RECENT KEY DELAWARE CORPORATE AND COMMERCIAL DECISIONS

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INTRODUCTION

This is a review of key opinions from the Delaware Court of Chancery and Delaware Supreme Court on corporate and commercial issues decided during 2009 and in the first two months of 2010. There were more than 250 such decisions and from these we selected a number of the more noteworthy cases that would be of the most wide-ranging interest.

Also included are recent seminal Delaware decisions on important e-discovery principles. All of the decisions have been highlighted and are available with links to the full text at www.delawarelitigation.com. Also of note is a discussion of a new procedure effective as of February 1, 2010 in the Delaware Court of Chancery that allows for confidential arbitration of major commercial disputes where the amount in controversy for claims seeking solely monetary damages must be more than $1 million. The rules provide for a final hearing within 90 days of the complaint being filed and appeals of those decisions are made directly to the Delaware Supreme Court.

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I.
MONITORING SUBPRIME RISKS AND EXECUTIVE COMPENSATION

In Re Citigroup Inc. Shareholder Derivative Litigation,[1] involved derivative claims brought by shareholders of Citigroup ("Citigroup" or the "Company") against current and former directors alleging: (i) breach of fiduciary duties for failing to properly monitor and manage the risks that Citigroup faced concerning problems in the subprime lending market; and (ii) failure to properly disclose the Company's exposure with respect to its subprime assets. The plaintiffs also alleged that certain defendants were liable to Citigroup for corporate waste in approving a November 2007 letter agreement concerning a payment and benefits package for Citigroup's former CEO. The Court of Chancery dismissed all but one of the plaintiffs' claims based on a failure to adequately plead demand futility; the plaintiffs' waste claim survived the motion to dismiss.

Plaintiffs claimed that there were extensive "red flags" starting in May 2005 that should have put defendants on notice about problems "that were brewing in the real estate and credit markets."[2] Defendants allegedly ignored the warnings and sacrificed the long term viability of Citigroup for short term profits. The plaintiffs also claimed that the director defendants and certain other defendants were liable for: (i) allowing Citigroup to purchase $2.7 billion in subprime loans in 2007; (ii) authorizing and not suspending the Company's share repurchase program in 2007 which allegedly resulted in the Company buying its own shares at "artificially inflated" prices; (iii) approving a multi-million dollar payment and benefit package in November 2007 for Citigroup's CEO; and (iv) allowing the Company to invest in "structured investment vehicles" ("SIVs") that were unable to pay off maturing debt.[3]

In analyzing the plaintiffs' theory of director liability for failure with respect to the duty to monitor, the Court reviewed the decisions of *In re Caremark Int'l Inc. Derivative Litigation* and *Graham v. Allis-Chalmers Manufacturing Company*.[4] With regard

1. 964 A.2d 106, 114-15 (Del. Ch. Feb. 24, 2009).
2. *Id.* at 111.
3. *Id.* at 111-12.
4. *Id.* at 121 (citing In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996); Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. 1963)).

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to director liability standards, the *Caremark* Court distinguished between (1) "*a board decision* that results in a loss because that decision was ill advised or 'negligent'" and (2) "an *unconsidered failure of the board to act* in circumstances in which due attention would, arguably, have prevented the loss."[5] In the first instance, the director's actions are measured against the business judgment rule. In the second instance, "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition for liability."[6]

The Court then turned to *Stone v. Ritter* where the Delaware Supreme Court approved the *Caremark* standard of director oversight liability, making it clear that liability was based on the concept of good faith which was embedded in the duty of loyalty and did not constitute a freestanding fiduciary duty.[7] Thus, the Court reasoned, "to establish oversight liability a plaintiff must show that the directors *knew* they were not discharging their fiduciary obligations or that the directors demonstrated a *conscious* disregard for their responsibilities such as by failing to act in the face of a known duty to act."[8] Moreover, in order for the plaintiffs to succeed, "a showing of bad faith is a *necessary condition* to director oversight liability."[9]

In *Citigroup*, the Court characterized the plaintiffs' claims as "a bit of a twist on the traditional *Caremark* claim" because they alleged that the defendants failed to monitor Citigroup's "business risk," specifically with respect to its exposure to the subprime mortgage market.[10] The plaintiffs also argued that the board should have been especially conscious of the warning signals because a majority of the directors served on the Citigroup board during the Enron crisis and were members of the Audit and Risk Management ("ARM") Committee and therefore considered "financial experts."[11] The Court, however, disagreed with plaintiffs, stating that "[a]lthough these claims are framed by plaintiffs as *Caremark* claims, plaintiffs'

5. *Id.* at 122 (citing *Caremark*, 698 A.2d at 967).
6. *Id.* at 122 (citing *Caremark*, 698 A.2d at 971).
7. *Id.* at 122 (citing Stone v. Ritter, 911 A.2d 362 (Del. 2006)).
8. *Id.* at 123.
9. *Id.*
10. *Id.*
11. *Id.* at 124.

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theory essentially amounts to a claim that the director defendants should be personally liable to the Company because they failed to fully recognize the risk posed by subprime securities. When one looks past the lofty allegations of duties of oversight and red flags used to dress up these claims, what is left appears to be plaintiff shareholders attempting to hold the director defendants personally liable for making (or allowing to be made) business decisions that, in hindsight, turned out poorly for the Company."[12]

The Court went on to note that the doctrines of the fiduciary duty of care and the business judgment rule have been developed to address those situations. As a result, the burden was on the plaintiffs not only to show gross negligence but to rebut the presumption that the directors acted in an informed basis, in good faith and in the honest belief that the action was taken in the best interests of the company. In addition, Citigroup had adopted a provision in its certificate of incorporation pursuant to Section 102(b)(7) of the Delaware General Corporation Law ("DGCL") that exculpates directors from personal liability for violations of breaches of fiduciary duty, except for, among other things, breaches of the duty of loyalty or actions or omissions not in good faith or that involve intentional misconduct or knowing violation of law.[13] In this action, while the plaintiffs had not alleged that the directors were interested in the transaction, they did allege that the directors acted in bad faith.

The Court concluded that "[a] plaintiff can thus plead bad faith by alleging with particularity that a director *knowingly* violated a fiduciary duty or failed to act in violation of a *known* duty to act, demonstrating a *conscious* disregard for her duties."[14] Did the director consciously disregard an obligation to be reasonably informed about the business and the risks or consciously disregard the duty to monitor and oversee the business? "The presumption of the business judgment rule, the protection of an exculpatory § 102(b)(7) provision, and the difficulty of proving a *Caremark* claim together function to place an extremely high burden on a plaintiff to state a claim

12. *Id.*

13. *See* DEL. CODE ANN. tit. 8, § 102(b)(7).

14. 964 A.2d at 125.

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for personal director liability for failure to see the extent of a company's business risk."[15]

A. *Court Found That Controls Were in Place*

In light of the "extremely high burden" placed on plaintiffs, the Court concluded that plaintiffs' conclusory allegations were insufficient to state a *Caremark* claim, thus not excusing demand. To the contrary, Citigroup had procedures and controls in place that were designed to monitor risk and the plaintiffs did not contest these standards. Citigroup also had an ARM Committee to assist the board in fulfilling its oversight responsibility regarding risk assessment and risk management. And even if there were warning signs, they "are not evidence that the directors consciously disregarded their duties or otherwise acted in bad faith," but may only be evidence that the directors made bad business decisions.[16] The Court stated:

That there were signs in the market that reflected worsening conditions and suggested that conditions may deteriorate even further is not an invitation for this Court to disregard the presumptions of the business judgment rule and conclude that the directors are liable because they did not properly evaluate business risk.[17]

The Court also found that the plaintiffs had failed in their attempt to show how the existence of the Enron scandal somehow put the Citigroup directors on "heightened alert" to problems years later with the subprime mortgage market. Moreover, the Court found that "the use of SIVs in the Enron related conduct would not serve to put the director defendants on any type of heightened notice to the unrelated use of SIVs in structuring transactions involving subprime securities."[18]

B. *Prior "Failure to Monitor" Case Distinguished*

The Court also distinguished another recent Court of Chancery decision—*American International Group, Inc. Consoli-*

15. *Id.*
16. *Id.* at 128.
17. *Id.* at 130.
18. *Id.* at 129.

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dated Derivative Litigation—that did allow a *Caremark* "failure to monitor" claim to survive a motion to dismiss (under a more plaintiff-friendly Rule 12(b)(6) standard).[19] The *AIG* case was distinguishable in part because the defendant directors in the *AIG* case "allegedly failed to exercise reasonable oversight over pervasive *fraudulent* and *criminal* conduct. Indeed, the Court in *AIG* even stated that the complaint there supported the assertion that top AIG officials were leading a 'criminal organization' and that '[t]he diversity, pervasiveness, and materiality of the alleged financial wrongdoing at AIG is extraordinary.'"[20] The claims against the Citigroup directors, however, involved allegedly failing to recognize the extent of a company's business risk—as opposed to allegedly failing to oversee employee fraudulent or criminal conduct. *Caremark*-type duties were not designed to impose oversight liability for business risk. As the Court noted, "[o]versight duties under Delaware law are not designed to subject directors, even expert directors, to *personal liability* for failure to predict the future and to properly evaluate business risk."[21]

Finally, the Court observed that the plaintiffs were asking it to engage in the exact kind of judicial second guessing that the business judgment rule proscribes. Especially in a case with staggering losses, it would be tempting to examine why the decision was wrong, but the presumption of the business judgment rule against an objective review of business decisions

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19. *See* Am. Int'l Group, Inc. Consol. Derivative Litig., 965 A.2d 763 (Del. Ch. 2009) (the "*AIG* case" or "*AIG*").

20. *Citigroup*, 964 A.2d at 130 (citing *AIG*, 965 A.2d at 799).

21. 964 A.2d at 131. The reasoning for the foregoing statement of Delaware law was explained by means of a query by the Court in footnote 78 of the opinion that deserves quoting verbatim:

> Query: if the Court were to adopt plaintiffs' theory of the case—that the defendants are personally liable for their failure to see the problems in the subprime mortgage market and Citigroup's exposure to them—then could not a plaintiff succeed on a theory that a director was personally liable for failure to predict the extent of the subprime mortgage crisis and profit from it, even if the company was not exposed to losses from the subprime mortgage market? If directors are going to be held liable for losses for failing to accurately predict market events, then why not hold them liable for failing to profit by predicting market events that, in hindsight, the director should have seen because of certain red (or green?) flags? If one expects director prescience in one direction, why not the other? *Id.* at 131 n.78.

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by judges is no less applicable when losses to the company are large.

C. *Disclosure Claims*

Plaintiffs argued demand futility with respect to their allegations regarding disclosure claims based on the "substantial likelihood of liability" standard which would, they argued, prevent the defendant directors from exercising independent and disinterested business judgment in reviewing a demand. Because of the Section 102(b)(7) provision in Citigroup's charter, plaintiffs would need to show that such disclosure violations were the result of bad faith, knowing or intentional acts. After reviewing these claims, the Court found them wanting in the particularity required by Rule 23.1. For example, plaintiffs failed to demonstrate that the directors knew that there were misstatements or omissions in the financial statements, or that they acted in bad faith by not informing themselves adequately.[22]

Importantly, the Court explained why the allegations against the ARM committee were insufficiently detailed for claims involving allegedly faulty financial statements to survive: "Under our law, to establish liability for misstatements when the board is not seeking shareholder action, shareholder plaintiffs must show that the misstatement was made knowingly or in bad faith."[23] In addition, the Court noted that even so-called financial experts on the audit committee were entitled to rely in good faith on reports and statements and opinions, pursuant to DGCL Section 141(e), from the corporation's officers and employees who were responsible for preparing the company's financial statements.

D. *Claim for Waste Regarding Executive Compensation and Demand Futility*

Plaintiffs argued that demand was futile for their waste claims under *Aronson v. Lewis*,[24] because the "challenged transaction was other than the product of a valid exercise of

22. *See* the Court's opinion at footnotes 83 to 87 and 92 to 93 for supporting cases relating to disclosure obligations and detail needed in disclosure violation claims. *Id.* at 131 nn.83-87, 92-93.

23. *Id.* at 135.

24. 473 A.2d 805 (Del. 1984).

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business judgment" which is a high threshold. In addition to the difficulty of satisfying the requirements of *Aronson*, a claim of waste under Delaware law is extremely hard to establish. Namely, one must plead particularized facts that lead to the inference that the directors approved an "exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration."[25]

The high hurdle plaintiffs had to clear was that they were attacking a compensation decision. However, the Court noted that there is "an outer limit" to the discretion of the board in setting compensation, "at which point a decision of the directors on executive compensation is so disproportionately large as to be unconscionable and constitute waste."[26] If waste is found, it is a non-exculpated violation, as the Delaware Supreme Court has held that waste constitutes bad faith. According to the complaint, a letter agreement provided that Charles Prince, former CEO of Citigroup who retired in November 2007, would receive $68 million upon his departure from the Company, including bonus, salary, and accumulated stockholdings, among other things. In exchange, Mr. Prince would sign a non-compete agreement, a non-disparagement agreement, a non-solicitation agreement, and a release of claims against the Company. Plaintiffs argued that this was "'so one sided'... because, in part, the Company paid the multi-million dollar compensation package to a departing CEO whose failures as CEO were allegedly responsible, in part, for billions of dollars of losses at Citigroup."[27]

The Court determined that, without additional information and accepting plaintiffs' allegations as true, "there is a reasonable doubt as to whether the letter agreement meets the admittedly stringent 'so one sided' standard or whether the letter agreement awarded compensation that is beyond the 'outer limit' described by the Delaware Supreme Court.[28] Accordingly, the Court found that the complaint had adequately alleged that demand was excused with regard to the waste claim.

25. 964 A.2d at 136 (citation omitted).
26. *Id.* at 138.
27. *Id.*
28. *Id.*

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II.
SUPREME COURT ADDRESSES *REVLON* AND *CAREMARK* ISSUES

In *Lyondell Chemical Co. v. Ryan*, the Delaware Supreme Court, in a unanimous *en banc* decision on an interlocutory appeal, reversed the Court of Chancery's decision denying summary judgment for the directors of Lyondell Chemical Company ("Lyondell") as to Revlon and "deal protection" claims and whether the directors of Lyondell acted in good faith in conducting the $13 billion sale of Lyondell.[29]

The class action complaint alleged that the Lyondell directors breached their fiduciary duties of care, loyalty and candor and put their personal interests ahead of the interests of the Lyondell shareholders. In particular, "the complaint alleged that: 1) the merger price was grossly insufficient; 2) the directors were motivated [by] self-interest; 3) the process by which the merger was negotiated was flawed; 4) the directors agreed to unreasonable deal protection provisions and; 5) the preliminary proxy statement omitted numerous material facts."[30] The facts, however, indicated that the merger price represented a substantial premium over the market price and the merger was approved not only by a disinterested board but also by more than 99% of the voted shares. Lyondell's charter contained an exculpatory provision pursuant to DGCL § 102(b)(7), protecting the directors from personal liability for breaches of the duty of care. Thus, the case turned on whether there were any shortcomings on the part of the directors to implicate their duty of loyalty (a breach of which cannot be exculpated). Because the Court of Chancery had found that the board was independent and was not motivated by self-interest or ill will, its analysis was focused on whether the directors were entitled to summary judgment on the claim that they breached their duty of loyalty by failing to act in good faith.

A. *Focuses on Process and Deal Protection Provisions*

The Court of Chancery rejected all of the plaintiffs' claims except those directed at the process by which the directors

29. *See* Ryan v. Lyondell Chem. Co., No. 3176-VCN, 2008 WL 2923427 (Del. Ch. July 29, 2008), *rev'd*, 970 A.2d 235 (Del. 2009).

30. 970 A.2d at 239.

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sold the company and the deal protection provisions in the merger agreement. In particular, the Court denied defendants' motion for summary judgment on the claim that under *Revlon v. MacAndrews & Forbes Holdings, Inc.*,[31] the directors failed to obtain the best available price in selling the company. The Court of Chancery decided that "unexplained inaction" by the Lyondell directors for two months permitted a reasonable inference that the directors may have consciously disregarded their fiduciary duties.[32] The Supreme Court disagreed, finding that there was no evidence from which to infer that the directors knowingly ignored their responsibilities, thereby breaching their duty of loyalty.[33]

The Supreme Court examined the concepts of "bad faith" and "failure to act in good faith" as well as the range of conduct that might be classified as such in light of existing Delaware case law.[34] While the Court of Chancery had denied summary judgment in order to obtain a more complete record before deciding whether the directors had acted in bad faith, the Supreme Court determined that the trial court "reviewed the existing record under a mistaken view of the applicable law."[35] The Supreme Court went on to note that: (i) the Court of Chancery imposed *Revlon* duties on the directors before they either decided to sell, or before the sale had become inevitable; (ii) the Court of Chancery read *Revlon* and its progeny as creating a set of requirements that must be satisfied during the sale process; and (iii) the Court of Chancery "equated an arguably imperfect attempt to carry out *Revlon* duties with a knowing disregard of one's duties that constitutes bad faith."[36]

B. *When Do* Revlon *Duties Arise?*

In analyzing *Revlon* and its progeny, the Court of Chancery determined that the directors must actively engage in the sale process, and confirm that they have obtained the best available price either by conducting an auction, a market

31. 506 A.2d 173, 182 (Del. 1986).
32. *See* 970 A.2d at 243.
33. *Id.*
34. *See* In re Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006); Stone v. Ritter, 911 A.2d 362 (Del. 2006); In re Caremark Int'l Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).
35. 970 A.2d at 241.
36. *Id.*

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check or demonstrating "an impeccable knowledge of the market."[37] The Court of Chancery concluded that because the *Revlon* sale process must follow one of the courses of conduct identified above and that the Lyondell directors had not followed any of the standards that the Court of Chancery extracted from *Revlon* and its progeny, the directors were unable to meet their burden under *Revlon*. The Supreme Court disagreed, noting that *Revlon* duties arise not because a company is "in play" (such as in this case where there was a Schedule 13D filing) but rather when the company "embarks on a transaction—on its own initiative or in response to an unsolicited offer—that will result in a change of control."[38] In this case, that was when the Lyondell directors began negotiating the sale of Lyondell. The Supreme Court further noted that "there are no legally prescribed steps that directors must follow to satisfy their *Revlon* duties" and that the Lyondell directors failure to take any specific steps during the sale process could not have demonstrated a "conscious disregard of their duties."[39]

The Supreme Court concluded that "[i]nstead of questioning whether disinterested, independent directors did everything that they (arguably) should have done to obtain the best sale price, the inquiry should have been whether those directors utterly failed to attempt to obtain the best sale price."[40] Finding that the record clearly established that the Lyondell directors did not breach their duty of loyalty by failing to act in good faith, the Supreme Court reversed the decision of the Court of Chancery and remanded the matter for entry of judgment in favor of the Lyondell directors.

III.
SUPREME COURT CLARIFIES FIDUCIARY DUTIES OF CORPORATE OFFICERS

In *Gantler v. Stephens*,[41] the Delaware Supreme Court for the first time confirmed and clarified that officers of Delaware corporations have the same fiduciary duties as directors of Del-

37. *Id.* at 243.
38. *Id.* at 242.
39. *Id.* at 243.
40. *Id.* at 244.
41. 965 A.2d 695 (Del. 2009).

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aware corporations. In addition, the Delaware Supreme Court clarified and enunciated Delaware common law on the issue of "shareholder ratification."

The Supreme Court determined that the breach of fiduciary duty claims in this case should be allowed to proceed, and explained why the board should not enjoy the presumption of the business judgment rule at this stage of the proceedings, based on the pled facts (contrary to the Court of Chancery's dismissal of the case). The plaintiffs in this action, who were certain shareholders of First Niles Financial, Inc. ("First Niles" or the "Company"), appealed the dismissal of their complaint which alleged that the defendants, who were officers and directors of First Niles, violated their fiduciary duties: (i) "by rejecting a valuable opportunity to sell the Company, deciding instead to reclassify the Company's shares in order to benefit themselves; and [(ii)] by disseminating a materially misleading proxy statement to induce shareholder approval."[42] The Supreme Court concluded that the complaint pled sufficient facts to overcome the business judgment presumption, and to state substantive fiduciary duty and disclosure claims.[43]

The board of First Niles had decided to sell the company, but then it did not take seriously three offers that it received. Instead, the board appeared to favor a privatization or a reclassification plan. The three basic claims in the complaint were: (i) that the board members breached their fiduciary duties to the First Niles shareholders by rejecting an offer from a potential buyer and abandoning the sale of the company; (ii) the defendant directors breached their fiduciary duty of disclosure by disseminating a materially false and misleading proxy regarding the reclassification; and (iii) the board breached its fiduciary duty by implementing the reclassification plan.

The Court of Chancery dismissed the amended complaint, ruling that it failed to allege facts that were sufficient to overcome the presumption of the business judgment rule and for failing to establish that the proxy was materially false and misleading, as well as based on the argument that the shareholders "ratified" the decision of the board to reclassify the shares. Although Count I of the complaint alleged that the directors breached their duties of loyalty and care by aban-

42. *Id.* at 699.
43. *Id.* at 699.

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doning the sale of the bank in order to retain the benefits of incumbency, the Court of Chancery concluded that the *Unocal* standard did *not* apply because the complaint did not allege any "defensive" action by the board. The Court of Chancery also determined that the entire fairness review was not applicable because the board did not interpose itself between the shareholders and a potential acquirer by means of defensive measures, and thus the trial court applied the business judgment standard and concluded that the allegations in the complaint failed to rebut the presumption of business judgment.

The Supreme Court upheld the Court of Chancery's refusal to apply the *Unocal* standard because the essence of the transaction at issue was not defensive and the initial count in the complaint was based on disloyalty as opposed to defensive conduct. Nor did Count I allege any hostile takeover attempt or similar threatened external action from which it could be inferred that the defendants acted defensively, despite the allegation that they improperly delayed or sabotaged the due diligence process.

A. *The Business Judgment Rule*

The Supreme Court also addressed whether the Court of Chancery appropriately found that the plaintiff did not satisfy the burden of pleading facts sufficient to rebut the presumption of the business judgment rule that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company."[44] The Supreme Court recognized that a board is generally entitled to the presumption of the business judgment rule in declining a merger opportunity because implicit in the statutory authority of the board to propose a merger, is also the power to decline a merger. In order to determine whether the board's action merits the business judgment presumption, the Supreme Court reviewed the *Aronson* two-part test: (i) did the board reach its decision in good faith pursuit a legitimate corporate interest; and (ii) did the board do so advisedly.[45]

44. *Id.* at 705-06 (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

45. *Id.* at 706.

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The first prong of the analysis requires that the duty of loyalty be examined. In this case, the plaintiff alleged that the directors had a disqualifying self-interest because they were financially motivated to maintain the status quo and to keep their current positions. The Supreme Court was wary of such an argument which it recognized to be tautological, to some extent, because a board decision to reject a merger proposal could always enable plaintiff to assert that a majority of the directors had an entrenchment motive. For that reason, the Supreme Court explained that in addition to that argument, other facts that support a disloyal motive must be stated.

The Supreme Court determined that the pled facts were sufficient to establish the disloyalty of at least three of the directors, which suffices to rebut the business judgment presumption because in this case three of the directors constituted a majority. Also, for purposes of Rule 12(b)(6) there was a sufficient "director-specific analysis" to demonstrate that a majority of the board was conflicted based on specific alleged conduct from which a duty of loyalty violation can reasonably be inferred. The Supreme Court recited in detail in its opinion specific facts about each individual director and why such allegations supported a conflict.

B. *Officers Share Same Fiduciary Duties as Directors*

Importantly, the Delaware Supreme Court for the first time explicitly stated what has been implicitly stated previously and has been also acknowledged by the Court of Chancery—that "officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and the fiduciary duties of officers are the same of directors."[46] On the issue of whether a delay in the due diligence process was a breach of the fiduciary duty of the directors, the Supreme Court disagreed with the Court of Chancery. The Supreme Court explained that on a motion to dismiss, the trial court is "not free to disregard that reasonable inference, or to discount it by weighing it against other, perhaps contrary, inferences that might also be drawn,"[47] making reference to the decision of the Court of

46. *Id.* at 708-09 n.36; *see also id.* at 709 n.37 (acknowledging that DGCL Section 102(b)(7) does not exculpate officers from liability for breaches of their duty of care).

47. *Id.* at 709.

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Chancery that a delay of a couple of weeks could not be the basis for a breach of fiduciary duties. In addition, the Supreme Court determined that the proxy disclosures concerning the deliberations of the board about the offer that was rejected were materially misleading. The Supreme Court reviewed the materiality standard and reached a different conclusion than the Court of Chancery, thus allowing that claim to proceed.

C. *Duty of Loyalty Claim Allowed to Proceed*

The Supreme Court also reversed the Court of Chancery's decision on Count III which alleged that the directors breached their duty of loyalty by recommending the reclassification proposal to shareholders for purely self-interested reasons (that is, to enlarge their ability to engage in stock buybacks and to trigger appraisal rights). The Supreme Court reasoned that the Court of Chancery's ruling on "shareholder ratification grounds" was in error for two reasons.[48] First, because a shareholder vote was required to amend the certificate of incorporation, without the approving vote, it could not operate to "ratify" the challenged conduct of the interested directors. Second, the claim that the reclassification proxy contained a material misrepresentation eliminates the essential prerequisite for applying the ratification doctrine, namely, that the shareholder vote was fully informed.

D. *Common Law Shareholder Ratification Doctrine Clarified and Enunciated*

The Supreme Court recognized that the current scope and effect of the common law doctrine of "shareholder ratification" in Delaware was unclear. Thus, to rectify the situation, the Court stated that:

[T]he scope of the shareholder ratification doctrine must be limited to its so-called "classic" form; that is, to circumstances where a fully informed shareholder vote approves director action that does *not* legally require shareholder approval in order to become legally effective. Moreover the only director action or conduct that can be ratified is that which the shareholders are specifically asked to approve. With one

48. *Id.* at 712.

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exception, the "cleansing" effect of such a ratifying shareholder vote is to subject the challenged director action to business judgment review, as opposed to "extinguishing" the claim altogether (i.e., obviating all judicial review of the challenged action).[49]

IV.
STANDARD OF REVIEW FOR MERGER INVOLVING A CONTROLLING STOCKHOLDER AND A THIRD-PARTY BUYER

In *In re John Q. Hammons Hotels Inc. Shareholder Litigation*,[50] a dispute arose out of the merger involving John Q. Hammons Hotels ("JQH") pursuant to which the holders of Class A common stock received $24 per share in cash. Plaintiffs alleged that: (i) the controlling shareholder breached his fiduciary duty by negotiating benefits for himself that the minority stockholders did not receive; (ii) the directors breached their fiduciary duties by permitting a deficient process and subsequent approval of the merger; (iii) the acquisition vehicle aided and abetted the breaches of fiduciary duties; and (iv) the company's proxy statement contained misstatements and omissions regarding the activities of the special committee process and certain conflicts with the company's financial advisors.

On cross-motions for summary judgment, the Court of Chancery concluded that *Kahn v. Lynch Communications Systems, Inc.* did not mandate the application of the entire fairness standard of review in this transaction. Procedural protections like a special committee or a vote requirement for the minority stockholders could have resulted in the application of the business judgment standard, but the procedures used here

49. *Id.* at 713 (internal footnotes and citations omitted). Moreover, yet another major judicial statement in this opinion is contained in footnote 54. Referring to the last sentence in the foregoing quote, footnote 54 states that "to the extent that *Smith v. Van Gorkom* holds otherwise, it is overruled." *Id.* at 713 n.54. Of special note in footnote 54 also is the clarification that the references in this opinion only refer to the common law doctrine of shareholder ratification and are not intended to alter the jurisprudence governing the approving vote of disinterested shareholders pursuant to Section 144 of the DGCL.

50. No. 758-CC, 2009 WL 3165613 (Del. Ch. Oct. 2, 2009).

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were insufficient. As a result, the Court determined that the applicable standard of review would be "entire fairness."[51]

JQH was a Delaware corporation that owned and managed a multitude of hotels. John Q. Hammons ("Hammons") was JQH's Chairman, CEO and controlling shareholder (he owned 5% of the Company's Class A common stock and all of the Class B common stock) with over 75% of the total vote in JQH, which in turn controlled John Q. Hammons Hotels, LP ("JQHLP"). Defendants JQH Acquisition, LLC ("Acquisition") and JQH Merger Corporation ("Merger Sub") were formed for purposes of the merger described below. Jonathan Eilian, who was not a defendant, was the principal of Acquisition, which wholly owned Merger Sub. Plaintiffs were owners of Class A stock of JQH, which was publicly traded (as opposed to Class B stock which was not).

A. *Potential Transactions with Barceló and Eilian*

In 2004, Hammons entered into discussions with third parties regarding a sale of JQH or at least his interest in JQH. By October, Barceló Crestline Corporation ("Barceló") entered into an agreement with Hammons for $13 per share for all outstanding Class A common stock. The deal was structured in a way that benefited Hammons in a number of ways, most especially from a tax standpoint. The Board recognized that Hammons' interests may not have been identical to those of the other JQH shareholders, so the Board appointed three independent directors to a special committee to evaluate and negotiate a proposed transaction on behalf of the unaffiliated stockholders and make a recommendation to the Board. The Special Committee hired a legal advisor and a financial advisor.

After Barceló's public announcement, Eilian told the Special Committee that he was interested in entering into a possible transaction with JQH. In December 2004, Eilian submitted a proposal to the Special Committee whereby he would acquire Hammons' interest in JQH and then make a tender offer for the remaining shares at a price to be determined later. After some negotiations with escalating offers from both

51. *Id.* at *2 (citing Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110 (Del. 1994)).

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Barceló and Eilian, exclusivity with Barceló was not renewed and negotiations proceeded with Eilian.

B. *Eilian's Offer*

In January 2005, Eilian made an offer whereby he would acquire all outstanding Class A stock for $24 per share. Hammons then informed the Special Committee that he wanted to negotiate with Eilian. On June 3, 2005, Eilian confirmed his offer of $24 per share of outstanding Class A stock. The Special Committee's financial advisor advised that the $24 per share offer was fair to the minority shareholders from a financial point of view and that "the allocation of the consideration between Hammons and the unaffiliated stockholders was reasonable."[52] The Special Committee approved the merger agreement and the Board voted to approve the merger and the transaction agreements. The merger was contingent upon approval of a majority of Class A stockholders voting on the transaction unless the Special Committee waived that requirement. The Merger Agreement included a $20 million termination fee and a "no shop" clause. Along with the merger agreement, Hammons and Acquisition entered into a number of other agreements "designed to provide Hammons financing to continue his hotel development activities without triggering the tax liability associated with an equity or asset sale. . . . In order to achieve his tax goals, Hammons had to have an ownership interest in the surviving LP and continue to have capital at risk."[53] Hammons was allocated a 2% interest in the cash flow distributions, preferred equity interest in the surviving LP and other rights and obligations. In addition, Hammons received $300 million in credit lines, as well as "(1) the Company's Chateau Lake property in exchange for transferring certain assets and related liabilities to an Acquisition affiliate, (2) a right of first refusal to acquire hotels sold post-merger, and (3) an indemnification agreement for any tax liability from the surviving LP's sale of any of its hotels during Hammons's lifetime."[54] At a special meeting of the shareholders on September 15, 2005, over 72% of the Class A issued and outstanding shares were voted to approve the Merger, and

52. *Id.* at *7.
53. *Id.*
54. *Id.* at *8.

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more than 89% of the Class A shares that voted on the merger voted in favor of the transaction.

C. *The Litigation*

The lawsuit was filed in October of 2004 and four years later, after discovery and an unsuccessful attempt at mediation, three sets of motions for summary judgment were filed:

- Director Defendants' Motion for Summary Judgment (filed October 24, 2008): The directors' basis for their motion was that "(1) plaintiffs cannot satisfy their burden to rebut the presumption of the business judgment rule, (2) the special committee members and the director defendants are shielded from monetary liability pursuant to the Company's 8 Del. C. [Section] 102(b)(7) exculpatory provision, and (3) there is no evidence to support the aiding and abetting claim."[55]
- Hammons' Motion for Summary Judgment (filed February 20, 2009): Hammons asserted that "he took no part in the negotiations for the purchase of the minority's shares and argues that he is entitled to summary judgment because plaintiffs cannot rebut the presumption of the business judgment rule and because even if entire fairness applies, Hammons acted fairly."[56]
- Plaintiffs' Motion for Summary Judgment (filed April 17, 2009): Plaintiffs contend that "(1) entire fairness is the applicable standard of review, (2) the special committee process and stockholder vote were ineffective and the burden of persuasion at trial remains with defendants, (3) the challenged transactions were the result of unfair dealing, (4) certain defendants are liable for aiding and abetting Hammons's breach, and (5) the only issue for trial is therefore fair price."[57]

D. *Standard of Review*

The Court noted that the threshold issue was whether the Court should apply the entire fairness standard or the business

55. *Id.* at *9.
56. *Id.*
57. *Id.*

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judgment rule in reviewing the merger. Claiming the merger to be a "minority squeeze-out transaction," plaintiffs contended that *Kahn* mandates that the Court apply the entire fairness standard of review.[58] Defendants countered, alleging the business judgment standard of review was appropriate.

The Court rejected the plaintiffs' argument, stating that under *Lynch*, "'the exclusive standard of judicial review in examining the propriety of an interested cash-out merger transaction by a controlling or dominating shareholder is entire fairness' and that '[t]he initial burden of establishing entire fairness rests upon the party who stands on both sides of the transaction.' Additionally, 'approval of the transaction by an independent committee of directors or an informed majority of minority shareholders' would shift the burden of proof on the issue of fairness to the plaintiff, but would not change that entire fairness was the standard of review."[59]

Hammons however, did not stand "on both sides of the transaction" and Hammons did not make the offer to the minority stockholders—an unrelated party, Eilian, made the offer. Eilian negotiated separately with Hammons, "who had a right to sell (or refuse to sell) his shares," and the minority shareholders, who were represented by the "disinterested and independent special committee."[60] Thus, regardless of any procedural protections in place for the minority shareholders, "*Lynch* does not mandate that the entire fairness standard of review apply notwithstanding any procedural protections that were used [i.e., the special committee or the approval of the majority of the minority shares voting.]."[61]

The Court stated that the business judgment standard "would be the applicable standard of review if the transaction were (1) recommended by a disinterested and independent special committee, *and* (2) approved by stockholders in a nonwaivable vote of the majority of all the minority stockholders."[62] However, in order to invoke the business judgment standard, "it is paramount—indeed, necessary. . .— that there be robust procedural protections in place to ensure that the

58. *Id.*
59. *Id.* at *10 (internal footnotes and citations omitted).
60. *Id.*
61. *Id.*
62. *Id.* at *12.

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minority stockholders have sufficient bargaining power and the ability to make an informed choice of whether to accept the third-party's offer for their shares."[63]

Here the Court found that the procedural protections in place (a vote of the minority stockholders where the special committee could choose to waive the vote and in any event the vote only required the approval of a majority of the *voting* minority shareholders as opposed to a majority of all of the minority shares) were not sufficient. Importantly, the Court stated that the minority vote serves as a complement to, and a check on, the special committee. It also noted that:

An effective special committee, unlike disaggregate stockholders who face a collective action problem, has bargaining power to extract the highest price available for the minority stockholders. The majority of the minority vote, however, provides the stockholders an important opportunity to approve or disapprove of the work of the special committee and to stop a transaction they believe is not in their best interests. Thus, to provide sufficient protection to the minority stockholders, the majority of the minority vote must be nonwaivable, even by the special committee.[64]

E. *Application of the Entire Fairness Standard: Fair Dealing and Fair Price*

In determining entire fairness "based on all aspects of the entire transaction," the Court considers both fair dealing and fair price.[65] While neither prong is considered in isolation, "[f]air dealing involves 'questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained,'" and "[f]air price involves questions of 'the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock.'"[66] The Court did note that while the Special Committee's approval and the majority of the minority vote were not sufficient

63. *Id.*
64. *Id.*
65. *Id.* at *13.
66. *Id.* (quoting Emerald Partners v. Berlin, 787 A.2d 85, 97 (Del. 2001)).

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to invoke the business judgment standard of review, that did not mean that the defendants per se would not be able to prevail on the issue of fair dealing.

Finding material factual issues as to the fairness of the price, including the actual value Hammons received and the financial advisor's valuation thereof, the Court denied the defendants' motion for summary judgment. Likewise, there were material factual issues as to the fairness of the deal as there were questions about whether the Special Committee was coerced by Hammons or whether Hammons' self-dealing negotiations depressed the value of the shares. Accordingly, the Court found that neither plaintiffs nor defendants were entitled to summary judgment on the issue of fair dealing.

F. *Disclosure Claims*

As noted above, plaintiffs also alleged that the JHQ's proxy statement contained material misstatements and omissions. Plaintiffs alleged four breaches of the duty of disclosure. First, plaintiffs alleged that the proxy statement mischaracterized the Special Committee process by failing to disclose that the Special Committee employed a "subservient, deferential approach" as opposed to a true arm's length bargaining process.[67] Under existing case law, directors are not required to engage in "self-flaggelation," so the Court granted summary judgment in favor of defendants on this claim.[68] Second, plaintiffs alleged that the proxy failed to disclose the potential conflict that the financial advisor had with Eilian. Defendants' motion was denied because the Court "has stressed the importance of disclosure of potential conflicts of interest of financial advisors."[69] Third, plaintiffs asserted that the law firm's representation of Eilian's financing entity iStar should have been disclosed. Even though this was disclosed to the Special Committee and measures were taken to use different lawyers within the law firm for iStar's representation, the Court nonetheless held that this type of conflict must be disclosed to the shareholders. As the Court reasoned, "[t]his is particularly true, where, as here, the minority stockholders are relying on the [S]pecial [C]ommittee to negotiate on their be-

67. *Id.* at *15.
68. *Id.*
69. *Id.* at *16.

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half in a transaction where they will receive cash for their minority shares."[70] Thus, the Court found that the defendants were not entitled to summary judgment on this claim.

Finally, plaintiffs alleged that it was a breach to not disclose a presentation to the Special Committee that Eilian made in 2004. In the presentation, Eilian provided a valuation of JQH's shares under what defendants alleged was a hypothetical scenario. Because the Court could not conclude whether the scenario was hypothetical or tied to the merger and thus potentially material to a shareholder's decision, the Court denied the defendants' motion for summary judgment on this claim.

One lesson that can be learned from this decision is that in a situation involving a merger where there is a majority shareholder, if one seeks to enjoy the benefits of the deferential business judgment rule, it remains necessary to carefully observe the prerequisites such as: (1) a recommendation of the transaction by a disinterested and independent special committee; and (2) approval by stockholders in a non-waivable vote of the majority of all the minority stockholders. The Court also emphasized that *Kahn v. Lynch* does not mandate the entire fairness standard of review notwithstanding the use of procedural protections.

V.
FORUM SELECTION CLAUSE IMPOSED ON NON-SIGNATORY

In *Weygandt v. Weco, LLC*,[71] the Court of Chancery addressed the issue of whether a non-signatory defendant can be required to appear in a forum chosen in an agreement executed by an affiliate. The Court determined that a party was subject to the personal jurisdiction of the Delaware courts based on a forum selection clause in an agreement that the party was not a signatory to, but which an affiliated party was a signatory to, in light of equitable estoppel.

The factual background involves the negotiated sale of an aviation repair business in California. The sale of the business included a contemporaneous lease agreement for the premises on which the purchased business was located. As a condi-

70. *Id.* at *17.

71. No. 4056-VCS, 2009 WL 1351808 (Del. Ch. May 14, 2009).

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tion to closing for the purchase of the business, the lease agreement was entered into for the premises which the business occupied.

The lease agreement was entered into by the entity that owned the building where the business was located, which was a different entity than the one that owned the business, but the same person controlled both entities. The Asset Purchase Agreement for the business contained a forum selection or "consent to jurisdiction" clause providing for exclusive personal jurisdiction over any party to the Asset Purchase Agreement in any state or federal court sitting in Delaware. The lease agreement, however, did not contain a "consent to jurisdiction" clause. The Court reasoned that the sale of the business was to be paid for in two ways: (i) the basic purchase price of the business, and (ii) the stream of lease payments from the lease for the premises on which the business was located.

The Court reiterated that on a motion to dismiss under Rule 12(b)(2), the plaintiff bears the burden of showing a basis for the exercise by the court of jurisdiction over a non-resident defendant.[72]

The Court rejected the applicability to these facts of the general rule that "agreements that are part of the same transaction are construed together."[73] However, the Court did find applicable the equitable estoppel theory which many cases have applied to hold that a non-signatory was bound by a forum selection clause based on a three part test. First, the forum selection clause must be valid. Second, the defendants need to be either third-party beneficiaries or "closely-related" to the relevant contract. Third, the claim must arise from the status of the defendant as closely-related to the agreement that contains the forum selection clause.

The purpose of the third prong of the three-part test is that the agreement containing the forum selection clause must also be the agreement that gives rise to the substantive claims brought by or against a non-signatory in order for the forum selection clause to be enforceable against a non-signatory.[74] The rationale for the decisions that have enforced forum selection clauses against non-signatory parties is based on

72. *Id.* at *3.
73. *Id.*
74. *See id.* at *12 nn.13-15, *16 n.18.

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the principle that a third-party beneficiary or closely-related party can not enjoy the benefits of an agreement without accepting its obligations.[75] Importantly, it is not only third-party beneficiaries, but also parties who are "closely related" to the agreement at issue that are estopped from avoiding the obligations of an agreement from which they benefit. Thus, even if an agreement expressly disclaims any third-party beneficiaries, a "closely related" party to the agreement can still be bound by its terms even if not a signatory.[76] A party will be considered "closely related" to an agreement for purposes of binding a non-signatory if: (1) she receives a direct benefit from the agreement; or (2) it was foreseeable that she would be bound by the agreement.[77]

A. *Direct Benefit*

In the instant case, the landlord, who was not a signatory to the purchase agreement which contained the forum selection clause, received a direct benefit from the purchase agreement because the buyer of the business would not have entered into the lease agreement with the landlord if it was not buying the business. Moreover, the lease was not only part of the "consideration" paid for the business, but was also a condition precedent to the purchase of the business.

B. *Foreseeability*

"[W]hen a control person agrees to a forum, it is foreseeable that the entities controlled by that person which are involved in the deal will also be bound to that forum."[78] The rationale for binding such entities rests on the public policy that forum selection clauses "'promote stable and dependable trade relations' and it would be inconsistent with that policy to allow the entities through which one of the parties chooses to act to escape the forum selection clause."[79]

If the purchaser of the business in this case was excused from buying the business because of fraud or falsity of repre-

75. *See* Capital Group Cos. v. Armour, No. Civ.A. 422-N, 2004 WL 2521295, at *6 (Del. Ch. Oct. 29, 2004).

76. *See id.* at *6.

77. *See Weygandt*, 2009 WL 1351808, at *4 & nn.18-19.

78. *Id.* at *5.

79. *Id.*.

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sentations and warranties, it would have no business reason or legal obligation to enter into the lease agreement which it needed only to operate the business. Thus, it was foreseeable that a dispute involving the purchase agreement and the lease agreements would have to be brought in Delaware because of the forum selection clause in the purchase agreement. Any contrary result would allow for duplicative and inefficient litigation in multiple forums and undermine the benefit of predictability that was provided to the purchaser by agreeing to a forum clause in the purchase agreement. Thus, the Court found that the landlord was equitably estopped from asserting that the Delaware court lacked jurisdiction.

VI.
COURT OF CHANCERY RULES ON CONTESTED BOARD ELECTIONS IN EXPEDITED SECTION 225 SUIT

In *Kurz v. Holbrook*,[80] the Delaware Court of Chancery decided an expedited claim based on DGCL § 225 challenging the election of board members.[81] The Court addressed competing requests for relief under Section 225 regarding control of the board of directors of EMAK Worldwide, Inc. ("EMAK" or the "Company"). The facts as described by the Court are as follows:

> Prior to December 18, 2009, the Board had six directors and one vacancy. On December 18, one director resigned, creating a second vacancy. The plaintiffs [argued] that on December 20 and 21, Take Back EMAK, LLC ("TBE") delivered sufficient consents (the "TBE Consents") to remove two additional directors without cause and fill three of the vacancies with Philip Kleweno, Michael Konig, and Lloyd Sems. Incumbent director Donald Kurz is a member of

80. 989 A.2d 140 (Del. Ch. 2010).

81. This decision addresses for the first time whether a bylaw amendment can reduce the size of a board. *See, e.g., id.* at 154. This decision is also required reading due to its treatment of the issues that arise in connection with the right to vote shares that are held in street name, some of which are addressed comprehensively by a Delaware court for the first time. *Id.* at 165-67. The "underdeveloped" topic of "third-party vote buying" in connection with corporate elections is also addressed in a scholarly fashion, noting that the analysis is different than what might apply in the political arena. *Id.* at 176-77.

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> TBE. The TBE Consents, if valid, would establish a new Board majority. The defendants [responded] that on December 18, 2009, Crown EMAK Partners, LLC ("Crown") delivered sufficient consents (the "Crown Consents") to amend EMAK's bylaws in two important ways. First, the Crown Consents purportedly amended Section 3.1 of the bylaws ("New Section 3.1") to reduce the size of the Board to three directors. Because Crown has the right to appoint two directors under the terms of EMAK's Series AA Preferred Stock, reducing the board to three, if valid, would give Crown a Board majority. Second, the Crown Consents purportedly added a new Section 3.1.1 to the bylaws ("New Section 3.1.1") providing that if the number of sitting directors exceeds three, then the EMAK CEO will call a special meeting of stockholders to elect the third director, who will take office as the singular successor to his multiple predecessors. The defendants contended that the bylaw amendments were valid and that the next step [was] for the EMAK CEO to call a special meeting.[82]

The Court of Chancery was not persuaded by the defendants' position. It held that:

> [T]he bylaw amendments adopted through the Crown Consents conflict with the DGCL and are void. They were therefore ineffective to shrink the Board or to require the calling of a special meeting. . . [T]he TBE Consents validly effected corporate action. The Board therefore consists of incumbent directors Kurz, Jeffrey Deutschman, and Jason Ackerman, and newly elected directors Kleweno, Konig, and Sems. One vacancy remains . . . . Contemporaneously with the issuance of this opinion, [the Court entered] a partial final judgment under Rule 54(b) to implement [its] decision, thereby facilitating a prompt appeal should the defendants wish to pursue it.[83]

82. *Id.* at 145.
83. *Id.*

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The Court also discussed the fact that many publicly traded shares in the United States are not actually registered in the name of their beneficial owners, but rather in the "street name" of the investor's brokerage firm.[84]

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84. The Court quoted from a leading treatise on the matter as follows:

> The vast majority of publicly traded shares in the United States are registered on the companies' books not in the name of beneficial owners-i.e., those investors who paid for, and have the right to vote and dispose of, the shares-but rather in the name of "Cede & Co.," the name used by The Depository Trust Company ("DTC"). Shares registered in this manner are commonly referred to as being held in "street name." . . . DTC holds the shares on behalf of banks and brokers, which in turn hold on behalf of their clients (who are the underlying beneficial owners or other intermediaries).

Id. .at 147 (quoting John C. Wilcox, John J. Purcell III, & Hye-Won Choi, *"Street Name" Registration & The Proxy Solicitation Process*, at 10-3 in Amy Goodman, et al., *A Practical Guide to SEC Proxy and Compensation Rules* (4th Ed. 2007 & 2008 Supp.) (hereinafter *"Street Name"*)).

Noting that "DTC figures prominently in this case [as] does the Investor Communications Solutions Division of Broadridge Financial Services, Inc. ("Broadridge")," the Court offered the following summary:

> For many years, banks and brokers maintained their own proxy departments to handle the back-office administrative processes of distributing proxy materials and tabulating voting instructions from their clients. Today, however, the overwhelming majority have eliminated their proxy departments and subcontracted these processes out to [Broadridge]. For many years, these proxy processing services were provided by Automatic Data Processing, Inc. ("ADP"), but on March 31, 2007, ADP spun off its Brokerage Services Group into a new independent company, Broadridge, which now provides these services to most banks and brokers. To make these arrangements work, Broadridge's bank and broker clients formally transfer to Broadridge the proxy authority they receive from DTC (via the [DTC] Omnibus Proxy) via written powers of attorney. On behalf of the brokers and banks, Broadridge delivers directly to each beneficial owner a proxy statement and, importantly, a voting instruction form (referred to as a "VIF") rather than a proxy card. Beneficial owners do not receive proxy cards because they are not vested with the right to vote shares or to grant proxy authority—those rights belong only to the legal owners (or their designees). Beneficial owners merely have the right to instruct how their shares are to be voted by Broadridge (attorney-in-fact of the DTC participants), which they accomplish by returning a VIF.

Id. at 147-48 (citing *Street Name*, at 10-14).

The Court recognized that:

> DTC is generally understood to be the entity with the power under Delaware law to vote the shares that it holds on deposit for the

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A. *Issue of First Impression: Reduction in Board Size via Bylaw Amendment*

The Court of Chancery also observed that no Delaware decision had addressed the reduction of the size of the board via bylaw amendment. As the Court stated: "Our law has not addressed what happens when a bylaw amendment would shrink the number of board seats below the number of sitting directors. The DGCL does not address it. No Delaware court has considered it. None of the leading treatises on Delaware law mention it. Indeed, no one seems to have contemplated it."[85] The Court observed:

> New [proposed bylaw] Section 3.1 would shrink the Board to three directorships at a time when five directors are in office. There are two possible consequences for the suddenly surplus directors. One is that their terms would end. The other is that they would continue to serve, albeit without official seats, until their terms were ended by a statutorily recognized means. [B]oth possibilities conflict with the DGCL.
>
> The notion that the terms of the extra directors would end conflicts with Section 141(b)'s mandate that "[e]ach director shall hold office until such di-

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banks and brokers who are members of DTC. Through the DTC omnibus proxy, DTC transfers its voting authority to the banks and brokers. The banks and brokers then transfer the voting authority to Broadridge, which votes the shares held at DTC by each bank and broker in proportion to the aggregate instructions received from the ultimate beneficial owners.

Id. at 148 (observing, however, that "[t]he evidence conflicts as to who had the responsibility to get the DTC omnibus proxy.").

The Court also discussed the concept of "Cede breakdown":

> If DTC holds shares of a corporation on behalf of banks and brokers, then the corporation can ask DTC to provide what is technically known as a participant listing and informally referred to as a "Cede breakdown." The Cede breakdown for a particular date identifies by name each bank or broker that holds shares with DTC as of that date and the number of shares held. In contrast to the DTC omnibus proxy, which is not governed by any legal authority, federal regulations require DTC to furnish a Cede breakdown promptly when a corporation requests it.

Id. at 153.

85. *Id.* at 155 (footnote omitted).

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> rector's successor is elected and qualified or until such director's earlier resignation or removal." Section 141(b) thus recognizes three procedural means by which the term of a sitting director can be brought to a close: (1) when the director's successor is elected and qualified, (2) if the director resigns, or (3) if the director is removed. Section 141(b) does not contemplate that a director's term could end through board shrinkage. A bylaw that seeks to achieve this result conflicts with Section 141(b) and is void.[86]

DGCL § 141(k) supports the general rule that a director or the entire board may be removed with or without cause by a majority of the shareholders entitled to vote.[87] Although directors may, in certain instances, fill vacancies on the board, directors cannot remove a fellow director.[88]

In holding that the bylaw amendment at issue was a violation of the DGCL, the Court of Chancery stated:

> In light of the three procedural means for ending a director's term in Section 141(b), I do not believe a bylaw could impose a requirement that would disqualify a director and terminate his service. Section 141(b)'s recognition of the bylaws as a locus for director qualifications instead contemplates reasonable qualifications to be applied at the front end, before a director's term commences, when the director is "elected and qualified."[89]

The Delaware Supreme Court on April 21, 2010 issued a 55-page decision that affirmed in part and reversed in part the Court of Chancery's decision in this case.[90] Although the Delaware Supreme Court agreed with the Court of Chancery to the extent that there was no improper vote-buying, unlike the trial court, the Supreme Court determined that the purchase of voting rights and other enumerated rights was a breach of the applicable Restricted Stock Agreement, and therefore, those votes could not be counted. Both courts reviewed the

86. *Id.* at 155-56 (quoting DEL. CODE ANN. tit. 8, § 141(b)).

87. DEL. CODE ANN. tit. 8, § 141(k); *see also* 989 A.2d at 156.

88. *See id.* at 157 ("For 89 years, Delaware law has barred directors from removing other directors.").

89. *See id.* at 157 (internal citation omitted).

90. *See* Crown EMAK Partners, LLC v. Kurz, 992 A.2d 377 (Del. 2010).

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requirements for written consents of shareholders in lieu of a meeting, pursuant to DGCL Section 228 and both recognized the requirement that such consents be executed by a stockholder of record. Where the two courts diverged, however, was at the point that the Court of Chancery determined that a Cede breakdown is part of the stock ledger for purposes of Section 219(c). The Supreme Court regarded this part of the Court of Chancery decision as *obiter dictum* and reasoned that in light of the purchased votes being invalidated, it was not necessary to address or decide the issue of whether the Cede breakdown was part of the stock ledger for Section 219 purposes.

Importantly, the Supreme Court also agreed with the Court of Chancery on the ruling that a bylaw amendment that purports to reduce the size of the board as a means of eliminating sitting directors is in violation of DGCL Section 109(b). Rather, the correct procedure would have been for the dissidents to follow a three-step process: first, remove the sitting directors by written consent, then reduce the size of the board, and then elect new directors.

VII.
COURT OF CHANCERY WARNS DELAWARE "LOCAL COUNSEL"

In *State Line Ventures, LLC v. RBS Citizens*[91] the Court of Chancery, in a two-page ruling, debunks any definition of "local counsel" in Delaware as being anything less than counsel of record fully responsible for every pleading filed, every discovery request or reply, and every argument made to the Court—regardless of the frequent and customary role of "forwarding counsel" being heavily involved in the prosecution of the case.

Although this ruling is only two-pages long, it should be required reading for every non-Delaware lawyer who handles a case with a Delaware lawyer. The Court made it clear that it will look to Delaware counsel to justify any positions taken in the case or the conduct of the litigation in general. Although the Court observed that it was very familiar with the practice of different allocations of work between forwarding counsel and Delaware counsel, and that forwarding counsel may have primary responsibility for a matter from the perspective of the

91. No. Civ.A. 4705-VCL, 2009 WL 4723372 (Del. Ch. Dec. 2, 2009).

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client, the Court "served notice" that it will hold Delaware attorneys who sign pleadings as fully responsible for the contents of those filings with the Court, regardless of who prepared the initial draft or how the underlying work was allocated.[92]

VIII.
STATUTE OF LIMITATIONS FOR CONTRACTS "UNDER SEAL"

In *Whittington v. Dragon Group L.L.C.*,[93] the Court of Chancery addressed for the second time in this case, the applicable statute of limitations for contracts under seal. The second opportunity came as a result of an appeal of the Court's prior ruling and a subsequent remand where the Delaware Supreme Court ruled that the applicable statute of limitations for claims on a contract "under seal" is 20-years.[94] In addition to defining laches and applying its elements such as "unreasonable de-

92. *Id.* at *1. Even though this is only a two-page ruling, the importance of the ruling requires that a substantial excerpt be provided verbatim, as follows:

> Our rules make clear that the Delaware lawyer who appears in an action always remains responsible to the Court for the case and its presentation. *See* Ct. Ch. R. 170(b) ("The admission of an attorney *pro hac vice* shall not relieve the moving attorney from responsibility to comply with any Rule or order of the Court."). So do the Principles of Professionalism for Delaware Lawyers.
>
> It is of course true that Delaware counsel and forwarding counsel necessarily allocate responsibility for work, and that in some cases, the allocation may be heavily weighted towards forwarding counsel. It is also true that forwarding counsel may have primary responsibility for a matter from the client's perspective, particularly if the Delaware litigation is one part of a larger picture. This is perfectly understandable, efficient, and appropriate. But it does not alter the Delaware lawyer's fundamental responsibility for the Delaware proceeding. A Delaware lawyer always appears as an officer of the Court and is responsible for the positions taken, the presentation of the case, and the conduct of the litigation.
>
> If a Delaware lawyer signs a pleading, submits a brief, or signs a discovery request or response, it is the Delaware lawyer that takes the positions set forth therein. This is true regardless of who prepared the initial draft or how the underlying work was allocated. When a particularly questionable argument was made in the briefing, I have not hesitated to ask the Delaware lawyer at the hearing how the argument possibly could be advanced, regardless of whether forwarding counsel was designated to make the argument.

93. No. 2291-VCP, 2010 Del. Ch. LEXIS 27 (Del. Ch. Feb. 15, 2010).

94. 991 A.2d 1 (Del. 2009).

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lay," the Court of Chancery also concluded that laches would not bar a claim that was brought a little after 3-years from the date that "inquiry notice" was imputed, in light of the statute of limitations that was 20-years long.[95]

IX.
COURT OF CHANCERY ADOPTS RULES FOR "LIGHTNING FAST" ARBITRATION OF MAJOR CASES

A new voluntary and confidential arbitration procedure for major disputes has been implemented for the Delaware Court of Chancery.[96] This new "rocket docket" allows for an exciting and creative method to obtain an adjudication from a member of the Court of Chancery at "lightning speed." It is designed to provide another option (in addition to the popular mediation program in the Court of Chancery) to litigants seeking expedited or summary proceedings. The new rules became effective on February 1, 2010. Key points include the following:

- The arbitrator will be a permanent sitting member of the Court of Chancery.
- A preliminary conference will be scheduled within 10 days of the filing of the petition (which is the commencement of the case) to address procedural and substantive aspects of the case.
- The hearing will generally "occur no later than 90 days following receipt of the petition."[97]
- The arbitration proceedings will be confidential.
- The parties must consent to this procedure.
- For claims seeking money damages only, the amount in controversy must be in excess of $1 million.
- Discovery and motion practice are limited.
- Appeals will be directly to the Delaware Supreme Court.

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95. 2010 Del. Ch. LEXIS 27, at *16-18. Some helpful take-aways from this decision include definitions by the Court of Chancery of "inquiry notice" and "law of the case" and how that concept differs from the obligation of the trial court after remand by the Supreme Court to apply new rulings of law. *Id.* at *8-10, *11,

96. *See* Del. Ch. Ct. R. 96, 97, 98; *see also* DEL. CODE ANN. tit. 10, § 349.

97. *See* Del. Ch. Ct. R. 97(e).

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- Filing and hearing fees are as follows: $12,000 for filing the petition, and $6,000 for each day of arbitration (to be shared by the parties).[98]

The reasoning behind these new rules is to allow cases to be filed in the Court of Chancery that would otherwise be excluded by its limited equitable jurisdiction. Additional benefits include confidentiality and an unprecedented speed in which a decision will be rendered, measured from the date the case is filed until a hearing is held. Finality is also a benefit with appeals going directly to the Delaware Supreme Court, which is expected to develop special rules for these appeals. The conventional wisdom is that the standard of review will be limited much like judicial review of arbitration decisions generally, although the precise provisions of those rules have not yet been determined.

X.
IMPORTANT DELAWARE COURT OF CHANCERY DECISIONS ON ELECTRONIC DISCOVERY ISSUES

Imagine a battle for control of a company is interrupted by a court finding that one of the parties failed to properly preserve critical evidence, resulting in severe sanctions, including dismissal of the case. Unfortunately like many litigations in recent years, disputes on the merits can get overshadowed by e-discovery disputes. Some of the most memorable e-discovery cases—*Zubulake v. UBS Warburg*,[99] *Qualcomm Inc. v. Broadcom Corp.*,[100] and *Coleman (Parent) Holdings, Inc. v. Morgan Stanley & Co. Inc.*,[101] involved situations where the Court, when faced with significant e-discovery problems, was forced to dole out sanctions that materially affected the litigation. Delaware courts, for the most part, have escaped these types of discovery problems caused by the mishandling of electronic information, until recently.

The Delaware Court of Chancery's recent focus on discovery disputes and sanctions dealing with the mishandling of electronically stored information or "ESI" has been significant and noteworthy. Since the beginning of 2009, the Court has

98. *See* Order of Jan. 4, 2010 establishing fee schedule.
99. 216 F.R.D. 280 (S.D.N.Y. 2003).
100. No. 05cv1958-B(BLM), 2008 WL 66932 (S.D. Cal. Jan. 7, 2008)
101. No. CA 03-5045 AI, 2005 WL 674885, (Fla. Cir. Ct. Mar. 23, 2005)

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addressed a number of complex issues dealing with ESI including the trigger of the duty to preserve potential relevant information, when ESI is readily accessible for production purposes and the role of backup tapes in discovery. The Court has also issued some very important decisions regarding sanctions such as adverse inferences and increasing the burden of proof. These decisions provide the clearest statement of the law in Delaware on these topics and at the same time they lay out the traps for the unwary attorney or client who does not have their ESI house in order.

A. *Intentional Destruction of ESI in Unallocated Space on a Hard Drive*

TR Investors, LLC v. Genger[102] involved a dispute under DGCL §§ 220 and 225, where weeks after the case was settled, plaintiffs TR Investors, LLC, and others (collectively, the "Trump Group") moved to reopen the matter and sought sanctions against defendant Arie Genger for intentionally causing computer "wiping" software to be installed and run on his desktop computer as well as TRI's hard drives, destroying a significant amount of information.

The Court of Chancery reopened the case and after a two-day hearing, found Genger in contempt because he had, through his agent, caused evidence that was on his computer as well as TRI's computers (and which was subject to a status quo order) to be intentionally destroyed.[103] In addition, the Court sanctioned Genger by, among other things, increasing his burden of proof, requiring him to provide corroborating evidence at trial (beyond just his own testimony), requiring him to produce certain documents to the plaintiffs that he had claimed were privileged, and awarding attorneys' fees at a "suggested" level of $750,000.[104]

B. *Background*

In 2008, Genger was the Chief Executive Officer of TRI and the Trump Group was a 47% owner of the outstanding stock of TRI.[105] The Trump Group purchased an additional

102. No. 3994-VCS, 2009 WL 4696062 (Del. Ch. Dec. 9, 2009)
103. *Id.* at *1, *2.
104. *Id.* . at *2, *19.
105. *Id.* at *2.

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19% block of TRI shares after which the Trump Group believed that it had voting control of TRI to remove the TRI board and install a new board.[106] At a board of directors meeting held on August 25, 2008, the Trump Group delivered written consents of its shares and proposed to reconstitute TRI's board.[107] The practical effect of this proposal was to eliminate Genger's control over TRI. Genger and two other directors rejected the proposal, believing that the Trump Group did not have the voting power to reconstitute the board.

C. *Section 225 and 220 Actions and the Status Quo Order*

On the same date as the Board meeting, TR Investors, LLC and others filed a Section 225 action asking the Court to, among other things: (a) declare that the Trump Group was the majority stockholder of TRI; (b) enjoin TRI from recognizing Genger as a director; (c) declare that the Trump Group, as the majority shareholder, was entitled to designate and elect two more of their designees to the TRI board, and to continue the terms of two directors; (d) declare that the TRI board was composed of their four designees; and (e) declare invalid any actions taken by a board not comprised of their designees from and after the delivery of their written consents.[108]

The Trump Group also filed a Section 220 action asking the Court to, among other things, order TRI to permit the Trump Group to inspect and copy books and records from TRI. On August 28, 2008, the parties to the Section 225 action entered into a Standstill Agreement which provided that "no action will be taken to prosecute or defend any of the Litigations during the Term of this Agreement."[109] The next day, the parties submitted a stipulated status quo order which contained a provision that prohibited the parties from modifying or destroying any TRI-related information.[110]

106. *Id.* at *3.
107. *Id.*
108. *Id.* at *4.
109. *Id.*
110. *Id.*

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D. *Preservation of TRI Information and Encryption of Genger's Personal Information*

In September 2008, in connection with the Section 225 action, TRI's outside counsel worked with Genger to identify information on TRI's computer system that was personal to Genger and not related to the business of TRI. Genger was concerned that if he lost control of TRI, the Trump Group would get access to his private information stored on TRI's computers. Apparently, Genger had high level contacts within the Israeli government for whom he performed sensitive tasks relating to Israel's national security and Genger used TRI's computer system to create and receive documents related to these tasks.[111]

TRI's outside counsel collected electronic information from Genger's TRI office and sent that information to the office of Genger's personal counsel pending the outcome of the lawsuits. This was done not only to segregate the non-TRI documents and to protect Genger's interest in keeping those documents confidential, but also to ensure that all of the documents related to TRI's business were preserved for those managing the corporation and for possible use as evidence by the parties in the pending litigation. It was also done to identify Genger's documents that were purely personal so that they could be encrypted in a manner that ensured that their confidentiality would be protected. As to non-personal documents, that information was preserved for use by TRI in its business and to ensure that it would be available if requested in the pending litigation.[112]

E. *Files Opened—Data Temporarily Stored in Unallocated Space*

In reviewing TRI's files, TRI's attorneys opened documents and e-mails that were potential targets for encryption to review their contents. This is important because, as the Court discussed, in dealing with electronic information, if a document is opened long enough for the program's autosave feature to function, the computer system will create a temporary copy of that file. These temporary copies are different than normal user-created files, such as word-processing documents,

111. *Id.* at *5.
112. *Id.*

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which are stored on the active, or allocated, space of a computer where such information is visible to a user. As long as the file is open, a temporary copy is in the active or allocated space. When the file is closed (or deleted by the user), the temporary copy is moved to the inactive, or unallocated, space of the computer until the computer needs that space to store other information at which time the original temporary copy is overwritten. While information in the unallocated space is hidden from the view of normal users, it can be recovered with the aid of technology consultants making a forensic copy.[113]

F. *Information in Unallocated Space Destroyed in Violation of Status Quo Order*

Oren Ohana, who had served for years as a technology consultant for both TRI and Genger, was contacted by Genger about the collection from TRI's computer system. During the preservation of Genger's electronic files and e-mails, parts of TRI's computer system were "imaged" which would show a "snapshot" of all information on the system as of that date. However, no image of the entire TRI hard drive was made, only an image of the active files on the TRI system (the information on the unallocated space had not been imaged or reviewed). Ohana informed Genger that during the review process, non-encrypted copies of Genger's personal files may have been created and left on the unallocated space of his computer and the TRI server. At Ohana's suggestion and with Genger's permission, Ohana ran a wiping software program on the hard drive of Genger's computer as well as TRI's server permanently overwriting and erasing the data on the unallocated space of a hard drive.[114]

About a month later and just after the parties settled the litigation, the Trump Group discovered that "wiping" software had been used to erase information on TRI's computer system. Within days of discovering the use of the "wiping" software, the Trump Group filed a motion to reopen the case and for an order to show cause as to why Genger should not be held in contempt.[115] Eventually, the action was reopened but Genger's destruction of documents created a question about

113. *Id.* at *6.
114. *Id.* at *7.
115. *Id.* at *11.

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the adequacy of the factual record and what, if any, consequences should result from his conduct.

A great deal of discovery was taken to determine whether any evidence was lost because of Genger's conduct. Because no image of the entire TRI hard drive was made during the review process (only an image of the active files on the TRI system), the Court noted that it would be impossible for the Trump Group to determine exactly what was erased. However, plaintiffs were able to prove that important information about the litigation that should have existed (because it was discovered in other sources) no longer existed.

G. *Court Finds Genger Guilty of Civil Contempt*

The Trump Group filed motions against Genger for civil contempt and spoliation of evidence.[116] The Court noted that to establish civil contempt, the petitioning party bears the burden initially to demonstrate by clear and convincing evidence that the contemnors violated a Court order "of which they had notice and by which they were bound."[117] The Court found that Genger acted in contempt of court by directing his agent Ohana to delete company-related information. The Court also found that the Trump Group had shown that Genger consciously violated the Status Quo Order, which prohibited him from destroying any TRI-related files. Genger had been made aware of that order, because of the work Genger did with TRI's outside lawyers.[118]

Moreover, the Court found evidence that "relevant documents have been lost due to Genger's misconduct. . . . [and] recently produced documents. . . show that Genger likely deleted several other documents relevant to the § 225 action from TRI's hard drive. Copies of those documents would likely have been on the unallocated space if they had not been erased."[119]

116. *Id.* at *12-15.
117. *Id.* at *15 (citing Del. Ch. Ct. R. 70(b)).
118. *Id.* at *16.
119. *Id.* at *17.

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H. *Court Finds Spoliation of Evidence*

The Court stated that "[d]ispositive sanctions, including dismissal of claims or imposition of an adverse inference, are only appropriate where a party acts to 'intentionally or recklessly destroy evidence, when it knows that the item in question is relevant to a legal dispute *or it was otherwise under a legal duty to preserve the item.*'"[120] Here the Court found that Genger intentionally caused the destruction of information he knew was relevant to the litigation in violation of the Status Quo Order and thus subject to a legal duty to preserve.[121] The Court also found that Genger acted recklessly by approving the use of the wiping software to wipe the unallocated space.[122] Moreover, the Court found that the Trump Group identified specific documents that existed and would have supported its position but for Genger's destructive actions.[123]

I. *Court Awards Multiple Sanctions*

As part of the Court's inherent power to fashion a remedy for such violations and in determining what remedy to award for spoliation, the Court considered: "(1) the culpability of the spoliating party; (2) the degree of prejudice suffered by the aggrieved party; and (3) the availability of lesser sanctions that could both avoid unfairness to the aggrieved party and serve as an adequate penalty to deter such future conduct."[124]

Here, although the Court believed that Genger was improperly motivated and intended to limit the Trump Group's ability to gather evidence in its disputes with him, the Court found that part of his motivation was to protect his confidentiality interests in his personal information.[125] In addition, the Trump Group did not suffer a high degree of prejudice because Genger's misconduct only affected the unallocated space on his computer and TRI's server, while the active files,

120. *Id.* at *17 (citing Sears, Roebuck & Co. v. Midcap, 893 A.2d 542, 552 (Del. 2006)).

121. *Id.* at *17.

122. *Id.* at *18.

123. *Id.*

124. *Id.*

125. *Id.*

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which were not deleted, contained a good deal of relevant information.[126]

As a result, the Court determined that: (1) because Genger destroyed evidence that otherwise would have been available to the Trump Group, the Court determined that Genger must produce certain relevant documents to which he had claimed privilege; (2) Genger's burden of persuasion necessary "to prevail on any affirmative defense or counter-claim that he has raised" would be "elevat[ed] by one level"; (3) Genger had to provide corroborating evidence to prove a material factual issue at trial because "his mere word will be insufficient to meet his burden of persuasion;" and (4) Genger shall pay the plaintiffs' reasonable attorneys' fees.[127] The Court suggested $750,000 as a reasonable amount "in light of what was at stake," and because that was consistent with the Court's impression that "both sides have engaged in overkill."[128]

XI.
FAILURE TO PRESERVE ESI AND ADVERSE INFERENCE

In *Beard Research, Inc. v. Kates*,[129] the plaintiffs filed a motion for sanctions against the defendant for alleged spoliation of evidence. In particular, the plaintiffs argued that the laptop of an ex-employee was irretrievably altered after a duty to preserve relevant information from that laptop had been triggered. By way of remedy, the plaintiffs wanted a default judgment in their favor for tortious interference with business relations and misappropriation of trade secrets. Alternatively, the plaintiffs requested an adverse inference that the destroyed evidence contained information that would favor their claims, in addition to the imposition of attorneys' fees and costs. The court declined to enter a default judgment but granted a request to draw an adverse inference based on the missing evidence.[130] In addition, the Court ordered that the ex-employee and his new employers reimburse the plaintiffs for the reason-

126. *Id.* at *19.
127. *Id.*
128. *Id.*
129. 981 A.2d 1175 (Del. Ch. 2009).
130. *Id.* at 1179.

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able attorneys' fees and expenses incurred in prosecuting the motion for sanctions.[131]

A. *Background*

The parties in this case were companies that provided outsourcing services, such as chemists, for the chemical industry. A variety of claims were made against several former employees and their subsequent employers. One of the former employees, Dr. Michael Kates, left the employment of the plaintiffs and went to work for a competitor but continued to use a laptop which he had used while working for the plaintiffs. The laptop contained proprietary information he obtained while working for the plaintiffs.[132]

In June 2005 plaintiffs served their discovery requests and they specifically requested documents kept in electronic form, including e-mail communications.[133] Nonetheless, in October 2005, Kates deleted key files from his laptop and "emptied" the computer's trash in the recycle bin.[134] In December 2005 and August 2006, he reformatted the hard drive and reinstalled system software, with the understanding that reformatting the hard drive or installing a new operating system would delete the old data.[135]

Plaintiffs filed motions to compel in May and December 2006. In June 2007, based on the second motion to compel, the court directed the IT expert for defendants to meet with plaintiffs to discuss a method and means of searching the computers and databases.[136]

In October 2007, defendants' counsel notified counsel for plaintiffs that the defendants had "nothing on their personal computers" and further advised them that access to any computer would require a court order.[137]

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131. *Id.*
132. *Id.* at 1181.
133. *Id.*
134. *Id.*
135. *Id.* at 1182.
136. *Id.*
137. *Id.* at 1183.

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B. *Motion to Compel Inspection of Laptop*

In July 2008, plaintiffs filed a third motion to compel requesting that the laptop of Kates be turned over to them so that it could be searched by plaintiffs' IT expert. The day before the hearing on that third motion to compel, Kates "defragmented the hard drive and computer" before being ordered by the court to produce the laptop, after being told by his lawyer that he would likely be required to produce his laptop.[138] The IT expert for plaintiffs conducted a forensic investigation which concluded that key data was deleted and sent to the recycle bin the day before the hearing on the motion to compel, and that more than 11,000 files were deleted previously on the laptop.[139]

In October 2008, plaintiffs filed a motion for sanctions for spoliation of evidence arguing that the destruction of Kates' laptop constituted spoliation of discoverable material in the face of a duty to preserve potentially relevant evidence.[140] The defendants responded by arguing that the deletions were performed in order to keep the laptop operational, and that the reason the information was deleted on the eve of the hearing on the motion to compel was to avoid revealing embarrassing personal information.[141]

C. *Court Finds Failure to Preserve Data*

Under Delaware law, "[a] party in litigation or who has reason to anticipate litigation has an affirmative duty to preserve evidence that might be relevant to the issues in a lawsuit."[142] The Court observed that whether a person has reason to anticipate litigation depends on the facts and circumstances that may lead to a conclusion that litigation is imminent or should be expected, but a court may sanction a party who "breaches this duty by destroying relevant evidence or by failing to prevent the destruction of such evidence."[143]

The Court referenced three specific actions where Kates disregarded his duty to preserve data: (1) the deletion of files

138. *Id.*
139. *Id.* at 1184.
140. *Id.* at 1184.
141. *Id.* at 1184-85.
142. *Id.* at 1185.
143. *Id.*

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from the original hard drive of the laptop in November of 2005; (2) the installation of a new hard drive in December of 2007; and (3) tampering with the laptop and deletion of files in July 2008.[144]

The Court had some advice for counsel on e-discovery matters:

> In complex commercial litigation today, virtually all discovery involves electronic discovery to some extent. It also is well known that absent affirmative steps to preserve it, at least some electronically stored information ("ESI") is likely to be lost during the course of litigation through routine business practices or otherwise. These realities counsel strongly in favor of early and, if necessary, frequent communications among counsel for opposing litigants to determine how discovery of ESI will be handled. To the extent counsel reach agreements recognizing and permitting routine destruction of certain types of files to continue during litigation, the Court has no reason to object. Conversely, if the parties do not focus on the handling of e-discovery in the early stages of a case, the Court is not likely to be sympathetic when, for example, one party later complains that stringent measures were not instituted voluntarily by her adversary to ensure that no potentially relevant information was lost. Rather, instead of holding a party to a stringent standard that might have been appropriate if established earlier in the case, the Court probably will apply an approach it deems reasonable, taking into account the insights provided by the case law and some of the guidelines and principles developed by various respected groups that have studied the challenges of electronic discovery.[145]

The Court expressed its outrage that in July 2008 "Kates brazenly ran a disk-cleanup program on the new hard drive on

144. *Id.* at 1186.

145. *Id.* at 1187; *see also, e.g.*, Conference of Chief Justices, *Guidelines for State Trial Courts Regarding Discovery of Electronically Stored Information* (2006), available at http://www.ncsconline.org/images/EDiscCCJGuidelinesFinal.pdf.

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the eve of the hearing" on the Motion to Compel.[146] The Court emphasized that it "cannot condone such flagrant disregard for the discovery rules in a party's obligation to preserve potentially relevant evidence."[147]

D. *What Sanctions are Appropriate for Failure to Preserve Evidence*

Court of Chancery Rule 37(a)(4), entitled "Expenses and Sanctions," and Rule 37(b)(2), entitled "Sanctions by Court," both provide a basis for penalties in this area. In addition, the Court has the power to issue sanctions for discovery abuses under its inherent equitable powers, as well as the Court's inherent power to manage its own affairs.[148] Although the plaintiffs requested a default judgment, the Court refused to issue such a sanction because in order to impose such a sanction, the spoliator must have acted "willfully or in bad faith and intended to prevent the other side from examining the evidence."[149] The Court explained that the record did not support such a severe remedy in this case.

E. *Adverse Inference*

The court explained the prerequisites based on recent Delaware Supreme Court precedent for the penalty of drawing an adverse inference against a spoliator of evidence as follows:

An adverse inference instruction is appropriate where a litigant intentionally or recklessly destroys evidence, when it knows that the item in question is relevant to a legal dispute or it was otherwise under a legal duty to preserve the item. Before giving such an instruction, a trial judge must, therefore, make a preliminary finding that the evidence shows such intentional or reckless conduct.[150]

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146. *Id.* at 1188.

147. *Id.* at 1189.

148. *Id.* (citing Residential Funding Corp. v. DeGeorge Fin. Corp., 306 F.3d 99, 106-07 (2d Cir. 2002); Shmid v. Milwaukee Elec. Tool Corp., 13 F.3d 76, 79 (3d Cir. 1994)).

149. *Id.* at 1190.

150. *Id.* at 1191.

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F. *Where Does an Adverse Inference in Chancery Court Get You?*

After determining the different requirements for drawing an adverse inference had been satisfied, the Court then analyzed in careful detail exactly what specific adverse inferences can be drawn based on the spoliation of specific evidence by Kates. Importantly, the Court emphasized that an adverse inference is "not substantive proof" and not a substitute for the proof of a fact necessary to the party's case. In addition, in order to obtain an adverse inference, a party must offer more than "mere speculation and conjecture that a particular document existed."[151] To that end, the Court noted that by definition an e-mail has both a sender and a receiver. Even if the e-mails were destroyed by the sender, in this case the plaintiffs received discovery responses from the likely receiver of the e-mail and no incriminating e-mails from that party were received.

The Court regarded as reckless the failure of Kates to fulfill his obligation to preserve potentially relevant evidence on the laptop and the adverse inference drawn was that there was relevant information on the laptop that would have shown confidential information of his former employer as part of a PowerPoint that Kates presented to a competitor.

G. *Attorneys' Fees and Costs*

In order to impose monetary sanctions, the Court "need only find that a party had a duty to preserve evidence and breached that duty. Essentially, this means that negligence alone may be sufficient to support the imposition of monetary sanctions."[152] The Court reserved some of its harshest language to justify the imposition of attorneys' fees in this case. In particular, the Court was troubled by the waste of time and resources suffered by the plaintiffs' counsel and the Court regarding a motion to compel the original hard drive. The Court emphasized that it was only after the Court read the opening brief on the motion did the defendants admit in their answering papers that the original hard drive had been replaced already.

151. *Id.* at 1193.
152. *Id.* at 1194.

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The Court added that "[t]he vexatiousness of Kates' conduct was compounded further by his undisclosed deletion of numerous files from the new hard drive before the July 2008 hearing," and that "Kates' intentional deletion of information in July 2008 was egregious and demonstrates a callous disregard for proper discovery in this [C]ourt."[153] Therefore, the Court awarded plaintiffs their attorneys' fees and expenses, including expert fees, associated with the motion for sanctions and imposed those amounts jointly and severally against Kates and his new employers. The expenses included those associated with the inspection of the laptop.

H. *Duty to Preserve and Data Wiping Software*

In *Triton Construction Co., Inc. v. Eastern Shore Electrical Services, Inc.*,[154] plaintiff Triton Construction Co. was a Delaware non-union commercial electrical contractor and defendant Tom Kirk was an employee of Triton from 2004 through 2007. He was hired as an estimator and a project manager, a full-time salaried position. Kirk was privy to confidential information about Triton's overhead, labor rates, material costs, equipment costs, profit, salaries and general financial information which he discussed with Triton executives on at least a weekly basis. Defendant Eastern Shore Electrical Services, Inc. was a non-union commercial electrical contractor that competed directly with Triton for some of the jobs it bid. Beginning in November 2005, Kirk began to work part-time for Eastern, offering his estimating services at the same time he maintained a full-time position at Triton. Neither Kirk nor Eastern ever informed Triton of the part-time job at Eastern. Following Kirk's resignation from Triton, he was hired full-time to work at Eastern.

I. *Procedural History*

In October 2007 Triton filed a Verified Complaint requesting injunctive and other relief and a Motion for Temporary Restraining Order (TRO).[155] The Court granted the TRO and in November 2007 the Court also granted a stipu-

153. *Id.*
154. No. 3290-VCP., 2009 WL 1387115 (Del. Ch. May 18, 2009).
155. *Id.* at *1.

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lated Temporary Restraining Order and Preliminary Injunction. A four-day trial was held in March 2008 and extensive post-trial briefing and argument followed. The Court also considered a motion for contempt due to a violation of the preliminary injunction. The Court granted that motion for contempt with an award of attorneys' fees incurred in that motion only.[156] The Court described the evidentiary standard applicable in this case which was proof by a preponderance of the evidence. In essence, this meant that Triton must merely prove that "it is more likely than not that it is entitled to relief."[157]

J. *Spoliation of Evidence and Duty to Preserve Evidence*

The Court considered a claim that Kirk intentionally destroyed evidence, including ESI, and a request for an adverse inference against Kirk as a result.[158] The Court accepted expert testimony on this point and found that Kirk installed a wiping program on his computer thereby making certain files irretrievable. The Court did not find Kirk's denials that he used the wiping program credible. The Court also noted that Kirk never produced his home computer or thumb drive; and found not believable that Kirk "no longer owned either of them."[159]

The Court acknowledged the Delaware law which imposes an affirmative duty "to preserve evidence [which] attaches upon the discovery of facts and circumstances that would lead to a conclusion that litigation is imminent or should otherwise be expected."[160] In order for an adverse inference to be drawn, Delaware requires a determination "that the party acted intentionally or recklessly in failing to preserve the evidence."[161] The Court found that Kirk either intentionally or recklessly destroyed or failed to preserve evidence relating to this litigation at a time when he knew such litigation was imminent or otherwise to be expected. Thus, the Court found an adverse inference to be appropriate based on the inference

156. *Id.* at *7.
157. *Id.* at *6 (citations omitted).
158. *Id.* at *7.
159. *Id.* at *8.
160. *Id.*
161. *Id.*

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that Kirk either destroyed or discarded his thumb drive and home computer or recklessly failed to fulfill his duty to preserve that potential evidence.[162]

K. *Cost Shifting and Backup Tapes*

In *Omnicare, Inc. v. Mariner Health Care Management Co.*,[163] the Court addressed two important ESI issues — cost-shifting and backup tapes.

Omnicare brought this action to compel performance of an alleged contractual obligation to guarantee the payment of approximately $100 million that the defendants (and their affiliates) owed under certain provisions (the "Guarantee Provisions"). Omnicare sought injunctive relief and damages to "remedy, among other things, [d]efendants' alleged ongoing breaches of their agreement to provide Omnicare and/or its pharmacies with 10-days advance written notice of any facility transfers and to ensure that any new lessee, manager, transferee or other operator of transferred facilities enters into successor agreements with Omnicare's pharmacies."[164] Omnicare also asserted causes of action for fraudulent transfer and alter ego/veil piercing.

L. *Cross-Motions to Compel*

Omnicare sought the production of the following six categories of information: (1) specific billing errors defendants identified, the basis for disputing the amounts; and the specific billing errors that the defendants objected to within 60 days of the date of the invoice; (2) information regarding transfers of facilities; (3) financial information "tailored to Omnicare's claims for fraudulent conveyance, alter ego and veil piercing"; (4) documents sufficient to identify individuals with any direct or indirect ownership interest in any of the defendants; (5) documents containing certifications and other statements made to the government regarding goods and services received from Omnicare and provided to Medicare patients; and (6) email on backup tapes for certain periods for which no email is available due to the automatic deletion pro-

162. *Id.*
163. No. 3087-VCN., 2009 WL 1515609 (Del. Ch. May 29, 2009).
164. *Id.* at *2.

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gram defendants had in effect prior to September 2007.[165] Defendants sought production of the following four categories of information: (1) contracts that relate to Omnicare's standing or right to assert its claims in this case; (2) "affiliate" level information and documents; (3) certain information and documents related to "most favorable pricing" and "Medicaid pending" elements of the billing dispute; and (4) information and documents showing prior investigations, charges, complaints or lawsuits regarding the billing process utilized by Omnicare or Omnicare pharmacies.[166] The Court reviewed and discussed in detail each of the topics in dispute and in the end granted both parties' motions to compel the information that each sought.

M. *Cost-Shifting and Backup Tape Analysis*

The Court discussed the issue concerning the destruction of emails—namely, that "all of Defendants' email for approximately three years. . . from 2003 to 2005 has been automatically deleted."[167] Apparently, in order to review and produce the emails from periods during which all email was automatically deleted, the defendants argued that they would need to restore the 2004 and 2005 backup tapes. The parties disagreed about who should pay for this restoration which was estimated to be between $22,000 and $40,000.[168] The general rule is that the responding party bears the expenses associated with producing electronic information sought in discovery, but the Court, "in the exercise of both its inherent equitable powers and the wide discretion to manage discovery under Court of Chancery Rule 26, may act to alter this norm when appropriate."[169]

The Court noted the dearth of Delaware law on the subject of ESI, cost-shifting, backup tapes and restoration of email before turning to the Federal Rules of Civil Procedure, which were amended in 2006, to address the discovery of data that is

165. *Id.* at *2-3.
166. *Id.* at *3.
167. *Id.* at *7.
168. *Id.*
169. *Id.*

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"not reasonably accessible because of undue burden or cost."[170]

After analyzing the multi-factor approach employed in the Court in the Southern District of New York in *Zubulake v. UBS Warburg LLC*,[171] the Court decided not to shift costs of production because "[d]efendants have not adequately demonstrated that the ESI in question is not reasonably accessible. Simply because the ESI is now contained on [b]ackup [t]apes instead of in active stores does not necessarily render it not reasonably accessible."[172] Interestingly, the Court commented on Omnicare's argument concerning records management policies noting that:

Omnicare's attempt to demonstrate impropriety in Defendants' data retention policy and its implementation is unpersuasive. The better approach is proposed by the Defendants. Production should first be from Defendants' active stores in order to assess the likelihood of finding relevant and discoverable data on the backup tapes. If that is productive, then it becomes more likely that recovery of information from backup tapes would be fruitful and the processing of the backup tapes at defendants' expense would be appropriate.[173]

N. *Failure to Preserve Corporate Directors' Email*

In *Grace Brothers, Ltd. v. Siena Holdings, Inc.*,[174] the Court granted plaintiff's motion to compel emails among defendant directors on an expedited basis. This action was filed in January 2004 by Grace Brothers challenging a reverse stock split by Siena as a violation of DGCL § 155. Grace Brothers asked Si-

170. *Id.* (citing Fed. R. Civ. P. 26(b)(2)(B)).

171. 216 F.R.D. 280, 284-91 (S.D.N.Y. 2003).

172. 2009 WL 1515609 at *7 (citing factor three of the Zubulake cost-shifting analysis). The Court also expressed no opinion as to "what recovery costs might be sufficient to carry the burden of demonstrating ESI as not reasonably accessible or to justify cost-shifting." *Id.*

173. *Id.* at *7. The opinion also references a *Duke Law Review* article dealing with various tests that courts have used to determine when cost-shifting is appropriate, and it discusses the language in Rule 26 of the Federal Rules of Civil Procedure ("not reasonably accessible due to undue burden or cost"), the leading Federal Case in this area, *Zubulake v. UBS Warburg LLC*, and the issue of the cost necessary for the producing party to carry its burden of demonstrating ESI as not reasonably accessible or to justify cost-shifting. *Id.* at *7 nn.32, 34.

174. No. 184-CC., 2009 WL 1547821 (Del. Ch. 2009).

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enna to produce emails among members of Siena's board of directors[175] and Sienna not only refused to produce the emails, it said that "there was no need for the board of directors to search for the emails."[176] Sienna not only failed to identify or locate this information, it failed to preserve this information and it failed to meet its burden of showing that Grace's document requests were improper or "unreasonably cumulative or duplicative."[177]

Siena argued that it didn't have to collect and produce the directors' email because the company had already produced the relevant emails when they produced the sender-side versions. Additionally, Siena argued that "its process of asking the directors about their document retention and email communication practices was sufficiently reasonable to determine if the directors had unique copies of any emails already produced from other sources. It concluded that the directors did not have any unique copies."[178] The Court disagreed with Siena's position and found that this request would not: (i) be overly burdensome; (ii) result in great expense for Siena; (iii) be duplicative; and (iv) harass Siena.[179] The Court granted the motion to compel this production in an expedited fashion given the impending trial date.[180]

O. *New York Federal Court Decision Influence E-Discovery Law in Delaware*

It is important to note the influence certain decisions from Judge Shira Scheindlin, a District Court Judge from the Southern District of New York have had and probably will have on the law regarding e-discovery in Delaware. The most influential have been the multiple decisions Judge Scheindlin issued in the *Zubulake v. UBS Warburg LLC* case.[181] The judges on the Court of Chancery have cited with approval Judge Scheindlin's *Zubulake* decisions in three decisions in 2009—*TR*

175. *See id.* at *1.
176. *Id.*
177. *Id.* (citing Del. Ch. Ct. R. 26(b)(1)).
178. *Id.* at *1.
179. *Id.*
180. *Id.* at *2.
181. *See* 229 F.R.D. 422 (S.D.N.Y. 2004); 220 F.R.D. 212 (S.D.N.Y. 2003); 216 F.R.D. 280 (S.D.N.Y. 2003); 217 F.R.D. 309 (S.D.N.Y. 2003); 230 F.R.D. 290 (S.D.N.Y. 2003).

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Investors, LLC v. Genger,[182] *Omnicare, Inc. v. Mariner Health Care Management Co.*,[183] and *Beard Research, Inc. v. Kates*.[184] Moreover, Judge Scheindlin recently issued another e-discovery "must-read" for practitioners, clients and judges alike dealing with the problems and pitfalls associated with the failure to properly preserve potential relevant ESI.

On January 15, 2010, Judge Scheindlin issued an amended opinion in *The Pension Committee of the University of Montreal Pension Plan v. Banc of America Securities, LLC*[185] ("Pension Committee"). Judge Scheindlin titled her 85-page opinion "Zubulake Revisited: Six Years Later."[186] The case looks at preservation and spoliation from the perspective of the plaintiff and the issue had to do with information that should have been preserved by the plaintiffs after the lawsuit was filed but was not. Judge Scheindlin addressed in great detail, ways to define the levels of culpability—negligence, gross negligence, and willfulness in the electronic discovery context, identifying the following "failures" and levels of culpability as examples:

- the failure to issue a written litigation hold (gross negligence);[187]
- the failure to collect information from key players (gross negligence or willfulness);[188]
- the destruction of email or backup tapes after the duty to preserve has attached (gross negligence or willfulness);[189]
- the failure to obtain records from all employees who had any involvement with the issues raised in the litigation or anticipated litigation, as opposed to just the key players (negligence);[190]

182. No. 3994-VCS., 2009 WL 4696062, at *17 n.65 (Del. Ch. Dec. 9, 2009).

183. 2009 WL 1515609, at *7 nn. 31-32 (Del. Ch. May 29, 2009).

184. 981 A.2d 1175, 1185 n.62 (Del. Ch. 2009).

185. No. 05 Civ. 9016(SAS), 2010 WL 184312 (S.D.N.Y. Jan. 15, 2010) (the original opinion was issued on January 11, 2010 and is available at 2010 WL 93124.).

186. *See* 2010 WL 184312.

187. *Id.* at *10.

188. *Id.* at *3.

189. *Id.*

190. *Id. See also* Amended Opinion and Order issued on May 28, 2010.

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- the failure to take all appropriate measures to preserve ESI (negligence);[191]
- the failure to collect information from the files of former employees that remain in a party's possession, custody, or control after the duty to preserve has attached (gross negligence);[192] and
- the failure to assess the accuracy and validity of selected search terms (negligence).[193]

Judge Scheindlin also discussed who should bear the burden of establishing the relevance of evidence that is lost and who should be required to prove that the absence of the missing material has caused prejudice to the innocent party.[194] Judge Scheindlin also suggested a novel burden-shifting test in dealing with burden of proof and severity of the sanction requested.[195] Finally, Judge Scheindlin provides guidance on the important issue of preservation of backup tapes.[196] In the end, Judge Scheindlin ordered an adverse inference instruction as well as costs against six plaintiffs who were grossly negligent in dealing with their preservation obligations.[197] She sanctioned seven other plaintiffs who were merely negligent in meeting their preservation obligations with only costs.[198]

EPILOGUE

A common theme of the recent Delaware decisions reviewed in this article is that the Delaware courts will continue to closely examine the detailed factual situation of each case in order to determine the applicable standard of review as opposed to a "one size fits all" approach. Decisions such as *Citigroup* remind us that when the prerequisites of the business judgment rule standard are satisfied, the Delaware courts will not second-guess business decisions that in retrospect could have been decided differently. However, as in *Hammons*, the Court of Chancery emphasized that a heightened standard of

191. *Id.*
192. *Id.*
193. *Id.*
194. *Id.* at *4-5.
195. *Id.* at *6.
196. *Id.* at *12 n.99.
197. *See id.* at *23-24.
198. *Id.* at *25 n.3.

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review, such as the entire fairness standard, will apply when procedural protections for minority shareholders are not observed.

Moreover, additional obligations imposed on attorneys that were ushered in by the 2006 changes to the Federal Rules of Civil Procedure regarding electronic discovery are now being imposed in Delaware, as explained by recent decisions outlined in this article. Attorneys must be aware of their duties to advise their clients to preserve and produce electronically stored information ("ESI"), in the multitude of places where ESI can be found, or risk substantial penalties that may be imposed on them and/or their clients for failing to observe the new standards applicable to ESI. Review of the cases selected for this article should make those who practice in Delaware better prepared to meet their responsibilities in this new area.

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