covad's termination of him were sufficient to disqualify him.[160] The other plaintiffs, however, did not have sufficient conflicts to support their disqualification.[161]

Having waded through the allegations and facts, the court dismissed Khanna as a class representative, allowed the complaint and record to be unsealed, and dismissed eight of the plaintiffs' ten claims. It then allowed the case to proceed on the claims for breach of fiduciary duty related to Covad's ill-executed rescue of CrossPoint, as well as the aiding and abetting claims for Crosspoint's support of that decision.[162]

Carlson v. Hallinan[163]

This opinion summarized the Chancery Court's findings and conclusions regarding the direct and derivative claims, including breach of fiduciary duty claims, asserted against various defendants by G. William Carlson and his company Contact Results, Inc. The defendants were CR Services Corp., its chairman, secretary, and treasurer Charles Hallinan, its vice president Gary Gordon, and various closely-held affiliated companies. The court's opinion addressed indemnification, compensation, receivership, dissolution, accounting of funds by a fiduciary, entire fairness versus business judgment rule, minority shareholder and committee ratification, and attorneys' fees.

Initially the parties to this suit created and operated CR as a small "payday" loan company with Carlson running the operations and Contact and Hallinan as its stockholders. Contact owned 30% of CR, Hallinan owned 65%, and Gordon owned the remaining 5%.[164] As the relationship deteriorated, Carlson was fired by Hallinan, although he remained a director and Contact continued to own 30% of CR's stock. A few months later, Contact made a books and records demand to CR's board which was answered by Hallinan circulating consents that purported to remove Carlson as a director of CR. Contact then filed suit under 8 Del. C. § 220 for books and records, which CR reluctantly but eventually complied with (the payment of attorneys' fees for the litigation related to that case was also addressed in this opinion).[165] Carlson eventually was reinstated as a director, although the tensions between the parties continued. During this period, CR began paying Hallinan a salary that ranged from $429,539 - $540,001, and Gordon was paid in the range of $55,846 - $84,000. CR also relocated its offices into office space owned by TC Services Corp. and began paying a management fee to TC. TC was another payday loan company owned and operated by Gordon.[166]

After recounting these facts, the court started its opinion by denying the defendants' post trial motion to supplement the record. Next, the court took up the plaintiffs' contract claims, holding that: (1) the written CR stockholders' agreement was not integrated and therefore testimony on matters not discussed in the agreement was appropriate, (2) an oral agreement that CR would pay Carlson a salary but not anyone else, and CR's stockholders would receive only pro rata distributions was enforceable, (3) the payment of salaries to Hallinan and Gordon violated this agreement, and (4) the brief removal of Carlson as CR's president and as a member of its board was not a violation of the stockholders' agreement.[167]

Turning to the plaintiffs' breach of fiduciary duty claims, the court noted that the entire fairness standard—fair dealing and a fair

price—applied to all of the transactions at issue because Hallinan stood on both sides of the transactions and Gordon either stood on both sides of the transactions or was not independent of Hallinan.[168]

The first transaction challenged was Hallinan's and Gordon's compensation. The court found their compensation to be unfair in both process and price because the board did not approve, or even consider, the salary they received and provided no evidence to justify their salaries in light of the limited work they did for CR.[169] As to the management fees CR paid to TC, the court likewise found that it was the product of unfair dealing with an unfair price because Carlson, and perhaps Gordon based on his impeached trial testimony, was not involved in the decision to pay the fee. Furthermore, the fee itself was unfair because it was disproportionate for the services CR received from TC when compared to other management fees TC received.[170] The next transactions at issue involved CR paying operating expenses for TC and other Hallinan affiliated entities. For these the court ordered an accounting "to determine the extent of the misallocation of expenses and the damages resulting therefrom."[171] The fifth transaction in question was Hallinan's decision to alter the operational structure of all of his payday loan companies except CR, an act the plaintiffs likened to usurpation of a corporate opportunity. The court disagreed, recognizing that the usurpation claims normally involve an opportunity that only one entity can take advantage of, which was not the case here, and even if the claims qualified as usurpation, the plaintiffs failed to sufficiently show money damages.[172] The last claim of breach of fiduciary duty the court reviewed was the removal of Carlson as President of CR. Recognizing that argument as novel and unsupported legally, the court found that the act of removal was not a breach of any fiduciary duty.[173]

Continuing, the court determined that the CR's payment of Hallinan and Gordon's legal fees to defend the case was an ultra vires act because the formalities for making a section 145 undertaking were not followed. Although the court acknowledged that a written undertaking was unnecessary under Delaware law, it also recognized that the business judgment rule would not protect the defendants' decision to have CR pay for their defense.[174] The court also found that the two interested directors aided and abetted each other's breach of their fiduciary duty.[175] As to the plaintiffs' request for the dissolution of CR and the appointment of a custodian, the court recognized that it had the authority to dissolve a solvent company, but only in extreme circumstances of gross mismanagement, positive misconduct or a breach of trust that would show imminent danger of great loss which could not otherwise be prevented, a rare situation. Here, however, the court ruled that the abuses and multiple breaches of fiduciary duty justified such extreme action.

The final questions addressed by the court were the plaintiffs' requests for attorneys' fees related to the previous section 220 action and to the case at hand. The plaintiffs argued that the defendants' bad faith warranted an exception to the normal rule that each party bear its own expenses in litigation.[176] In light of the defendants' conduct in refusing the inspection demand, the court agreed with the plaintiffs and awarded litigation costs related to the section 220 action to the plaintiffs; however, the court did not allow "fees on fees" because the opposition to the request for attorneys' fees was not egregious. Similarly, the court held that the plaintiffs could recover their attorneys' fees based on the derivative claims because of the common fund doctrine; however, the court ordered 30% of the recovered money damages to go directly to the plaintiffs so that the two culpable shareholders would not benefit without contributing to the costs incurred by the plaintiff.[177]

Vice Chancellor Parsons, who authored the opinion, issued a letter order clarifying it on May 22. Addressing Carlson's unreimbursed business expenses and whether the defendants should bear the expense of the accounting and receivership previously ordered, the letter order held that Carlson should be reimbursed for his expenses, Hallinan and Gordon were responsible for the cost of the accounting, and CR itself should bear the expense for its receivership.[178]

In re PNB Holding Co. Shareholders Litigation[179]

Providing guidance about the standard for calculating the "majority of the minority" necessary to invoke the protections of the business judgment rule when a controlling stockholder is not on both sides of a transaction, this opinion found the terms of a merger unfair and awarded damages to the stockholders who did not vote for the merger or who sought appraisal.

PNB Holding Company, a bank holding company, operated as a community bank until it embarked on an expansion plan in the mid-1990s. Despite initial setbacks, PNB eventually began reaping rewards from its expansion and decided to convert to an S corporation for the tax benefits.[180] However, because PNB had too many stockholders to qualify as an S corporation, its board planned a merger to cash out enough of its stockholders to get below the 75 stockholder maximum for an S corporation. PNB formed an S Corporation Conversion Committee to determine the "fair value" of the company's capital stock. The Committee hired Prairie Capital Services, Inc., an independent investment banker, to help determine a fair price for the cash-out.[181]

Based on Prairie Capital's advice, the Committee recommended, and PNB's board approved, a cash-out price of $41.00 per share. The plan would keep the largest 68 stockholders, including all of PNB's directors, as stockholders while all other stockholders would be cashed out.[182] After issuing proxy materials, the board offered the merger proposal to the stockholders for approval. At the meeting, 92.6% of the shares that were voted in person or by proxy approved the merger, although only 48.8% of the departing stockholders voted in its favor. The other 51.2% consisted of 37.3% who failed to return a proxy, 6.2% who perfected a demand for appraisal rights, 4.3% who voted against the merger, and 3.4% who abstained.[183]

The stockholders filing this lawsuit fell into two classes, (1) those that dissented from the merger and perfected their appraisal rights, and (2) those that accepted the merger proposal but nonetheless sued PNB's directors for breach of fiduciary duty. Underlying the claims of both was "the notion that the $41.00 per share paid in the Merger was unfair."[184]

Addressing the equitable claim of the stockholders who accepted the merger but felt it was approved by PNB's directors in violation of their fiduciary duties to minority stockholders, the court determined that unless a majority of disinterested shareholders approved the transaction, the entire fairness standard would apply. Under the terms of the merger, the court reasoned, the directors who approved it all remained as directors and therefore would benefit if the price paid was lower rather than higher.[185] Therefore, the court reviewed the shareholder approval of the merger to determine if a "majority of the minority" approved it. Clarifying Delaware law, the court held that a "majority of the minority" approval requires a vote of a majority of all of the minority shares entitled to vote, not just a majority of those that actually vote.[186]

Ultimately, the court decided that the procedure used in arriving at the merger price was unfair because the only real safeguard employed was the retention of Prairie Capital. Similarly, according to the court, the price obtained was unfair based on the evidence presented. Because neither the process nor the price were fair, the court held that the transaction failed the entire fairness test and awarded the appraisal claimants $52.34 per share and the claimants who did not vote for the merger $11.34 per share (the difference between the fair $52.34 price and the $41.00 paid).[187]

Trenwick America Litigation Trust v. Ernst & Young, L.L.P. [188]

"Delaware law does not recognize this catchy term, [deepening insolvency,] as a cause of action, because catchy though the term may be, it does not express a coherent concept." So stated the Court of Chancery in this opinion, which sharply criticized the plaintiff litigation trust for proffering a "deepening insolvency" claim along with other claims (including breach of fiduciary duty) against the former directors of Trenwick Group ("Trenwick"), its subsidiary Trenwick America Corporation ("Trenwick America"), and certain of Trenwick's former professional advisors.[189] In dismissing the plaintiff's claims, the court's opinion also reinforced the bases and applicability of the business judgment rule.

Trenwick Group was an insurance and reinsurance organization that embarked on a strategy of growth by acquisition marked by the purchase or merger of three unaffiliated insurance companies. The two transactions at issue here (the "Acquisitions") involved the acquisition of publicly-traded entities approved by Trenwick's board—all but one of who was independent—and by Trenwick's stockholders, which were diverse and did not contain a controlling stockholder.[190] As part of the second transaction, Trenwick redomiciled in Bermuda and reorganized its operations by geographic interests, thus creating Trenwick America and other subsidiaries. Trenwick America also was a guarantor of Trenwick's debt including $260 million in bank debt and $190 million in debt securities. Despite this guarantor status, Trenwick America maintained a positive net asset value of over $200 million.[191] The prosperity did not last long, however, as Trenwick and Trenwick America filed bankruptcy because their insureds' claims exceeded estimates and surpassed the companies' abilities to service the claims and debt.[192]

Trenwick America's bankruptcy plan created a Litigation Trust (the "Trust") which brought this action premised on claims that Trenwick's majority independent board engaged in an imprudent business strategy by acquiring other insurers with erroneous and understated estimates of their potential claims exposure, which injured Trenwick and Trenwick America's creditors when the companies became insolvent. Specifically, the complaint alleged that: (1) Trenwick's directors breached their fiduciary duties of care and loyalty which were owed to Trenwick's creditors because Trenwick was insolvent, (2) Trenwick America's directors likewise breached their fiduciary duties of care and loyalty, conspired with the Trenwick directors in their actions, and deepened the insolvency of Trenwick America by increasing its debt exposure, and (3) Trenwick's professional advisors conspired as well as aided and abetted the directors of both entities.[193]

First, the Court of Chancery considered the Trust's standing to bring the claims and determined that the trust agreement gave the Trust the authority to pursue only claims on behalf of Trenwick America, thus creating a lack of standing for direct claims.[194] Having made that determination, the court then analyzed the allegation that Trenwick's board breached its fiduciary duties in approving the Acquisitions, but found the argument at odds with "settled principles of Delaware law, [that] a parent corporation does not owe fiduciary duties to its wholly-owned subsidiaries or their creditors."[195] The court noted that, if the claim had been brought on behalf of Trenwick, it would fail because of Trenwick's exculpatory charter provision pursuant to Delaware General Corporate Law section 102(b)(7). Further, according to the court, Trenwick owed no fiduciary duties to Trenwick America at the time of the Acquisitions because the Trust failed to plead facts that supported a finding that Trenwick or Trenwick America was insolvent at that time.[196]

Second, the court considered the allegations against Trenwick America's directors. Unlike its ruling for Trenwick's directors, the court held that Trenwick America's directors at least owed fiduciary duties to Trenwick America and were obligated to lend support to the business strategy of Trenwick and manage Trenwick America in accordance with Trenwick's wishes.[197] The Trust's allegations invoking "deepening insolvency" likewise failed because there was "no absolute obligation on the board of a company that is unable to pay its bills to cease operations and to liquidate, [thus] [e]ven when the company is insolvent, the board may pursue, in good faith, strategies to maximize the value of the firm."[198] As the court saw it,

nothing would be gained by adding deepening insolvency to the traditional toolkit plaintiffs have for curing deficiencies on the part of directors; the additional fact of insolvency does not render the concept of "deepening insolvency" any more logical one than the concept of "shallowing profitability."

The Chancery Court also reaffirmed that the protections of the business judgment rule extend to an insolvent entity. As the court explained, when a board acts with due diligence and in good faith in support of a business strategy that it believes will increase the corporation's value, even if it increases the corporation's debt, that board does not become a guarantor of the strategy's success—to hold otherwise would rob the business judgment rule of much of its utility.[199]

Finally, the court addressed the claims against Trenwick's professional advisors—Ernst & Young, PriceWaterhouseCoopers, Baker & Mackenzie, and Milliman. Those claims failed because: (1) the complaint failed to state a claim for breach of fiduciary duty against Trenwick America and Trenwick, as well as their directors, therefore the defendant advisors could not aid and abet or conspire in such acts; (2) the complaint failed because the claims were not pled with sufficient particularity; and (3) the Trust had no standing to bring malpractice claims against the professional advisors.

In the end, the Court of Chancery found it "regrettable that Trenwick and Trenwick America became insolvent," but "the mere fact of a business failure does not mean that a plaintiff can state claims against the directors, officers, and advisors on the scene just by pointing out that their business strategy did not pan out."[200]

ENDNOTES

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2 906 A.2d 27 (Del. 2006).

3 *Id.* at 34-46.

4 *Id.* at 47.

5 *Id.* at *47-48.

6 *Id.* at 49.

7 *Id.* at 49-50.

8 *Id.* at 51-52.

9 *Id.* at 52.

10 *Id.* at 52-62.

11 *Id.* at 62-63.

12 *Id.* at 63.

13 *Id.*

14 *Id.* at 64.

15 *Id.* at 64-66.

16 *Id.* at 64-65.

17 *Id.* at 66.

18 *Id.* at 66.

19 *Id.*

20 *Id.*

21 *Id.* at 67.

22 *Id.*

23 *Id.* at 66-75.

24 No. Civ.A. 1570-N, 2006 WL 302558 (Del. Ch. January 26, 2006).

25 911 A.2d 362 (Del. 2006).

26 2006 WL 302558 at *1.

27 *Id.*

28 *Id.* at *2.

29 *Id.* at *2.

30 *Id.* at *2 (citing *In re Walt Disney Co. derivative Litig.*, 2005 WL 2056651 (Del. Ch. Aug. 9, 2005)).

31 *Id.* at 367.

32 *Id.* at 367-69 (citing *Graham v. Allis-Chalmers Mfg Co.*, 188 A.2d 125 (Del. 1963), *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996), and *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27 (Del. 2006) (discussed *supra*)).

33 *Id.* at 370.

34 *Id.*

35 *Id.* at 372-73.

36 344 B.R. 283 (Bankr. Del. 2006).

37 *Id.*. at 284-85.

38 *Id.* at 285.

39 *Id.*

40 *Id.*

41 *Id.* at 286-87 (citing *Southwest*, 315 B.R. 565 (Bankr. D. Ariz. 2004)).

42 *Id.* at 288.

43 *Id.* at 289 (relying on *Prod. Res. Group, L.L.C. v. NCI Group, Inc.*, 863 A.2d 772, 791-92 (Del. Ch. 2004) to clarify *Southwest's* discussion of a director's fiduciary duties to an insolvent corporation).

44 *Id.* at 291.

45 906 A.2d 766 (Del. 2006).

46 *Id.* at 768-69.

47 *Id.* at 769.

48 *Id.* at 769-70 (The court did however state that the failure to disclose allegations might have supported a claim for injunctive or other equitable relief.).

49 *Id.* at 770 (citing *Tri-Star*, 634 A.2d 319 (Del. 1993)).

50 *Id.* (citing *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135 (Del. 1997)).

51 *Id.* (quoting *Loudon*, 700 A.2d at 141).

52 *Id.* at 770-71.

53 906 A.2d 91 (Del. 2006).

54 *Id.* at *1-7.

55 *Id.* at *19.

56 *Id.* at *20-21.

57 *Id.* at *21.

58 *Id.* at *22 & n.129.

59 906 A.2d 91 (Del. 2006).

60 *Id.* at 93 (citing 2005 WL 2810683 (Del. Ch. Oct. 20, 2005)).

61 *Id.* at 94.

62 *Id.* at 95.

63 *Id.*

64 *Id.*

65 *Id.* at 99.

66 *Id.* at 101.

67 *Id.* at 102.

68 902 A.2d 1130 (Del. 2006).

69 *Id.* at 1136.

70 *Id.* at 1136-39.

71 *Id.* at 1138.

72 *Id.* at 1138-39.

73 *Id.* at 1139.

74 *Id.* at 1140-41.

75 *Id.* at 1141-42.

76 *Id.* at 1142-43.

77 *Id.* at 1144 (citing *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983)).

78 *Id.* at 1144-52; The court also expressed "very serious doubts about Ottensoser's familiarity and competence to give a client advice about Delaware fiduciary duty law." *Id.* at 1151.

79 *Id.* at 1154-64.

80 *Id.* at 1164.

81 No. Civ.A. 1449-N, 2006 WL 391931 (Del. Ch. February 13, 2006).

82 *Id.* at *1.

83 *Id.*

84 *Id.* at *3.

85 *Id.* at *4.

86 *Id.*

87 *Id.* at *5.

88 *Id.* No. Civ.A. 1039-N, 2006 WL 587846 (Del. Ch. Feb. 28, 2006).

89 *Id.* at *2.

90 *Id.*

91 *Id.* at *8.

92 *Id.* at *3.

93 *Id.* at *7 (citing 8 Del. C. §§ 280-282).

94 *Id.*

95 *Id.* at *8 (citing 8 Del. C. § 280(a)).

96 *Id.*

97 *Id.* at *8 (citing 8 Del. C. § 281(b)).,

98 No. Civ.A. 1184-N, 2006 WL 456786 (Del. Ch. Feb. 22, 2006).

99 *Id.* at *1.

100 *Id.*

101 *Id.*

102 *Id.* at *2.

103 *Id.*

104 *Id.* at *3.

105 *Id.* at *5-6.

106 *Id.* at *6.

107 *Id.* at *7 (As examples, the court described CCWIPP's allegation "that Alden failed to prevent Bibicoff from investing his own money in lines of business similar to those pursued by Case," and both "failed to stop each other...from running other businesses out of their Case Financial offices.").

108 *Id.* at *7 n.54.

109 *Id.* at *10.

110 *Id.*

111 No. Civ.A. 1668-N, 2006 WL 2521426 (Del. Ch. Aug. 25, 2006).

112 *Id.* at *1.

113 *Id.* at *2.

114 *Id.* at *3.

115 *Id.* at *5.

116 *Id.* at *6.

117 906 A.2d 827 (Del. Ch. 2006).

118 *Id.* at 829-30.

119 *Id.* at 831.

120 *Id.* at 832-33.

121 No. Civ.A. 188-N, 2006 WL 2337593 (Del. Ch. Aug. 3, 2006).

122 *Id.* at *1.

123 *Id.*

124 *Id.* at *4.

125 *Id.* at *7.

126 No. Civ.A. 16570-NC, 2006 WL 1064169 (Del. Ch. April 14, 2006).

127 *Id.* at *35.

128 *Id.* at *2-12.

129 *Id.* at *12.

130 *Id.*

131 *Id.* at *15.

132 *Id.* at *30.

133 *Id.* at *19-20.

134 *Id.* at *20.

135 *Id.* at *31.

136 *Id.* at *33.

137 *Id.* at *34.

138 No. Civ.A. 1456-N, 2006 WL 2588971 (Del. Ch. Sept. 1, 2006).

139 *Id.* at *1.

140 *Id.* at *2.

141 *Id.* at *5.

142 *Id.*

143 *Id.* at *6.

144 *Id.* at *8.

145 *Id.* at *16.

146 *Id.* at *13.

147 No. Civ.A. 20545-NC, 2006 WL 1388744 (Del. Ch. May 9, 2006).

148 *Id.* at *44-45.

149 *Id.* at *1.

150 *Id.* at *7-8.

151 *Id.* at *1.

152 *Id.*

153 *Id.* at *13.

154 *Id.* at *14.

155 *Id.* at *14-22 (citing *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) and *Rales v. Blasband*, 634 A.2d 927 (Del. 1993).

156 *Id.* at *22-26.

157 *Id.* at *26-27.

158 *Id.* at *28-36.

159 *Id.* at *36-40.

160 *Id.* at *40-44.

161 *Id.* at *44.

162 *Id.*

163 No. Civ.A. 19808, Civ.A. 19466, 2006 WL 771722 (Del. Ch. March 21, 2006).

164 *Id.* at *2-3.

165 *Id.* at *3.

166 *Id.* at *1, *4.

167 *Id.* at *7-11.

168 *Id.* at *12-13.

169 *Id.* at *13-15.

170 *Id.* at *15-17.

171 *Id.* at *17.

172 *Id.* at *17-19.

173 *Id.* at *19.

174 *Id.* at *19-20.

175 *Id.* at *20-21.

176 *Id.* at *22-23.

177 *Id.* at *24.

178 Letter Order dated May 22, 2006, from Vice Chancellor Donald F. Parsons, Jr.

179 No. Civ.A. 28-N, 2006 WL 2403999 (Del. Ch. Aug. 18, 2006).

180 *Id.* at *2-4.

181 *Id.* at *4-6.

182 *Id.* at *5-7.

183 *Id.* at *8.

184 *Id.*

185 *Id.* at *9-12.

186 *Id.* at *14-15.

187 *Id.* at *33.

188 906 A.2d 168 (Del. Ch. 2006).

189 *Id.* at 174.

190 *Id.* at 172, 175-86.

191 *Id.* at 180-81.

192 *Id.* at 186.

193 *Id.* at 187-88.

194 *Id.* at 190-91.

195 *Id.* at 191.

196 *Id.* at 198-200.

197 *Id.* at 200-03.

198 *Id.* at 204.

199 *Id.* at 205, 193.

200 *Id.* at 218.

Business Torts Update – Spring 2007

By William M. Katz, Jr., Moses Cage III, and Ramsey Lauren Burke[1]

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This survey examines significant business torts decisions by Texas courts for the period from April 2006 through March 8, 2007. "Business torts" obviously covers a broad spectrum and, in narrowing the survey, we included cases that either decided new issues or examined issues of particular interest to business litigators. During the survey period, Texas courts addressed (1) the timing at which a fiduciary duty must exist in an action for breach; (2) whether attorneys' fees and expenses constitute actual damages in DTPA, breach of contract, breach of fiduciary duty, and fraud claims; (3) whether a partner's actions must rise to the level of a breach of duty for a dissolution claim to succeed; (4) whether a preexisting relationship must be present for a fiduciary duty to exist; and (5) defamation, tortious interference, and attempted monopolization claims between competitors.

Fiduciary Duty Must Exist at the Time of Alleged Breach

In *Willis v. Donnelly*,[2] the Texas Supreme Court reversed the lower court's ruling in a breach of fiduciary duty case involving a majority stockholder and an officer in a closely held corporation because no fiduciary duty existed. The court based its holding on the fact that: (1) no transfer of stock to the purported minority stockholder ever occurred; (2) the purported majority and minority stockholders were experienced businessmen who had never met before the transaction at issue; (3) the contract at issue required issuance of stock by a corporate entity, not the majority stockholder; and (4) the contract postponed the transfer of stock when the alleged breaches of fiduciary duty occurred.

Michael Willis, a Houston entrepreneur, planned to open a high-end spa to provide hair styling and other personal services. Willis created two corporations to carry out the plan; one corporation, Urban Retreat of Houston, Inc (URH), would operate the spa, and the other corporation, Willis/Hite Enterprises, Inc. (WHE), would serve as an umbrella company. Willis hired Richard Hite as a consultant to help develop the business.

Hite contacted hair stylist Dan Donnelly, the co-owner of Hairmasters of Houston, Inc., to discuss the idea for the spa. Thereafter, the parties signed a letter agreement that required Donnelly to transfer Hairmasters to URH and said that Donnelly "will have the responsibility to oversee the management of the day to day operations of the URH facility." The agreement obligated WHE and URH to issue Donnelly 25 percent ownership in URH within 12 months of the URH "Grand Opening," or when URH's gross revenues reached Hairmasters' 1988 annual gross revenues, whichever occurred first.

Although the spa was not profitable, it generated sufficient gross revenues to trigger the provision requiring the issuance of stock to Donnelly. Because the spa was unprofitable, however, Willis asked Donnelly to delay the transfer of stock, and according to Donnelly, he agreed to do so based on assurances from Willis that he would eventually comply with the letter agreement. But Donnelly never received any stock.

Later, a separate dispute arose between Willis and Donnelly. In 1992, Willis loaned Donnelly $18,000, which was secured by a promissory note. After Willis made a second loan to Donnelly, the two loans were consolidated into a single promissory note. The lawsuit started when Willis sued Donnelly for defaulting on the consolidated promissory note.

Donnelly filed a counterclaim and third-party action against Willis, WHE, and URH. The case

proceeded to trial, and the jury ruled in favor of Willis on the promissory note, but in favor of Donnelly on his breach of contract and breach of fiduciary duty claims against Willis. After the court of appeals affirmed the trial court's rulings, the Texas Supreme Court reversed.

The supreme court held that the breach of fiduciary duty claim failed because each of the alleged breaches occurred before Donnelly became a shareholder in URH, and that there can be no breach of duty before a fiduciary relationship arises. The court reasoned that the only conceivable basis for a fiduciary relationship in this case would be a duty owed by a majority shareholder to a minority shareholder. Because Donnelly never became a shareholder of URH or WHE, however, no duty ever arose. In reaching its decision, the court relied heavily on Donnelly's agreement to postpone the issuance of the stock.

Although Donnelly had a contractual right to receive stock, he was discharged before the issuance of stock that would have made him a minority stockholder. Because Willis and Donnelly were both experienced businessmen who had never met before the transaction at issue, were conducting business under a written agreement that expressly required corporate entities (not the majority stockholder) to issue the stock, and agreed to postpone the stock transfer when the alleged breaches occurred, Donnelly's claim failed.

Attorneys' Fees and Expenses Do Not Constitute Actual Damages

In *Haden v. David J. Sacks, P.C.*,[3] the Houston Court of Appeals held that the attorneys' fees and expenses a party incurred to defend a lawsuit, or would have incurred if the party had lost, do not constitute substantive evidence of actual damages to support its counterclaims for DTPA violations, breach of contract, breach of fiduciary duty, and fraud.

Charles Haden, Jr. hired David J. Sacks and his law firm to handle an appellate brief for Haden's company. Haden alleged that, under the parties' engagement letter, all work was to be done by Sacks and there was a maximum fee of $10,000. When the final bill totaled more than $37,000, Haden refused to pay and Sacks filed a lawsuit for breach of contract. Haden counterclaimed for violations of the DTPA, breach of contract, breach of fiduciary duty, and fraud.

The trial court ruled in Sacks's favor of the breach of contract claim for the unpaid invoices and granted summary judgment on Haden's counterclaims. Haden then appealed. The Houston Court of Appeals issued an opinion and judgment on September 7, 2006. The court then granted Haden's motion for rehearing and withdrew its September 7, 2006 opinion.

On rehearing, the court examined the counterclaims, focusing on the alleged damages. The court analyzed whether Haden and the company could substantiate the damages required for them to prevail on the counterclaims by relying on attorneys' fees and expenses incurred to defend the lawsuit, as well as those they risked incurring if the lawsuit failed. The court noted that, under Texas law, a party may recover attorneys' fees only as provided by statute or contract. The court found that attorneys' fees ordinarily are not recoverable as actual damages but rather are incidental to the recovery of actual damages. Thus, the court held that Haden and the company could not rely on assertions of attorneys' fees and expenses as actual damages in attempting to substantiate their claim that they sustained damages required to prevail on their counterclaims for violations of the DTPA, breach of contract, breach of fiduciary duty, and fraud.

Partner's Action Need Not Constitute a Breach of Duty for Dissolution to Apply

In *Dunnagan v. Watson*,[4] the Fort Worth Court of Appeals held that a jury's finding that a limited partner did not breach his fiduciary duties did not conclusively overcome the finding that it was not practicable for the partnership to continue.

James R. Dunnagan and Joseph Earl Watson, two members of a limited partnership, sued each other after several disagreements about the partnership's activities. As the partnership's ventures began to fail, the limited partners started fighting over what to do with the partnership and disagreed about many things, including whether to dissolve or sell the partnership.

Dunnagan sued Watson for breach of fiduciary duty and dissolution in February 2003. The trial court found that Dunnagan did not breach any fiduciary duty owed to the limited partnership, that Watson did breach any fiduciary duty owed to the limited partnership, and that it would be impracticable for the limited partnership to continue.

The appellate court analyzed whether the finding that Dunnagan did not breach his fiduciary duty negated the need to determine whether his actions required dissolution of the partnership. The court found that, in a breach of fiduciary duty case, it was possible for a partner's actions to fall short of breaching a fiduciary duty, but constitute actions sufficient to require dissolution of the partnership.

Preexisting Relationship Must Be Present for Fiduciary Duty to Exist

In *Ramco Oil & Gas Ltd. v. Anglo-Dutch L.L.C.*,[5] the Houston Court of Appeals held that companies contemplating an investment to develop a foreign oil and gas field, and allegedly breaching a confidentiality agreement, did not owe a fiduciary duty to an

investor planning to buy a controlling interest in the field. The lack of any preexisting relationship among the parties outside of a contract doomed the plaintiff's claim.

Scott Van Dyke repeatedly tried without success to realize his "dream and business plan" to purchase stock in a company holding development rights in a potentially lucrative oil and gas field in Kazakhstan. After learning that another company acquired the development rights he was seeking, Van Dyke concluded that the purchaser used information obtained in violation of confidentiality agreements. Van Dyke's companies then filed a lawsuit.

The trial court awarded a $6.4 million judgment to Van Dyke and his companies for lost profits caused by breaches of the various confidentiality agreements. However, the trial court granted the defendants' no evidence summary judgment motion on Van Dyke's claim for misappropriation of trade secrets and breach of fiduciary duty, but did not specify the bases for its ruling. After hearing the case and issuing an opinion, the Houston Court of Appeals withdrew its June 6, 2006 opinion issued and re-heard the appeal.

With respect to the breach of fiduciary duty claim, the Houston court affirmed the trial court's summary judgment ruling. The court held that the companies that considered participating in the oil and gas field with Van Dyke and allegedly breached the confidentiality agreements, owed no fiduciary duty to Van Dyke. Although Van Dyke intended to purchase a controlling interest in the field, and shared that information with certain companies in confidence, there was no preexisting relationship between him and the other investing companies, and thus no fiduciary duty existed.

Defamation, Tortious Interference, and Attempted Monopolization

In *Texas Disposal Systems Landfill, Inc. v. Waste Management Holdings, Inc.*,[6] the Austin Court of Appeals held that defamation claims are not amenable to the relation-back or the continuing tort doctrines. The court also concluded that a party's mere authorization to negotiate and execute a contract did not express sufficient intent to be bound to support a tortuous interference with existing contract claim. The court further declined to expand the scope of a claim for tortious interference with a prospective contract to include a competitor's conduct that merely delayed a contract's execution. Additionally, the court held that a party must provide evidence regarding the relevant market and a competitor's economic power in that market to show a dangerous probability of monopolization as part of an attempted monopolization claim.

Texas Disposal Systems Landfill, Inc. ("Texas Disposal") started negotiating in 1995 with the cities of San Antonio and Austin for waste disposal contracts. San Antonio even passed ordinances authorizing the negotiations. At the end of January 1997, Waste Management, Inc. ("Waste Management") faxed an "Action Alert" memo to leaders in Austin raising questions about the integrity of Texas Disposal's landfill and encouraging them to communicate this information to leaders in San Antonio. Texas Disposal finally signed contracts with both cities, but not until after it filed a defamation suit in October 1997, alleging damages from the delay in securing the contracts.

In 1998 Waste Management sent a series of communications (the "1998 Communications") to various parties in San Antonio and published a press release, all of which continued to discourage them from doing business with Texas Disposal. In July 2000, Texas Disposal amended its petition to include the 1998 Communications as an "ongoing pattern of conduct." Waste Management filed a motion for summary judgment that the district court granted as to the 1998 Communications based on the statute of limitations. The district court also found the Action Alert memo defamatory as a matter of law. The jury concluded that the memo was false and that Waste Management knew it was false or acted with reckless disregard for the truth; however, the jury awarded no damages.

In 2005, the Austin Court of Appeals affirmed the trial court's judgment. In 2006, the Austin court granted Texas Disposal's motion for rehearing and withdrew its opinion and judgment. On rehearing, the court first considered a cross-point raised by Waste Management. Waste Management argued that the take-nothing judgment should be affirmed because there was no clear and convincing evidence of malice which would allow Texas Disposal to prevail on a defamation claim. The court found that evidence that the authors of the Action Alert had significant doubts about the accuracy of its information was clear and convincing evidence of actual malice.

The court next addressed issues raised by Texas Disposal. First, Texas Disposal argued that the trial court's refusal to give a defamation *per se* instruction was error. The Austin court found that the trial court had erred in refusing to instruction the jury regarding defamation *per se* and that the failure to question the jury was harmful to Texas Disposal. The court noted that the court's previous rulings indicated that there were underlying ambiguities surrounding the defamation *per se* claim that could not be decided as a matter of law and needed to go to the jury.

Second, Texas Disposal argued that the jury's zero damages award was against the great weight and preponderance of the evidence. The court found that it was necessary to remand the damages issue to the trial court because Texas Disposal would be entitled to presumed damages if a jury found defamation *per se*. The court also remanded the issues of special and exemplary damages arising from the defamation claim on the basis that without those issues, the "presentation of evidence would be unfairly hindered and piecemeal."

Third, Texas Disposal challenged the trial court's dismissal of several of its claims on summary judgment. Texas Disposal alleged the 1998 Communications were not time barred because either the communications related back to the original petition as a pattern of

continuing wrongful conduct, or they were part of a continuing tort that had not yet occurred. The Austin court found that the 1998 Communications did not relate back to the original petition. Each of the 1998 Communications was "new" because it occurred after the original petition's filing, and each was "distinct and different" because each "was addressed to a different audience about different specific issues and was issued months apart from the other communications." Furthermore, Texas law treats each "publication as a single transaction with an independent injury." The court also declined to extend the continuing tort doctrine to include defamation or tortious interference; rather, it reasoned that the doctrine applied only to an ongoing wrong and a plaintiff who wanted to avoid filing successive suits.

Texas Disposal next argued that the trial court erred in granting summary judgment on Waste Management's defense that the 1998 Communications were privileged. In light of its finding that claims arising from the 1998 Communications were time-barred, the court did not decide whether the communications were privileged.

Texas Disposal also argued that the district court should not have dismissed its tortuous interference claims. Texas Disposal alleged that San Antonio's ordinances created contracts with which Waste Management tortiously interfered. The Austin court refused to recognize the ordinances as more than negotiation authorizations in light of "public policy allowing governmental agencies to reconsider actions taken with respect to a contract not yet finalized." The court concluded that where there is no contract there can be no claim for tortious interference with an existing contract. Moreover, Texas Disposal's claim for tortious interference with a prospective contract was properly dismissed because the company was ultimately awarded the contracts. Because Waste Management did not prevent Texas Disposal's contractual relationships from forming, summary judgment was proper. The court also declined to expand the scope of tortious interference with prospective business relationships to include conduct that results only in a delay of the execution of a contract, because delays caused by a competitor are just part of doing business and public policy encourages competition.

Texas Disposal further argued that the district court erred by dismissing its attempted monopolization claim. Texas Disposal argued that Waste Management lobbied and negotiated with government officials in a way that was harmful to, and defamatory of, Texas Disposal and that advanced Waste Management's business. In affirming the dismissal, the court found that Texas Disposal did not present any evidence that Waste Management's actions created a "dangerous probability of monopoly" because it did not present any evidence concerning the relevant market and Waste Management's ability to lessen competition within that market.

ENDNOTES

1 Mr. Katz is a partner and Mr. Cage and Ms. Burke are associates in the Dallas office of Thompson & Knight LLP.

2 199 S.W.3d 262 (Tex. 2006).

3 ____ S.W.3d ____-, 2007 WL 686998 (Tex.App.-Houston [1st Dist.] March 8, 2007).

4 204 S.W.3d 30 (Tex. App.—Fort Worth 2006, no pet.).

5 207 S.W.3d 801 (Tex. App. - Houston [14th Dist.] 2006).

6 ___ S.W.3d ____, No. 03-03-00631-CV, 2006 WL 3841504 (Tex. App.—Austin, December 29, 2006).

The End of the Arbitration Era

By John H. McFarland[1]

The title of this article would suggest that the End to the Arbitration Era is imminent. Let me hasten to advise that it is not. Far otherwise. The state and federal courts have, if anything, expanded the right to enforce arbitration and declared it virtually unassailable. Instead, this article swims against that current and seeks to restrain the knee-jerk impulse to include an arbitration provision in every business contract, to acquiesce in that inclusion, and to enforce the right if included. In most instances, the costs of arbitration are higher and the risks greater than is commonly thought.

The cost savings from arbitration have not materialized. The proponents of arbitration projected and touted significant cost savings as one of the principal benefits to result from arbitrating rather than litigating disputes. In a streamlined arbitration where the parties agreed – or the arbitrators demanded – that discovery be pared back to the minimum, the client might see some savings. More typically, the arbitration of a matter of any complexity will see the full panoply of discovery tools employed. Even if those litigation costs were somehow minimized or even eliminated, the cost of the arbitrators themselves will quickly eat up any savings otherwise enjoyed by the parties. First is the filing fee; the greater the amount in dispute, the higher the fee. Without addressing the fundamental fairness (or unfairness) aspect of this reality, the fee to file arbitration is a significant cost. But it is the arbitrators' time that really skews the cost analysis. Because one of the supposed benefits sought through arbitration is the expert as fact finder (more on that later), the parties have to pay a premium for the arbitrators' expertise. Highly-regarded arbitrators rightly charge anywhere from $500 to $1,000 per hour for their time; some charge more. If the parties have elected to have their case heard by more than one arbitrator, the effect on cost is obviously geometric.

Does it matter if you are run over by a run-away jury panel or a run-away arbitration panel? The answer is clearly yes. If your client is trampled by a jury, you have the right to seek a new trial or to appeal. If your client is trampled by an arbitration panel, however, I wish you the very best of luck in your future endeavors. Unless you can demonstrate that the panel manifestly disregarded the law or one of the other narrow exceptions that permit the vacating of an arbitration award, your options are extremely limited. Arbitrations awards are intended to be final.

That finality comes at the expense of any meaningful review of whether the result is fair, comports with justice, and is countenanced by existing law. While review of an arbitration award under the Federal Arbitration Act is conducted *de novo*, that review is also "exceedingly deferential."[2] Vacatur of an award is only available on the basis of certain statutory grounds, including "where the arbitrators exceeded their powers,"[3] or under narrow common law exceptions, such as where the award demonstrates "manifest disregard for the law" or is "contrary to public policy."[4]

The Texas Arbitration Act provides for similarly narrow bases for vacating an arbitration award. The Texas Act requires that an award be vacated only where it is shown that the award was obtained by corruption, fraud or undue means, that the rights of a party were prejudiced by evident partiality, corruption, or misconduct on the part of an arbitrator, or that the arbitrators exceeded their powers, refused to postpone the hearing after a showing of sufficient cause for the postponement, refused to hear evidence material to the controversy, or conducted the hearing in a manner that substantially prejudiced the rights of a party.[5] As is the case under the Federal Arbitration Act, simply being wrong on the facts or the law – or both – is not enough.

While the repeat litigant might see a normative effect over a large number of cases, that is small comfort for the episodic litigant, typically the plaintiff. Even the repeat litigant may find that one runaway arbitration award – with no right of appeal – can overcome any number of more reasonable awards.[6] Further, removing these disputes from judicial resolution prevents the common law from providing guidance that might otherwise help parties resolve or avoid future disputes.

You do not know what you do not know about your arbitrator. Arbitration panels are selected through a process that highlights the qualifications of the proposed arbitrators. Some parties will be privileged to have an idea of the reputation of some or several of the proposed arbitrators, some will not. But no party

will be offered the opportunity to conduct a *voir dire* examination of the panelists, as it would with a jury. No party will be able to review written opinions issued by the arbitrator that might provide some insight into how the arbitrator has ruled on an issue in the past, as it might with a judge. This is more troublesome than perhaps it first appears. By choosing to arbitrate its disputes, a party has traded expertise for potential bias. I suggest that this is a poor trade. A potential juror is typically a blank slate on the technical matters involved in your client's dispute but may have biases that can be discovered through *voir dire*. An arbitrator, on the other hand, is supposed to be an expert regarding the technical matters involved in your client's dispute and, as a result of that expertise, has almost assuredly developed biases regarding them. While a trial may successfully focus on educating the fact finder as to the issues upon which the case turns, a trial that depends on overcoming the fact finder's biases is usually a futile effort.

Juries get it mostly right most of the time. Perhaps I am old-fashioned but I really believe that twelve people considering an issue together are collectively wiser than any one person considering an issue alone. While I have never been privy to the caucus of a deliberating jury (except in *Twelve Angry Men*), my experience in trying cases to juries and in polling the jurors afterwards has convinced me that the risk of a runaway jury that will decide the case based on factors other than the facts and the law is overstated. The risk of a sole fact finder fixating on an issue and incorrectly deciding the matter based upon it seems a much greater risk.

Jury waivers are enforceable and make more sense. In any event, the Texas Supreme Court has confirmed (repeatedly now) that clauses waiving a parties' right to a jury are enforceable.[7] For a relatively modest filing fee ($150 in Harris County), you have access to the talented men and women who have sworn an oath to pursue justice and follow the law in civil matters. The bar associations and other organizations have prepared materials that provide insight into how these judges have ruled on matters in the past. The judge's campaign materials and stump speeches provide insight as well. Most lawyers practicing in the area will have met the judge in some context and will be able to provide further insight. By invoking a jury waiver, all that you have forgone is the jury of your client's peers. All of the other procedural protections and trappings that accompany the civil litigation practice, including the right of appeal, are in place. Those protections have evolved over hundreds of years and have been codified by some of the finest legal minds that the State of Texas has had to offer; they ought not be lightly discarded.

Arbitration is and will always be. But you should weigh the true costs and the true risks before recommending that an arbitration provision be included in your client's contracts or in recommending that the provision be enforced in your client's disputes.

ENDNOTES

1 John McFarland is a native Houstonian and a shareholder in the litigation/dispute resolution department of Winstead PC. He has a broad trial practice that focuses on complex business litigation and lender liability suits including products liability and premises liability cases and construction and surety cases.John has tried several cases to both juries and the bench, as well as in arbitration.

2 *Brabham v. A.G. Edwards & Sons, Inc.*, 376 F.3d 377, 380 (5th Cir. 2004).

3 9 U.S.C. § 10(a)(4).

4 *See, e.g., Kergosien v. Ocean Energy, Inc.*, 390 F.3d 346, 353 (5th Cir. 2004); *Trans Chem. Ltd. v. China Nat'l Mach. Import &Export Corp.*, 161 F.3d 314, 319 (5th Cir. 1998) (per curiam).

5 TEX. CIV. PRAC. & REM. CODE § 171.088(a) (Vernon Supp. 1999).

6 *See, e.g., Apache Bohai Corp. LDC v. Texaco* China BV, 2007 WL 587233 (refusing to vacate $71 million award despite exculpatory clause in contract).

7 *See, e.g., In re Prudential Insurance Co. of America*, 148 S.W.3d 124, 129-35 (Tex. 2004).

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