10.2 Solving a Collective Action Problem: Attorneys' Fees and the Incentive to Sue

The fundamental problem in the governance of publicly financed corporations is the collective action problem associated with dispersed share ownership. Where all investors hold small stakes in the enterprise, no single investor has a strong incentive to invest time and money in monitoring management. Nor will derivative or class suits prove to be practical if shareholders have no individual economic incentive to expend the time and money necessary to prosecute them. Of course, if minority shareholders own large fractions of company shares, as is common in closely held companies, the economic benefits of a shareholder suit alone may suffice to induce minority shareholders to litigate. But if the shareholder suit is to be plausible for enforcing fiduciary duties in widely held corporations, the law must construct an incentive system to reward small shareholders for prosecuting meritorious claims. Such a system has evolved out of the court of equity's practice of awarding attorneys' fees to plaintiffs whose litigation created a common fund that benefited others as well as plaintiff herself. Consequently, the large majority of shareholder suits against the directors and officers of public companies are initiated by the plaintiffs' bar. In fact, the attorneys who bring shareholder suits seeking to earn fees from a positive outcome are the real parties in interest in these actions. Plaintiffs' attorneys are paid — or not — by order of the court or as part of a settlement at the conclusion of the litigation. In form, these attorneys are the economic agents of their shareholder-clients. In substance, they are legal entrepreneurs motivated by the prospect of attorneys' fees.

Whether an attorney for the plaintiff in a shareholder action receives a fee at all turns on whether the suit is dismissed or a judgment is entered in the suit, either through litigation (rare) or settlement (common). The plaintiffs' attorney receives nothing when a derivative suit is dismissed because there is no recovery and no benefit. When a derivative suit succeeds on the merits or settles (the usual outcome), the corporation is said to benefit from any monetary recovery or governance change resulting from the litigation. However, the corporation and its insurer also generally bear the bulk of litigation costs on both sides. The company is likely to have advanced the cost of defense to its managers, and it must usually pay the plaintiff a sum for "costs" that ranges, in the case of monetary recoveries, that ranges from a couple of percent (where the financial benefit is very large) to up to as much as 30 percent in some cases. While the formulas used to calculate contingent fees differ by jurisdiction and suit, the percentage of the recovery awarded for legal costs remains surprisingly stable.[3]

3. See Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. Econ. & Org. 55 (1991).

FLETCHER v. A.J. INDUSTRIES, INC.

72 Cal. Rptr. 146, 266 Cal. App. 2d 313 (1968)

RATTIGAN, A.J.:

This appeal is from certain orders entered in a stockholders' derivative action against appellant A.J. Industries, Inc. (hereinafter called the "corporation," or "AJ"). . . . The named defendants included the corporation; respondents Ver Halen and Malone . . . [and other members of A.J.'s board of directors].

The complaint alleged generally that . . . Ver Halen had dominated and controlled the board and the management of the corporation . . . and that, in consequence, the corporation had been damaged in the various transactions. . . . The complaint prayed for several forms of relief on behalf of the corporation, including a money judgment against Ver Halen for $134,150 and one against all the individual defendants in the amount of $1,000,000. . . .

During the course of a protracted hearing . . . a settlement of the action was negotiated. . . .

The "executory provisions" of the stipulation included these agreements: Four incumbent directors were to be replaced by persons acceptable to plaintiffs, to Ver Halen, and to the corporation; failing their agreement, the new directors were to be appointed by the trial court. The corporation agreed to employ a new officer who would be in charge of its "operations," and who would be one of the four new directors. In the election of future directors, Ver Halen's voting powers as a stockholder were to be limited so as to permit him to elect only two of the board's nine members. His employment contract was to be amended to provide that he could be employed as president of the corporation or, at the board's option, as chairman of the board. Malone was to be one of the directors replaced, and he was to resign as the corporation's treasurer.

Several of the specific charges alleged in plaintiffs' complaint related to claimed mismanagement of the corporation due to Ver Halen's "domination" of its affairs; to Malone's allegedly excessive salary; and to Ver Halen's asserted breach of his employment contract. The stipulated agreements summarized above apparently disposed of these matters.

Most of the other charges made in the complaint related to specific transactions in which plaintiffs asserted misconduct on the part of Ver Halen. In other "executory provisions" of the stipulation it was agreed that these would be referred to arbitration. . . .

Whether the corporation was entitled to monetary recovery in any respect was, thus, to be determined in the future. In contrast, the stipulated agreements — providing for the reorganization of the corporation's board of directors and its management, the ouster of Malone, and the amendment of Ver Halen's contract of employment — were to be performed immediately.

The stipulation further provided that the arbitrator could award attorneys' fees, to be paid by the corporation, to any counsel who appeared in the arbitration proceeding, except that plaintiffs' attorneys could be awarded fees only in the event the corporation received a monetary award. The parties acknowledged (1) that plaintiffs' . . . attorneys intended to apply to the trial court — as distinguished from the future arbitrator — for fees and costs to be paid to them by the corporation "in connection with this action," but (2) that the corporation could take "any position in connection with such applications that it may choose." . . .

In its order granting plaintiffs' application for attorneys' fees and costs, the trial court found that they had employed their attorneys to prosecute the derivative action, in good faith, on behalf of themselves and the other stockholders of the corporation, and that the corporation was able to pay the fees and costs incurred. The court also found that by reason of the action, and its settlement, "substantial benefits have been conferred" upon the corporation.[2] Based upon these findings, the court ordered the corporation to pay plaintiffs' attorneys' fees ($64,784) and costs ($2,179.26).

. . . Under the general rule in California and in most American jurisdictions, the party prevailing in an action may not recover attorneys' fees unless a statute expressly permits such recovery. . . .

An exception to the general rule is found, however, in the so-called common-fund doctrine. . . . "It is a well-established doctrine of equity jurisprudence that where a common fund exists to which a number of persons are entitled and in their interest successful litigation is maintained for its preservation and protection, an allowance of counsel fees may properly be made from such fund. By this means *all* of the beneficiaries of the fund pay their share of the expense necessary to make it available to them." . . .

Under the "substantial benefit" rule, a variant of the common-fund doctrine as applied more recently in other jurisdictions, the successful plaintiff in a stockholder's derivative action may be awarded attorneys' fees against the corporation if the latter received "substantial benefits" from the litigation, although the benefits were not "pecuniary" and the action had not produced a fund from which they might be paid. . . .

In the present case, some of the causes of action alleged in plaintiffs' complaint might have produced a "common fund" in the form of a money judgment against appellant corporation. None, however, did: they were referred to an arbitration proceeding which was to be conducted in the future. For the obvious reason that no fund existed, the trial court applied the substantial-benefit rule . . . under which the award of attorneys' fees is charged directly against the corporation. . . .

[W]e conclude, that under the California rule (1) an award of attorneys' fees to a successful plaintiff may properly be measured by, and paid from, a common fund where his derivative action on behalf of a corporation has

2. [I]n the following particulars, to wit:

a) That by reason of the settlement of said action, and without regard to whether plaintiffs or defendants would have been successful in the ultimate outcome thereof, the defendant A.J. Industries, Inc., a corporation, has been saved substantial expenditures for attorneys' fees, costs, and the loss of valuable time of valued employees by reason of the fact that the settlement and compromise obviates the necessity of a trial of this cause on its merits. Probable expenditures by the corporation, aforesaid, have been estimated by witnesses offered by defendants to be in excess of the sum of $200,000.00.

b) That by reason of said settlement the rights of the defendant corporation, if any, to recover from the defendant C.J. Ver Halen monies . . . has been fully protected and reserved in that a fair and equitable arbitration proceeding is provided for as a part of the terms of said settlement. . . .

recovered or protected a fund in fact; but (2) the existence of a fund is not a prerequisite of the award itself....

The stockholder's derivative suit ... is an effective means of policing corporate management. [It] should not be inhibited by a doctrine which limits the compensation of successful attorneys to cases which produce a monetary recovery: the realization of substantial, if nonpecuniary, benefits by the corporation should [also] be the criterion....

The final question ... is whether the benefits realized by the corporation were sufficiently "substantial" to warrant the award. To find that they were, ... [i]t will suffice if the [trial] court finds, upon proper evidence, that the results of the action "maintain the health of the corporation and raise the standards of 'fiduciary relationships and of other economic behavior,' " or "*prevent* an abuse which would be prejudicial to the rights and interests of the corporation or affect the enjoyment or protection of an essential right to the stockholder's interest." [Citation omitted.] ...

It is not significant that the "benefits" found were achieved by settlement of plaintiffs' action rather than by final judgment. The authorities recognizing the substantial-benefit rule have permitted attorneys' fee awards in settled cases.... This is in keeping with the law's general policy favoring settlements ... and in a stockholder's derivative action the trial court is in a position to scrutinize the fairness of a settlement because the court alone can authorize the action's dismissal....

Some of the "benefits" found by the trial court in the present case related to the comparative economy to be realized by proceeding in arbitration rather than in conventional adversary litigation. Other "benefits," though, were realized in the form of immediate changes in the corporate management. The corporation argues that some of these had been under consideration by its board of directors before plaintiffs sued and settled, and that the real value of others is speculative. But the trial court found that the changes were substantial as benefits to the corporation and, in effect, that plaintiffs' action had brought them about. The finding is supported by ample evidence, and it is decisive on the appeal. We therefore affirm the award of attorneys' fees.

CHRISTIAN, J. (dissenting in part).

... The majority opinion refers to certain considerations of policy which appear to indicate that it would be a good thing to allow attorneys' fees against a corporation when one of its shareholders succeeds in a derivative action and substantial benefit to the corporation results.... But countervailing policy arguments are not lacking: for example, if the existence of a "common fund" ... is not prerequisite to the allowance of fees the officers and directors [of the corporation] may well be faced with a liquidation of assets to pay fees, even though resulting harm to the corporation might be disproportionate to the "substantial benefits" derived from the lawsuit. Considerations of this character can better be appraised in the legislative process than by the [courts]. Moreover, it appears likely that the new enlargement of the "common fund" exception to the rule laid down in the statute may greatly outweigh in practical importance the court-created exception on which it is to be grafted. The variety of shareholders' actions in which "substantial benefit" to the corporation may be found is literally boundless....

QUESTIONS ON FLETCHER v. A.J. INDUSTRIES, INC.

1. What was the "substantial benefit" conferred on the corporation by the derivative suit in this litigation?

2. The rationale for shifting from the traditional common fund doctrine to the substantial benefit test for attorneys' fees is obvious. Is there a counterargument as well? What new risk is introduced by the substantial benefit test? How do you imagine courts deal with that risk?

3. Should the avoidance of litigation costs figure among the "benefits" conferred by the settlement of a derivative suit?

NOTE ON AGENCY COSTS IN SHAREHOLDER LITIGATION

The role of lawyer as bounty hunter creates an obvious agency problem in its own right. Legally, the plaintiffs' lawyers are agents of shareholders, just as the corporate defendants are fiduciaries charged with acting for the corporation and, ultimately, for its shareholders. But both sides have important financial interests at stake: fees for the lawyers and potential liability for corporate officers and directors. Much of the law of derivative suits is an effort to deal with the crosscutting agency problems that arise on the side of the plaintiffs' lawyers, on the one hand, and on that of the corporate managers, on the other. One such problem is that plaintiffs' lawyers may initiate so-called strike suits, or suits without merit, simply to extract a settlement by exploiting the nuisance value of litigation and the personal fears of liability—even if unfounded—of officers and directors. A second problem is that the corporate defendants may be too eager to settle because they bear at least some of the costs of litigation personally (e.g., the pain of depositions and the risk of personal liability), but they do not bear the cost of settling, which is borne by the corporation or its insurer. Strike suits have long been a concern of the corporate bar and are widely discussed in the literature.[4] One controversial article has even argued that the merits of litigation are unrelated to settlement amounts in the related context of securities class actions.[5]

Agency problems also arise when shareholder litigation is meritorious and corporate managers face a serious prospect of liability. In this case, plaintiffs' attorneys and corporate defendants—if these defendants remain in control of the corporations—have an incentive to settle on terms that are

4. See, e.g., Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. Econ. & Org. 55 (1991); John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications for Private Enforcement of Law Through Class and Derivative Actions*, 86 Colum. L. Rev. 669 (1986).

5. Janet C. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497 (1991). For criticism of this initial study, see, e.g., Leonard B. Simon & William S. Dato, *Legislating on a False Foundation: The Erroneous Academic Underpinnings of the Private Securities Litigation Reform Act of 1995*, 33 San Diego L. Rev. 959, 964 (1996). For more recent empirical work on this question, compare Marilyn F. Johnson, Karen K. Nelson & A.C. Pritchard, *Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act*, 23 J.L. Econ. & Org. 627 (2007) (finding a "closer relation between factors related to fraud and the filing of securities class actions after the passage of the PSLRA") with Stephen J. Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?*, 23 J.L. Econ. & Org. 598 (2007) (reporting some evidence that meritorious suits were deterred by the PSLRA).

mutually advantageous but that allow the defendants to fully escape personal liability for their conduct.

Finally, the legal system itself can generate agency problems by structuring attorneys' fees in dysfunctional ways. For example, awarding plaintiffs' attorneys a percentage of the recovery may encourage premature settlement. The chief alternative fee rule, the so-called lodestar formula sometimes used in federal securities litigation, pays attorneys a base hourly fee for the reasonable time expended on a case, inflated by a multiplier to compensate for unusual difficulty or risk. By decoupling attorneys' fees from the recovery amount, this rule eliminates the incentives of attorneys to settle too soon, but it creates the opposite incentive to spend too much time litigating relative to the likely settlement outcomes.[6] Finally, as a reaction to the evident weaknesses in both techniques for the awarding of attorneys' fees, some courts have experimented with auctioning the rights to represent the corporation (or the class of shareholders) to the law firm that makes the best bid. But even this technique is vulnerable to "gaming" by plaintiffs' attorneys. The incentives of bidding firms may, for example, lead to low bids that permit a lawyer to control the case in order to negotiate a settlement.[7]

Thus, while paying bounties to plaintiffs' lawyers mitigates the shareholders' collective action problem in widely held corporations, it also gives rise to new risks and challenges for the legal system. Much of what follows in this Chapter — specifically the law of presuit demand and the law of dismissal by independent board committees — can be understood as judicially created measures intended to fine-tune the power and incentives of plaintiffs' lawyers to prosecute shareholder suits.

In addition to these judicial innovations, there have been several statutory responses to the agency problems of fee-driven litigation. Beginning in the 1940s, a number of states adopted "security for expenses" statutes, which permitted corporate defendants to require plaintiffs (or their attorneys) to post a bond to secure coverage of the company's anticipated expenses in the litigation. See, e.g., NYBCL §627; Cal. Corp. Code §800. The purpose of these statutes was to add a stick to the carrot of the attorneys' fees — to engineer a fee rule that would discourage strike suits as well as encourage meritorious litigation. But however attractive this approach seems in theory, it appears to have failed in practice. Savvy plaintiffs' attorneys, reluctant defendants, and sympathetic judges together ensure that plaintiffs are rarely forced to post bonds and are virtually never charged with the litigation costs of corporate defendants.[8]

General dissatisfaction with the growth in the number of securities class actions led to enactment of the federal Private Securities Litigation Reform Act (PSLRA) of 1995.[9] That statute embraces a variety of devices to discourage nonmeritorious suits, such as particularized pleading requirements and changes in substantive law, and to encourage institutional shareholders to assume control of shareholder litigation under the "most adequate plaintiff"

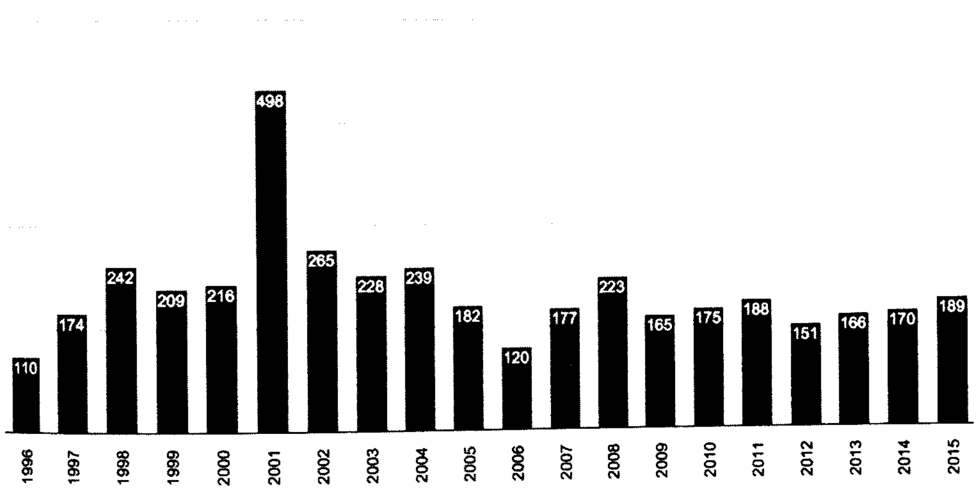
6. See, e.g., John C. Coffee, *The Unfaithful Champion: The Plaintiff as Monitor of Shareholder Litigation*, 48 Law & Contemp. Probs. 5 (1985).

7. See Third Circuit Task Force Report on Selection of Class Counsel, 74 Temple L. Rev. 685 (2001).

8. See Robert Clark, Corporate Law §15.5.

9. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified throughout 15 U.S.C. §§77-78).

FEDERAL SECURITIES CLASS ACTION LITIGATION 1996 - YTD



Source: Stanford Law School Securities Class Action Clearinghouse.

rule considered below. The above chart shows the number of securities class actions filed since 1994, the year before the PSLRA was passed.

As shown, new securities fraud filings decreased after the PSLRA was passed, but only for one year. Filings then returned to their 1994 level of approximately 200 new cases per year, then exploded in 2001 with a wave of "IPO Allocation" lawsuits, alleging that underwriters engaged in undisclosed practices in connection with the distribution of IPO (initial public offering) shares. 2008 was also a busy year for securities class action litigation, driven by massive litigation against financial institutions. This data generally supports the conventional wisdom that the PSLRA provides a minor speed-bump for plaintiffs' lawyers on the way to the courthouse, but that "fundamentals" such as stock market volatility (which increases litigation) are more important drivers of overall litigation activity.[10] As the chart indicates, in recent years filings have roughly held steady while trending down a bit, but — significantly — the total amount of dollars expended in settlements has very recently decreased dramatically. This too may in part be explained by an extended period of low volatility in stock prices prior to mid-2015. Visit the Stanford Securities Class Action Clearinghouse on the internet for a trove of data on this topic.

10.3 Standing Requirements

Standing requirements, which screen who may bring a derivative suit, are established both by statute and by court rule. See, e.g., 10 Del. Code Com. §327; Fed. R. Civ. P. 23.1. They are premised on the assumption that screening for qualified litigants increases the quality of shareholder litigation, that is, that some potential litigants have better incentives to sue than others. (Compare,

10. See, e.g., Cornerstone Research, Securities Class Action Case Filings: 2005.

c. A rule permitting judges to auction standing to bring derivative actions to the highest bidder — with the proceeds of the auction going to the corporation, a finder's fee to the attorney who filed the initial complaint, and any recovery to the winning bidder who prosecutes the suit.[13]

10.4 Balancing the Rights of Boards to Manage the Corporation and Shareholders' Rights to Obtain Judicial Review

An important set of legal doctrines is intended to balance the rights of boards to manage their companies (including deciding which of its potential claims are litigated) against the rights of shareholder-plaintiffs to obtain judicial review of alleged corporate claims. Just when a shareholder-plaintiff should be empowered to take a corporate claim out of the hands of the board, against the will of management, is an issue that can arise in several contexts. First, it arises when a company moves to dismiss a derivative suit on the ground that the shareholder-plaintiff has made a pre-suit demand on the board, as contemplated by Rule 23.1, but the board has refused to bring the suit. Here the court must decide whether or not to defer to the board's business judgment in electing not to prosecute the action. The issue of deference to the board also arises when the shareholder-plaintiff does *not* make demand on the board, on the ground that the board could not exercise disinterested business judgment. Here the court must pass on the validity of the plaintiff's excuse for not making presuit demand. In addition, the question of board deference arises when the board seeks to terminate a derivative suit at a later point in the litigation, after the suit has already survived the company's initial motion to dismiss. That is, even if the company's board was disqualified from dismissing the suit at the time the complaint was filed, it may be that the board has subsequently become capable of exercising its business judgment over the action — usually because new directors have joined the board. In this case, the board should arguably be able to reclaim its power to direct the company's litigation strategy.[14]

13. There is a lively controversy about the policy merits of auctioning shareholder suits. See Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiff's Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. Chi. L. Rev. 1 (1991). Compare Randall S. Thomas & Robert G. Hansen, *Auctioning Class Action and Derivative Lawsuits: A Critical Analysis*, 87 Nw. U. L. Rev. 423 (1993); Jonathan R. Macey & Geoffrey P. Miller, *Auctioning Class Action and Derivative Suits: A Rejoinder*, 87 Nw. U. L. Rev. 458 (1993).

14. While this may sound like the derivative plaintiff is apt to get the runaround, in fact there are some circumstances when this step is clearly appropriate. Imagine, for example, that a hostile takeover follows the initiation of a derivative suit. Even though the old board may have been implicated in the matter sued on, the new board is not and therefore should be given its rights to manage the company's claim in litigation. The matter becomes far less clear when the company's newfound ability to make a valid business judgment comes not from a complete turnover of the board but from the appointment of one or two new directors, who thereafter are appointed to a special committee to review the matter. This is the situation presented in the well-known Delaware case of *Zapata Corp. v. Maldanado*, set forth below.

Finally, the need for courts to balance the rights of management and shareholders in the derivative context arises in connection with settlements of shareholder suits, and especially in the rare case in which a derivative case is settled over the objection of a derivative plaintiff. We discuss settlements in the next section.

10.4.1 The Demand Requirement of Rule 23

The demand requirement originates in the traditional rule that a derivative complaint must "allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority . . . or the grounds for not making the effort." Fed. R. Civ. P. 23.1 (Delaware has the identical rule). But what precisely are the circumstances in which the complaint may be dismissed once the plaintiff does — or does not — make a demand on the board? The answer is a matter of common law.

LEVINE v. SMITH
591 A.2d 194 (Del. 1991)

[Shareholders of General Motors Corporation (GM) brought several derivative actions involving a transaction by which Ross Perot — a director of GM, and as holder of 0.8 percent of its stock, GM's largest shareholder — and a few associates sold back to GM their holdings of GM Class E stock in exchange for $743 million. This repurchase was in response to disagreements between Perot and GM senior management concerning the management of GM's EDS subsidiary and its automobile business as well. By the time of the repurchase, GM was in the awkward position of facing accusations by its director and shareholder, Ross Perot, that it sold "second rate cars." A committee of outside directors negotiated the buy-back transaction for GM, which was subsequently approved by the full board at a meeting that Perot did not attend. Part of the consideration on Perot's side was a covenant not to compete with GM and a promise not to publicly criticize the company. The suit named all directors and Perot as defendants, and claimed that the transaction paid Perot a premium for his shares for no reason other than stopping his criticisms.]

HORSEY, J.:

. . . The directors of a corporation and not its shareholders manage the business and affairs of the corporation . . . and accordingly, the directors are responsible for deciding whether to engage in derivative litigation. . . .

The demand requirements of Rule 23.1 represent a procedural restatement of these bedrock principles. . . . Rule 23.1's alternative requirements of pleading, demand futility or wrongful refusal of demand, are designed to strike a balance between a shareholder's claim of right to assert a derivative claim and a board of directors' duty to decide whether to invest the resources of the corporation in pursuit of the shareholder's claim of corporate wrong. . . . Both the requirements of demand futility and wrongful refusal of demand are predicated upon and "inextricably bound to issues of business judgment and the standards of that doctrine's applicability." *Aronson*, 473 A.2d at 812. Thus, the correct application of the business judgment rule is crucial to a determination of the sufficiency of a derivative complaint to withstand a Rule 23.1 motion in both a demand excused and a demand refused context....

...In determining the sufficiency of a complaint to withstand dismissal under Rule 23.1 based on a claim of demand futility, the controlling legal standard is well established. The trial court is confronted with two related but distinct questions: (1) whether threshold presumptions of director disinterest or independence are rebutted by well-pleaded facts; and, if not, (2) whether the complaint pleads particularized facts sufficient to create a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment....

The premise of a shareholder claim of futility of demand is that a majority of the board of directors either has a financial interest in the challenged transaction or lacks independence or otherwise failed to exercise due care.... On either showing, it may be inferred that the Board is incapable of exercising its power and authority to pursue the derivative claims directly. When lack of inde-

H. ROSS PEROT

Ross Perot will long be remembered for his feisty third-party political campaigns in the 1992 and 1996 U.S. presidential elections. His outspoken career, however, had begun well before he came to political prominence. As a child in Depression-era Texas, Perot honed his entrepreneurial instincts by selling newspapers, garden supplies, and farm animals. He graduated from the U.S. Naval Academy in 1953 and, after four years in the Navy, joined IBM's sales department. Soon the company's top computer sales representative, Perot tried unsuccessfully to convince IBM's management that selling technology servicing contracts, in addition to hardware, was the trend of the future. When IBM wasn't convinced, he resigned in 1962 to form Electronic Data Services (EDS) with $1,000 in capital. In 1968, the company's wildly successful initial public offering made Perot a billionaire.

General Motors purchased EDS for $2.4 billion in 1984, retaining Ross Perot as CEO of the EDS division and giving him a seat on the GM board. Perot soon became disenchanted, but his demand for a change in GM's corporate culture clashed with GM CEO Roger Smith's autocratic management style and explosive temper. Perot took his case to the public, criticizing GM and Smith's management in interviews with prominent business publications. "Revitalizing GM is like teaching an elephant to tap dance," he told *Business Week*. "You find the sensitive parts and start poking."[1] In 1986, Smith orchestrated a $743 million purchase of Perot's ownership, hoping to be rid of his critic. Perot had the last word, however, when at a news conference he implied that the buyout deal he had reluctantly accepted was a waste of stockholder funds.

1. Doron Levin, Irreconcilable Differences: Ross Perot versus General Motors (1989).

pendence is charged, a plaintiff must show that the Board is either dominated by an officer or director who is the proponent of the challenged transaction or that the Board is so under his influence that its discretion is "sterilize[d]."...

Assuming a plaintiff cannot prove that directors are interested or otherwise not capable of exercising independent business judgment, a plaintiff in a demand futility case must plead particularized facts creating a reasonable doubt as to the "soundness" of the challenged transaction sufficient to rebut the presumption that the business judgment rule attaches to the transaction. The point is that in a claim of demand futility, there are two alternative hurdles, either of which a derivative shareholder complainant must overcome to successfully withstand a Rule 23.1 motion.

In addressing plaintiffs' restated claim of demand futility, the Vice Chancellor correctly limited his threshold analysis to the issue of director independence. We decline to revisit plaintiffs' ... allegation that the GM Directors, in approving the Perot buy-out, acted out of motives of entrenchment or financial self-interest. We also decline to reconsider plaintiffs' allegations that the buy-out represented a waste of corporate assets....

Plaintiffs' remaining allegations, offered to sustain a claim of demand futility, are that the GM outside directors lacked independence because they were deceived or misled by management or inside directors concerning the true purpose of the Perot buy-out and the substantial progress that had been made in resolving the ongoing disputes between GM and EDS. Plaintiffs claim that the GM outside directors were so manipulated, misinformed and misled that they were subject to management's control and unable to exercise independent judgment. Plaintiffs assert that their restated complaint pleads with sufficient particularity the manner in which the GM outside directors, though they comprise the majority of the Board, were dominated and controlled by its management directors. As a result, plaintiffs allege that the outside directors' "independence was thereby destroyed and they were effectively dominated by the management directors."[4]

The Court of Chancery found that plaintiffs' restated claim of demand futility failed to plead particularized facts sufficient to create a reasonable

4. The crux of plaintiffs' claim of demand excused is found in the following allegations of the Second Amended Complaint:

> 56. Demand upon the GM Board is excused. The approval by the GM Board of the Perot Buy Out was not approval by an independent or disinterested Board. . . . The outside directors knew or should have known that Smith [GM's CEO — Eds.] and his fellow management directors had a direct personal and financial interest in seeing that Perot's objections were silenced because, if voiced and if convincing, Perot's objections could result in the loss of hundreds of thousands of dollars to the management directors.
>
> 57. The management directors' personal financial interest in maintaining their high salaries, bonuses and perquisites caused them to conceal material information from many of the outside directors, including members of the Oversight Committee, concerning the pivotal fact that the prior disputes between Perot and EDS over auditing, pricing and compensation were already substantially resolved. The outside directors had good reason to question and investigate the expressed justification for the Buy Out. Had they done so, they could have discovered that material facts were being concealed from them. Instead, members of the Oversight Committee and members of the full Board allowed themselves to be misinformed and uninformed. . . .

doubt as to the independence of a majority of the GM Board. The court found that plaintiffs' claims based on newly discovered evidence implicated, at most, only two of GM's fourteen outside directors, thereby leaving at least twelve of the twenty-one directors (excluding Perot) independent and "capable of impartially considering a demand." The court also found any alleged deception concerning the placement of blame for the GM/EDS disputes immaterial to the fundamental decision of severing the GM-Perot relationship. Hence, the court found plaintiffs' Second Amended Complaint to have inadequately pleaded a claim of futility of demand. . . .

We affirm the Vice Chancellor's findings. . . . Plaintiffs' conclusory allegations that the outside directors' independence was compromised by the inside directors' misleading, manipulative and deceptive conduct are unsupported by particularized facts. Such allegations of improper conduct by management are also inadequate to establish Board domination or control of GM's outside directors sufficient to find the latter lacking in "independence," in the customary definition of the term. See *Aronson*, 473 A.2d at 815-816. . . . Plaintiffs' allegations detailed in paragraphs 56 and 57 of their restated complaint more appropriately relate to the issue of director due care and the business judgment rule's application to the challenged transaction. Indeed, plaintiffs plead virtually the same averments for both purposes.

The question then becomes whether the restated Grobow complaint otherwise pleads particularized facts sufficient to rebut the presumption that the Perot buy-back was the product of a valid exercise of business judgment. . . .

Plaintiffs allege that GM's "outside" directors acted with such haste and were so misled by management as to reach an uninformed decision in approving the Perot buy-out. In [a previous decision], we carefully addressed plaintiffs' original allegations of the GM Board's lack of procedural due care. *Grobow I*, 539 A.2d at 190-191. We reviewed the role of the GM "Special Review Committee," and we especially noted the absence of any allegations "that the GM directors, and in particular its outside directors, were dominated or controlled by GM's management. . . ." *Id.* at 191. In their restated complaint, plaintiffs delete reference to GM's Special Review Committee and the exclusive role played by GM's outside directors in reviewing the challenged transaction. Instead, plaintiffs now contend that a majority of GM's outside directors were uninformed because: (a) they were allegedly misled concerning the gravity of the disputes between senior management and Perot, and (b) the deposition testimony of two of GM's fourteen outside directors, Evans and Wyman (suggesting that they had misimpressions concerning the buy-out), is sufficient to defeat the presumption otherwise attached to an approval of a transaction by a board consisting of a majority of independent and disinterested directors.

. . . We have previously found wanting plaintiffs' allegations that GM's outside directors lacked independence because they were manipulated, misinformed or misled by management. . . . [T]hese findings with respect to director independence have equal application to the issue of director due care. In summary, we agree with the Court of Chancery that plaintiffs' restated complaint fails to plead particularized facts sufficient to raise a reasonable doubt that a majority of the GM Board acted in so uninformed a manner as to fail to exercise due care. . . .

NOTE AND QUESTIONS ON ABA AND ALI PROPOSALS FOR REFORM

Both the American Bar Association and the American Law Institute have proposed wholesale — and in some respects similar — revisions of the common law screening doctrines developed by the Delaware courts. Read over RMBCA §§7.42-7.44, and compare these provisions to ALI, Principles of Corporate Governance §§7.03, 7.08, and 7.10.

1. How would you contrast the common approach of the ALI and the RMBCA to the demand requirement with that of the Delaware courts? Which approach do you prefer?

2. How do the approaches of the ALI and the RMBCA differ? Which places more faith in the corporate board?

3. Will either reform proposal significantly improve shareholder litigation incentives?

10.4.2 Special Litigation Committees

In contrast to the demand requirement, which is embedded in Rule 23.1 of the Federal Rules of Civil Procedure, there is no basis in positive law for a procedure under which a court, upon the motion of a special committee of disinterested directors, may dismiss a derivative suit that is already under way. Nevertheless, many state courts adopted such a special litigation procedure under the pressure of growing numbers of shareholder suits in the 1970s and 1980s.[17] The special litigation committee is now a standard feature of derivative suit doctrine even though it is not triggered in every case (unlike the demand requirement). Different jurisdictions treated the question differently. The chief divide is between those jurisdictions that follow Delaware's lead in the 1981 case of *Zapata Corp. v. Maldonado*, reviewed below, in giving a role to the court itself to judge the appropriateness of a special litigation committee's decision to dismiss a derivative suit and those jurisdictions, such as New York, that apply a rule that, if the committee is independent and informed, its action is entitled to business judgment deference without any further judicial second-guessing. See *Auerbach v. Bennett*, 393 N.E.2d 994 (N.Y. 1979).

ZAPATA CORP. v. MALDONADO
430 A.2d 779 (Del. 1981)

QUILLEN, J.:

In June, 1975, William Maldonado, a stockholder of Zapata, instituted a derivative action in the Court of Chancery on behalf of Zapata against ten officers and/or directors of Zapata, alleging, essentially, breaches of fiduciary duty. Maldonado did not first demand that the board bring this action, stating instead such demand's futility because all directors were named as defendants and allegedly participated in the acts specified. . . .

17. See Robert Charles Clark, Corporate Law, at 645-649.

By June, 1979, four of the defendant-directors were no longer on the board, and the remaining directors appointed two new outside directors to the board. The board then created an "Independent Investigation Committee" (Committee), composed solely of the two new directors, to investigate Maldonado's actions, as well as a similar derivative action then pending in Texas, and to determine whether the corporation should continue any or all of the litigation. The Committee's determination was stated to be "final, . . . not . . . subject to review by the Board of Directors and . . . in all respects . . . binding upon the Corporation."

Following an investigation, the Committee concluded, in September, 1979, that each action should "be dismissed forthwith as their continued maintenance is inimical to the Company's best interests. . . ."* Consequently, Zapata moved for dismissal or summary judgment. . . .

[W]e turn first to the Court of Chancery's conclusions concerning the right of a plaintiff stockholder in a derivative action. We find that its determination that a stockholder, once demand is made and refused, possesses an independent, individual right to continue a derivative suit for breaches of fiduciary duty over objection by the corporation, . . . is erroneous. . . . *McKee v. Rogers*, Del. Ch., 156 A. 191 (1931), stated "as a general rule" that "a stockholder cannot be permitted . . . to invade the discretionary field committed to the judgment of the directors and sue in the corporation's behalf when the managing body refuses. This rule is a well settled one." 156 A. at 193.

The *McKee* rule, of course, should not be read so broadly that the board's refusal will be determinative in every instance. Board members, owing a well-established fiduciary duty to the corporation, will not be allowed to cause a derivative suit to be dismissed when it would be a breach of their fiduciary duty. Generally disputes pertaining to control of the suit arise in two contexts.

Consistent with the purpose of requiring a demand, a board decision to cause a derivative suit to be dismissed as detrimental to the company, after demand has been made and refused, will be respected unless it was wrongful.[10] . . . A claim of a wrongful decision not to sue is thus the first exception and the first context of dispute. Absent a wrongful refusal, the stockholder in such a situation simply lacks legal managerial power. . . .

* As reasons for dismissal, the Committee stated: "(1) the asserted claims appeared to be without merit; (2) costs of litigation, exacerbated by likelihood of indemnification; (3) wasted senior management time and talents on pursuing litigation; (4) damage to company from publicity; (5) that no material injury appeared to have been done to company; (6) impairment of current director-defendants' ability to manage; (7) the slight possibility of recurrence of violations; (8) lack of personal benefit to current director-defendants from alleged conduct; (9) that certain alleged practices were continuing business practices, intended to be in company's best interests; (10) legal question whether the complaints stated a cause of action; (11) fear of undermining employee morale; (12) adverse effects on the company's relations with employees and suppliers and customers." *Maldonado v. Flynn*, 485 F. Supp. 274, 284 n.35 (S.D.N.Y. 1980). — EDS.

10. In other words, when stockholders, after making demand and having their suit rejected, attack the board's decision as improper, the board's decision falls under the "business judgment" rule and will be respected if the requirements of the rule are met. . . . That situation should be distinguished from the instant case, where demand was not made, and the *power* of the board to seek a dismissal, due to disqualification, presents a threshold issue. . . . We recognize that the two contexts can overlap in practice.

But it cannot be implied that, absent a wrongful board refusal, a stockholder can never have an individual right to initiate an action. For, as is stated in *McKee*, a "well settled" exception exists to the general rule. "[A] stockholder may sue in equity in his derivative right to assert a cause of action in behalf of the corporation, *without prior demand* upon the directors to sue, when it is apparent that a demand would be futile, that the officers are under an influence that sterilizes discretion and could not be proper persons to conduct the litigation." . . . A demand, when required and refused (if not wrongful), terminates a stockholder's legal ability to initiate a derivative action. But where demand is properly excused, the stockholder does possess the ability to initiate the action on his corporation's behalf.

These conclusions, however, do not determine the question before us. Rather, they merely bring us to the question to be decided . . . : When, if at all, should an authorized board committee be permitted to cause litigation, properly initiated by a derivative stockholder in his own right, to be dismissed? As noted above, a board has the power to choose not to pursue litigation when demand is made upon it, so long as the decision is not wrongful. If the board determines that a suit would be detrimental to the company, the board's determination prevails. Even when demand is excusable, circumstances may arise when continuation of the litigation would not be in the corporation's best interests. Our inquiry is whether, under such circumstances, there is a permissible procedure under §141(a) by which a corporation can rid itself of detrimental litigation. If there is not, a single stockholder in an extreme case might control the destiny of the entire corporation. . . .

Section 141(c) allows a board to delegate all of its authority to a committee. Accordingly, a committee with properly delegated authority would have the power to move for dismissal or summary judgment if the entire board did.

Even though demand was not made in this case and the initial decision of whether to litigate was not placed before the board, Zapata's board, it seems to us, retained all of its corporate power concerning litigation decisions. If Maldonado had made demand on the board in this case, it could have refused to bring suit. Maldonado could then have asserted that the decision not to sue was wrongful and, if correct, would have been allowed to maintain the suit. The board, however, never would have lost its statutory managerial authority. The demand requirement itself evidences that the managerial power is retained by the board. When a derivative plaintiff is allowed to bring suit after a wrongful refusal, the board's authority to choose whether to pursue the litigation is not challenged although its conclusion reached through the exercise of that authority is not respected since it is wrongful. Similarly, Rule 23.1, by excusing demand in certain instances, does not strip the board of its corporate power. It merely saves the plaintiff the expense and delay of making a futile demand resulting in a probable tainted exercise of that authority in a refusal by the board or in giving control of litigation to the opposing side. But the board entity remains empowered under §141(a) to make decisions regarding corporate litigation. The problem is one of member disqualification, not the absence of power in the board.

The corporate power inquiry then focuses on whether the board, tainted by the self-interest of a majority of its members, can legally delegate its authority to a committee of two disinterested directors. We find our statute clearly requires an affirmative answer to this question. As has been noted, under an express provision of the statute, §141(c), a committee can exercise all of the authority of the board to the extent provided in the resolution of the board. . . .

We do not think that the interest taint of the board majority is per se a legal bar to the delegation of the board's power to an independent committee composed of disinterested board members. The committee can properly act for the corporation to move to dismiss derivative litigation that is believed to be detrimental to the corporation's best interest.

Our focus now switches to the Court of Chancery which is faced with a stockholder assertion that a derivative suit, properly instituted, should continue for the benefit of the corporation and a corporate assertion, properly made by a board committee acting with board authority, that the same derivative suit should be dismissed as inimical to the best interests of the corporation.

At the risk of stating the obvious, the problem is relatively simple. If, on the one hand, corporations can consistently wrest bona fide derivative actions away from well-meaning derivative plaintiffs through the use of the committee mechanism, the derivative suit will lose much, if not all, of its generally-recognized effectiveness as an intra-corporate means of policing boards of directors. . . . If, on the other hand, corporations are unable to rid themselves of meritless or harmful litigation and strike suits, the derivative action, created to benefit the corporation, will produce the opposite, unintended result. . . . It thus appears desirable to us to find a balancing point where bona fide stockholder power to bring corporate causes of action cannot be unfairly trampled on by the board of directors, but the corporation can rid itself of detrimental litigation.

[T]he question has been treated by other courts as one of the "business judgment" of the board committee. If a "committee, composed of independent and disinterested directors, conducted a proper review of the matters before it, considered a variety of factors and reached, in good faith, a business judgment that [the] action was not in the best interest of [the corporation]," the action must be dismissed. . . . The issues become solely independence, good faith, and reasonable investigation. The ultimate conclusion of the committee, under that view, is not subject to judicial review.[11] . . .

We are not satisfied, however, that acceptance of the "business judgment" rationale at this stage of derivative litigation is a proper balancing point. While we admit an analogy with a normal case respecting board judgment, it seems to us that there is sufficient risk in the realities of a situation like the one presented in this case to justify caution beyond adherence to the theory of business judgment.

The context here is a suit against directors where demand on the board is excused. We think some tribute must be paid to the fact that the lawsuit was properly initiated. It is not a board refusal case. Moreover, this complaint

11. The leading case is *Auerbach v. Bennett*, . . . 393 N.E.2d 994 . . . (1979).

was filed in June of 1975 and, while the parties undoubtedly would take differing views on the degree of litigation activity, we have to be concerned about the creation of an "Independent Investigation Committee" four years later, after the election of two new outside directors. Situations could develop where such motions could be filed after years of vigorous litigation for reasons unconnected with the merits of the lawsuit.

Moreover, notwithstanding our conviction that Delaware law entrusts the corporate power to a properly authorized committee, we must be mindful that directors are passing judgment on fellow directors in the same corporation and fellow directors, in this instance, who designated them to serve both as directors and committee members. The question naturally arises whether a "there but for the grace of God go I" empathy might not play a role. And the further question arises whether inquiry as to independence, good faith and reasonable investigation is sufficient safeguard against abuse, perhaps subconscious abuse.

. . . There is some analogy to a settlement in that there is a request to terminate litigation without a judicial determination of the merits. . . . "In determining whether or not to approve a proposed settlement of a derivative stockholders' action [when directors are on both sides of the transaction], the Court of Chancery is called upon to exercise its own business judgment." *Neponsit Investment Co. v. Abramson*, Del. Supr., 405 A.2d 97, 100 (1979) and cases therein cited. In this case, the litigating stockholder plaintiff facing dismissal of a lawsuit properly commenced ought, in our judgment, to have sufficient status for strict Court review. . . .

Whether the Court of Chancery will be persuaded by the exercise of a committee power resulting in a summary motion for dismissal of a derivative action, where a demand has not been initially made, should rest, in our judgment, in the independent discretion of the Court of Chancery. We thus steer a middle course between those cases which yield to the independent business judgment of a board committee and this case as determined below which would yield to unbridled plaintiff stockholder control. In pursuit of the course, we recognize that "[t]he final substantive judgment whether a particular lawsuit should be maintained requires a balance of many factors ethical, commercial, promotional, public relations, employee relations, fiscal as well as legal." *Maldonado v. Flynn*, supra, 485 F. Supp. at 285. But we are content that such factors are not "beyond the judicial reach" of the Court of Chancery which regularly and competently deals with fiduciary relationships, disposition of trust property, approval of settlements and scores of similar problems. We recognize the danger of judicial overreaching but the alternatives seem to us to be outweighed by the fresh view of a judicial outsider. Moreover, if we failed to balance all the interests involved, we would in the name of practicality and judicial economy foreclose a judicial decision on the merits. At this point, we are not convinced that is necessary or desirable.

After an objective and thorough investigation of a derivative suit, an independent committee may cause its corporation to file a pretrial motion to dismiss in the Court of Chancery. The basis of the motion is the best interests of the corporation, as determined by the committee. The motion should include a thorough written record of the investigation and its findings and recommendations. Under appropriate Court supervision, akin to proceedings on summary judgment, each side should have an opportunity to make a record on the motion. As to the limited issues presented by the motion noted below, the moving party should be prepared to meet the normal burden under Rule 56 that there is no genuine issue as to any material fact and that the moving party is entitled to dismiss as a matter of law. The Court should apply a two-step test to the motion.

First, the Court should inquire into the independence and good faith of the committee and the bases supporting its conclusions. Limited discovery may be ordered to facilitate such inquiries. The corporation should have the burden of proving independence, good faith and a reasonable investigation, rather than presuming independence, good faith and reasonableness.[17] If the Court determines either that the committee is not independent or has not shown reasonable bases for its conclusions, or, if the Court is not satisfied for other reasons relating to the process, including but not limited to the good faith of the committee, the Court shall deny the corporation's motion. If, however, the Court is satisfied under . . . [summary judgment] standards that the committee was independent and showed reasonable bases for good faith findings and recommendations, the Court may proceed, in its discretion, to the next step.

The second step provides, we believe, the essential key in striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation's best interests as expressed by an independent investigating committee. The Court should determine, applying its own independent business judgment, whether the motion should be granted.[18] This means, of course, that instances could arise where a committee can establish its independence and sound bases for its good faith decisions and still have the corporation's motion denied. The second step is intended to thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation's interest. The Court of Chancery of course must carefully consider and weigh how compelling the corporate interest in dismissal is when faced with a non-frivolous lawsuit. The Court of Chancery should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation's best interests.

If the Court's independent business judgment is satisfied, the Court may proceed to grant the motion, subject, of course, to any equitable terms or conditions the Court finds necessary or desirable.

. . . [Reversed and remanded.]

17. Compare *Auerbach v. Bennett*, 393 N.E.2d 994 (1979). Our approach here is analogous to and consistent with the Delaware approach to "interested director" transactions, where the directors, once the transaction is attacked, have the burden of establishing its "intrinsic fairness" to a court's careful scrutiny. . . .

18. This step shares some of the same spirit and philosophy of the statement by the Vice Chancellor: "Under our system of law, courts and not litigants should decide the merits of litigation." 413 A.2d at 1263.

NOTES AND QUESTIONS ON ZAPATA v. MALDONADO

1. If, as *Zapata* holds, a court may second-guess the board's evaluation of a derivative action when demand is excused, why shouldn't a court be able to do the same in cases in which demand was required but the board rejected suit? Academic commentary has generally criticized the "demand required/demand excused" distinction,[18] arguing that courts should be able to exercise their own judgment in both classes of cases. As one might expect, corporate counsel have criticized this distinction in the name of *Auerbach v. Bennett* and have urged that the board's business judgment should prevail in both classes of cases.

2. What elements should be included in an appraisal of the corporation's "best interests" in the second step of the *Zapata* test? In particular, what "matters of law and public policy"— if any — should a court consider in addition to the corporation's economic best interests? Would a court's decision to weigh matters other than the company's economic interests be consistent with viewing the derivative suit as an asset "belonging to" the corporation? (One former Delaware Chancery Court judge was heard to confide about the second level of *Zapata* inquiry, "I have no business judgment. If I had I wouldn't be a judge.")

3. In the later case of *Kaplan v. Wyatt*, 499 A.2d 1184 (Del. 1988), the Delaware Supreme Court held that whether to proceed to the second step of the *Zapata* test, and how much discovery to accord derivative plaintiffs, lies entirely within the discretion of the Delaware Chancery Court.

In re Oracle Corp. Derivative Litigation demonstrates the highly individualized inquiry that the Delaware Chancery Court may pursue in probing the independence of a Special Litigation Committee that requests the dismissal of a shareholder derivative action.

IN RE ORACLE CORP. DERIVATIVE LITIGATION

824 A.2d 917 (Del. Ch. 2003)

Strine, V.C.:

In this opinion, I address the motion of the special litigation committee ("SLC") of Oracle Corporation to terminate this action, "the Delaware Derivative Action," and other such actions pending in the name of Oracle against certain Oracle directors and officers. These actions allege that these Oracle directors engaged in insider trading while in possession of material, non-public information showing that Oracle would not meet the earnings guidance it gave to the market for the third quarter of Oracle's fiscal year 2001. The SLC bears the burden of persuasion on this motion and must convince me that

18. E.g., Reporters Notes to ALI, Principles of Corporate Governance §7.03 (1994).

there is no material issue of fact calling into doubt its independence. This requirement is set forth in *Zapata Corp. v. Maldonado* and its progeny. . . .

The question of independence "turns on whether a director is, *for any substantial reason,* incapable of making a decision with only the best interests of the corporation in mind." . . . That is, the independence test ultimately "focus[es] on impartiality and objectivity." . . . In this case, the SLC has failed to demonstrate that no material factual question exists regarding its independence. . . .

Ellison is Oracle's Chairman, Chief Executive Officer, and its largest stockholder, owning nearly twenty-five percent of Oracle's voting shares. By virtue of his ownership position, Ellison is one of the wealthiest men in America. By virtue of his managerial position, Ellison has regular access to a great deal of information about how Oracle is performing on a week-to-week basis.

Henley is Oracle's Chief Financial Officer, Executive Vice President, and a director of the corporation. Like Ellison, Henley has his finger on the pulse of Oracle's performance constantly.

Lucas is a director who chairs Oracle's Executive Committee and its Finance and Audit Committee. . . .

Boskin is a director, Chairman of the Compensation Committee, and a member of the Finance and Audit Committee. As with Lucas, Boskin's access to information was limited mostly to historical financials and did not include the week-to-week internal projections and revenue results that Ellison and Henley received. . . .

The plaintiffs make two central claims in their amended complaint in the Delaware Derivative Action. First, the plaintiffs allege that the Trading Defendants [Ellison, Henley, Lucas, and Boskin] breached their duty of loyalty by misappropriating inside information and using it as the basis for trading decisions. This claim rests its legal basis on the venerable case of *Brophy v. Cities Service Co.* Its factual foundation is that the Trading Defendants were aware (or at least possessed information that should have made them aware) that the company would miss its December guidance by a wide margin and used that information to their advantage in selling at artificially inflated prices.

Second, as to the other defendants — who are the members of the Oracle board who did not trade — the plaintiffs allege a *Caremark* violation, in the sense that the board's indifference to the deviation between the company's December guidance and reality was so extreme as to constitute subjective bad faith. . . .

On February 1, 2002, Oracle formed the SLC in order to investigate the Delaware Derivative Action and to determine whether Oracle should press the claims raised by the plaintiffs, settle the case, or terminate it. Soon after its formation, the SLC's charge was broadened to give it the same mandate as to all the pending derivative actions, wherever they were filed.

The SLC was granted full authority to decide these matters without the need for approval by the other members of the Oracle board. . . .

Two Oracle board members were named to the SLC. Both of them joined the Oracle board on October 15, 2001, more than a half a year after Oracle's 3Q FY 2001 closed. The SLC members also share something else: both are tenured professors at Stanford University.

Professor Hector Garcia-Molina is Chairman of the Computer Science Department at Stanford and holds the Leonard Bosack and Sandra Lerner Professorship in the Computer Science and Electrical Engineering Departments at Stanford. . . .

The other SLC member, Professor Joseph Grundfest, is the W.A. Franke Professor of Law and Business at Stanford University. He directs the University's well-known Directors' College[8] and the Roberts Program in Law, Business, and Corporate Governance at the Stanford Law School. Grundfest is also the principal investigator for the Law School's Securities Litigation Clearinghouse. Immediately before coming to Stanford, Grundfest served for five years as a Commissioner of the Securities and Exchange Commission. Like Garcia-Molina, Grundfest's appointment at Stanford was a homecoming, because he obtained his law degree and performed significant post-graduate work in economics at Stanford. . . .

For their services, the SLC members were paid $250 an hour, a rate below that which they could command for other activities, such as consulting or expert witness testimony. Nonetheless, during the course of their work, the SLC members became concerned that (arguably scandal-driven) developments in the evolving area of corporate governance as well as the decision in *Telxon v. Meyerson*, . . . might render the amount of their compensation so high as to be an argument against their independence. Therefore, Garcia-Molina and Grundfest agreed to give up any SLC-related compensation if their compensation was deemed by this court to impair their impartiality.

The SLC members were recruited to the board primarily by defendant Lucas, with help from defendant Boskin. . . . The wooing of them began in the summer of 2001. Before deciding to join the Oracle board, Grundfest, in particular, did a good deal of due diligence. His review included reading publicly available information, among other things, the then-current complaint in the Federal Class Action.

The SLC's investigation was, by any objective measure, extensive. The SLC reviewed an enormous amount of paper and electronic records. SLC counsel interviewed seventy witnesses, some of them twice. SLC members participated in several key interviews, including the interviews of the Trading Defendants. . . .

During the course of the investigation, the SLC met with its counsel thirty-five times for a total of eighty hours. In addition to that, the SLC members, particularly Professor Grundfest, devoted many more hours to the investigation.

In the end, the SLC produced an extremely lengthy Report totaling 1,110 pages (excluding appendices and exhibits) that concluded that Oracle should not pursue the plaintiffs' claims against the Trading Defendants or any of the other Oracle directors serving during the 3Q FY 2001. . . . I endeavor a rough attempt to capture the essence of the Report in understandable terms, . . .

. . . [T]he SLC concluded that even a hypothetical Oracle executive who possessed all information regarding the company's performance in December and January of 3Q FY 2001 would not have possessed material, non-public

8. In the interests of full disclosure, I spoke at the Directors' College in spring 2002.

information that the company would fail to meet the earnings and revenue guidance it provided the market in December. Although there were hints of potential weakness in Oracle's revenue growth, especially starting in mid-January 2001, there was no reliable information indicating that the company would fall short of the mark, and certainly not to the extent that it eventually did.

Consistent with its Report, the SLC moved to terminate this litigation. The plaintiffs were granted discovery focusing on three primary topics: the independence of the SLC, the good faith of its investigative efforts, and the reasonableness of the bases for its conclusion that the lawsuit should be terminated. Additionally, the plaintiffs received a large volume of documents comprising the materials that the SLC relied upon in preparing its Report.

III. THE APPLICABLE PROCEDURAL STANDARD

In order to prevail on its motion to terminate the Delaware Derivative Action, the SLC must persuade me that: (1) its members were independent; (2) that they acted in good faith; and (3) that they had reasonable bases for their recommendations. If the SLC meets that burden, I am free to grant its motion or may, in my discretion, undertake my own examination of whether Oracle should terminate and permit the suit to proceed if I, in my oxymoronic judicial "business judgment," conclude that procession is in the best interests of the company. This two-step analysis comes, of course, from *Zapata*. . . .

. . . I begin with certain features of the record — as I read it — that are favorable to the SLC. Initially, I am satisfied that neither of the SLC members is compromised by a fear that support for the procession of this suit would endanger his ability to make a nice living. Both of the SLC members are distinguished in their fields and highly respected. Both have tenure, which could not have been stripped from them for making a determination that this lawsuit should proceed.

Nor have the plaintiffs developed evidence that either Grundfest or Garcia-Molina have fundraising responsibilities at Stanford. . . .

Defendant Michael J. Boskin is the T.M. Friedman Professor of Economics at Stanford University. During the Administration of President George H.W. Bush, Boskin occupied the coveted and important position of Chairman of the President's Council of Economic Advisors. He returned to Stanford after this government service, continuing a teaching career there that had begun many years earlier.

During the 1970s, Boskin taught Grundfest when Grundfest was a Ph.D. candidate. Although Boskin was not Grundfest's advisor and although they do not socialize, the two have remained in contact over the years, speaking occasionally about matters of public policy. . . .

As noted in the SLC Report, the SLC members admitted knowing that Lucas was a contributor to Stanford. They also acknowledged that he had donated \$50,000 to Stanford Law School in appreciation for Grundfest having given a speech at his request. About half of the proceeds were allocated for use by Grundfest in his research.

But Lucas's ties with Stanford are far, far richer than the SLC Report lets on. To begin, Lucas is a Stanford alumnus, having obtained both his undergraduate and graduate degrees there. By any measure, he has been a very loyal alumnus.

In showing that this is so, I start with a matter of some jousting between the SLC and the plaintiffs. Lucas's brother, Richard, died of cancer and by way of his will established a foundation. Lucas became Chairman of the Foundation and serves as a director along with his son, a couple of other family members, and some non-family members. A principal object of the Foundation's beneficence has been Stanford. The Richard M. Lucas Foundation has given $11.7 million to Stanford since its 1981 founding. Among its notable contributions, the Foundation funded the establishment of the Richard M. Lucas Center for Magnetic Resonance Spectroscopy and Imaging at Stanford's Medical School. Donald Lucas was a founding member and lead director of the Center.

The SLC Report did not mention the Richard M. Lucas Foundation or its grants to Stanford. In its briefs on this motion, the SLC has pointed out that Donald Lucas is one of nine directors at the Foundation and does not serve on its Grant Review Committee. Nonetheless, the SLC does not deny that Lucas is Chairman of the board of the Foundation and that the board approves all grants.

Lucas's connections with Stanford as a contributor go beyond the Foundation, however. From his own personal funds, Lucas has contributed $4.1 million to Stanford, a substantial percentage of which has been donated within the last half-decade. . . . From these undisputed facts, it is inarguable that Lucas is a very important alumnus of Stanford and a generous contributor to [the school]. . . .

With these facts in mind, it remains to enrich the factual stew further, by considering defendant Ellison's ties to Stanford. There can be little doubt that Ellison is a major figure in the community in which Stanford is located. The so-called Silicon Valley has generated many success stories, among the greatest of which is that of Oracle and its leader, Ellison. One of the wealthiest men in America, Ellison is a major figure in the nation's increasingly important information technology industry. Given his wealth, Ellison is also in a position to make — and, in fact, he has made — major charitable contributions.

Some of the largest of these contributions have been made through the Ellison Medical Foundation, which makes grants to universities and laboratories to support biomedical research relating to aging and infectious diseases. Ellison is the sole director of the Foundation. Although he does not serve on the Foundation's Scientific Advisory Board that sifts through grant applications, he has reserved the right — as the Foundation's sole director — to veto any grants, a power he has not yet used but which he felt it important to retain. The Scientific Advisory Board is comprised of distinguished physicians and scientists from many institutions, but not including Stanford.

Although it is not represented on the Scientific Advisory Board, Stanford has nonetheless been the beneficiary of grants from the Ellison Medical Foundation — to the tune of nearly $10 million in paid or pledged funds. Although the Executive Director of the Foundation asserts by way of an affidavit that the grants are awarded to specific researchers and may be taken to another institution if the researcher leaves, . . . the grants are conveyed under contracts between the Foundation and Stanford itself and purport by their terms to give Stanford the right (subject to Foundation approval) to select a substitute principal investigator if the original one becomes unavailable. . . .

During the time Ellison has been CEO of Oracle, the company itself has also made over $300,000 in donations to Stanford. Not only that, when Oracle established a generously endowed educational foundation — the Oracle Help Us Help Foundation — to help further the deployment of educational technology in schools serving disadvantaged populations, it named Stanford as the "appointing authority," which gave Stanford the right to name four of the Foundation's seven directors. . . . Stanford's acceptance reflects the obvious synergistic benefits that might flow to, for example, its School of Education from the University's involvement in such a foundation, as well as the possibility that its help with the Foundation might redound to the University's benefit when it came time for Oracle to consider making further donations to institutions of higher learning.

Taken together, these facts suggest that Ellison (when considered as an individual and as the key executive and major stockholder of Oracle) had, at the very least, been involved in several endeavors of value to Stanford. . . .

Having framed the competing views of the parties, it is now time to decide.

I begin with an important reminder: the SLC bears the burden of proving its independence. It must convince me.

. . . Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement. *Homo sapiens* is not merely *homo economicus.* We may be thankful that an array of other motivations exist that influence human behavior; not all are any better than greed or avarice, think of envy, to name just one. But also think of motives like love, friendship, and collegiality, think of those among us who direct their behavior as best they can on a guiding creed or set of moral values. . . .

Nor should our law ignore the social nature of humans. To be direct, corporate directors are generally the sort of people deeply enmeshed in social institutions. Such institutions have norms, expectations that, explicitly and implicitly, influence and channel the behavior of those who participate in their operation. . . . Some things are "just not done," or only at a cost, which might not be so severe as a loss of position, but may involve a loss of standing in the institution. In being appropriately sensitive to this factor, our law also cannot assume — absent some proof of the point — that corporate directors are, as a general matter, persons of unusual social bravery, who operate heedless to the inhibitions that social norms generate for ordinary folk.

In examining whether the SLC has met its burden to demonstrate that there is no material dispute of fact regarding its independence, the court must bear in mind the function of special litigation committees under our jurisprudence. . . .

Special litigation committees are permitted as a last chance for a corporation to control a derivative claim in circumstances when a majority of its directors cannot impartially consider a demand. By vesting the power of the board to determine what to do with the suit in a committee of independent directors, a corporation may retain control over whether the suit will proceed, so long as the committee meets the standard set forth in *Zapata.*

In evaluating the independence of a special litigation committee, this court must take into account the extraordinary importance and difficulty of such a committee's responsibility. It is, I daresay, easier to say no to a friend, relative, colleague, or boss who seeks assent for an act (*e.g.*, a transaction) that has not yet occurred than it would be to cause a corporation to sue that person....

The difficulty of making this decision is compounded in the special litigation committee context because the weight of making the moral judgment necessarily falls on less than the full board. A small number of directors feels the moral gravity — and social pressures — of this duty alone....

I conclude that the SLC has not met its burden to show the absence of a material factual question about its independence. I find this to be the case because the ties among the SLC, the Trading Defendants, and Stanford are so substantial that they cause reasonable doubt about the SLC's ability to impartially consider whether the Trading Defendants should face suit.... In so concluding, I necessarily draw on a general sense of human nature. It may be that Grundfest is a very special person who is capable of putting these kinds of things totally aside. But the SLC has not provided evidence that that is the case. In this respect, it is critical to note that I do not infer that Grundfest would be less likely to recommend suit against Boskin than someone without these ties. Human nature being what it is, it is entirely possible that Grundfest would in fact be tougher on Boskin than he would on someone with whom he did not have such connections. The inference I draw is subtly, but importantly, different. What I infer is that a person in Grundfest's position would find it difficult to assess Boskin's conduct without pondering his own association with Boskin and their mutual affiliations. Although these connections might produce bias in either a tougher or laxer direction, the key inference is that these connections would be on the mind of a person in Grundfest's position, putting him in the position of either causing serious legal action to be brought against a person with whom he shares several connections (an awkward thing) or not doing so (and risking being seen as having engaged in favoritism toward his old professor ...).

The same concerns also exist as to Lucas.... [F]or both Grundfest and Garcia-Molina, service on the SLC demanded that they consider whether an extremely generous and influential Stanford alumnus should be sued by Oracle for insider trading. Although they were not responsible for fundraising, as sophisticated professors they undoubtedly are aware of how important large contributors are to Stanford, and they share in the benefits that come from serving at a university with a rich endowment. A reasonable professor giving any thought to the matter would obviously consider the effect his decision might have on the University's relationship with Lucas, it being (one hopes) sensible to infer that a professor of reasonable collegiality and loyalty cares about the well-being of the institution he serves....

In view of the ties involving Boskin and Lucas alone, I would conclude that the SLC has failed to meet its burden on the independence question. The tantalizing facts about Ellison merely reinforce this conclusion. The SLC, of course, argues that Ellison is not a large benefactor of Stanford personally, that Stanford has demonstrated its independence of him by rejecting his child for admission, and that, in any event, the SLC was ignorant of any negotiations between Ellison and Stanford about a large contribution. For these reasons, the SLC says, its ability to act independently of Ellison is clear.

I find differently. The notion that anyone in Palo Alto can accuse Ellison of insider trading without harboring some fear of social awkwardness seems a stretch. That being said, I do not mean to imply that the mere fact that Ellison is worth tens of billions of dollars and is the key force behind a very important social institution in Silicon Valley disqualifies all persons who live there from being independent of him. Rather, it is merely an acknowledgement of the simple fact that accusing such a significant person in that community of such serious wrongdoing is no small thing.

Before closing, it is necessary to address two concerns. The first is the undeniable awkwardness of opinions like this one. By finding that there exists too much doubt about the SLC's independence for the SLC to meet its *Zapata* burden, I make no finding about the subjective good faith of the SLC members, both of whom are distinguished academics at one of this nation's most prestigious institutions of higher learning.... Nothing in this record leads me to conclude that either of the SLC members acted out of any conscious desire to favor the Trading Defendants or to do anything other than discharge their duties with fidelity. But that is not the purpose of the independence inquiry.

That inquiry recognizes that persons of integrity and reputation can be compromised in their ability to act without bias when they must make a decision adverse to others with whom they share material affiliations. To conclude that the Oracle SLC was not independent is not a conclusion that the two accomplished professors who comprise it are not persons of good faith and moral probity, it is solely to conclude that they were not situated to act with the required degree of impartiality. *Zapata* requires independence to ensure that stockholders do not have to rely upon special litigation committee members who must put aside personal considerations that are ordinarily influential in daily behavior in making the already difficult decision to accuse fellow directors of serious wrongdoing.

The SLC's motion to terminate is DENIED. IT IS SO ORDERED.

NOTES & QUESTIONS ON IN RE ORACLE

1. Vice Chancellor (now Chief Justice) Strine's rational for declining to follow or implement the special committee's findings and recommendations is arguably superior to the rational offered by Justice Quillen in *Maldanato*. It provides a basis — independence of judgment — to assess the recommendation upon which judges have some expertise, while the *Maldanato* basis — judicial business judgment — has no precedent in the cases as such and thus offers no standard for judicial decision. As a result, it would be very awkward for a court to apply with confidence. It has rarely, if ever, actually been used by Delaware courts.

2. In the *Oracle* case, plaintiffs subsequently dropped their claims against defendants Lucas and Boskin. In November 2004, the court granted summary judgment for defendants Ellison and Henley[19] — thereby reaching precisely the same conclusion on the merits of the plaintiffs' case that Grundfest and Garcia-Molinas had reached more than a year earlier.

3. Consider the problem that a board now faces in the aftermath of *In re Oracle*. *Zapata* makes clear that the power to appoint an SLC comes from DGCL §141(c), which means that the SLC must consist entirely of directors. But wouldn't the independence of any current director be questioned considering the "'thickness' of the social and institutional connections" between themselves and the defendant directors? And if so, would a board be forced to add new directors whenever it wished to establish an SLC? How would you advise a board that wanted to establish an SLC without expanding, but also staying within the constraints imposed by *In re Oracle*?

4. In *Beam v. Martha Stewart*, plaintiffs claimed that demand was futile against the board of Martha Stewart Living Omnimedia (MSO) for claims arising from Stewart's trading in ImClone stock, because a majority of the MSO board was not independent of Martha Stewart. Chancellor Chandler, applying the test for demand futility articulated in *Rales v. Blasband*, held that demand was not excused, even though there were "relationships," "friendships," and "inter-connections" between Martha Stewart and the other MSO board members reminiscent of *In re Oracle*.[20] The Delaware Supreme Court affirmed, and, noting the apparent tension between *Beam* and *Oracle*, drew a distinction between the SLC context and the demand excused context: "Unlike the demand-excusal context, where the board is presumed to be independent, the SLC has the burden of establishing its own independence by a yardstick that must be 'like Caesar's wife' — 'above reproach.'"[21] As a policy matter, do you find this distinction justifiable?

HOW DOES THE COURT EXERCISE ITS BUSINESS JUDGMENT?

What does it mean to exercise business judgment about whether litigation should go forward? Is litigation "like" an investment in a factory? And does the business judgment of a court resemble the business judgment of a corporate manager, or may the court weigh matters of public interest as well as the private interest of the firm? Consider the following excerpt from a well-known case.

JOY v. NORTH
692 F.2d 880 (2d Cir. 1982)

[In a diversity case, the court predicted that Connecticut would adopt the *Zapata* approach to derivative suits and, exercising its business judgment, rejected a special litigation committee's motion to dismiss.]

19. *In re Oracle Corp. Derivative Litigation*, C.A. No. 18751 (Nov. 24, 2004).
20. *Beam v. Martha Stewart*, 833 A.2d 961, 984 (Del. Ch. 2003).
21. *Beam v. Martha Stewart*, 845 A.2d 1040, 1055 (Del. 2004).