A Primer on the Basics of Directors' Duties in Delaware: The Rules of the Game (Part I)

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A PRIMER ON THE BASICS OF DIRECTORS' DUTIES IN DELAWARE: THE RULES OF THE GAME (PART I)

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MARK A. KEARNEY**

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(1297)
I. Introduction

Disputes concerning decisions made by boards of directors of Delaware corporations are initially decided by the Delaware Court of Chancery, an equity court. The Chancery Court applies the statutory laws and adapts the common law to balance the complex and varied interests of the board, the shareholders and other affected parties. Since the Delaware courts must decide issues that can dramatically affect the business world, they are cognizant of their role as providers of stability and certainty for corporate decision-makers. At the same time, they try to ensure a just and fair result in the case before them.

As in popular sports, knowledge of the rules of the game is a prerequisite for playing the game. Winning, however, requires preparation, skill, luck and an understanding of the fundamentals of the game. This Article focuses on the fundamentals.

Typically, corporate litigation begins when a shareholder challenges a board’s decision. The challenging shareholder may bring suit to prevent the corporation from taking action, to require the corporation to take action or to seek damages arising out of actions or decisions made by the board. These cases require the court to review the challenged board decisions. In doing so, the court must decide upon and apply the appropriate level of scrutiny to the board action. The level of scrutiny is frequently referred to as “the

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1. Delaware’s preeminent stature in corporate litigation can be attributed, in large part, to the sound and consistent application of the Delaware General Corporation Law by its equity courts to expedite disputes concerning the application of the business judgment rule. In Delaware, jurisdiction over corporate litigation is vested in the Court of Chancery. Del. Const. art. IV, § 14. See Michael Hanrahan, The Development of the Delaware Court of Chancery as a Corporate Forum, 2 Del. Law. 34 (Spring 1984); Donald E. Schwartz, The Delaware Chancery Court: A National Court of Corporate Law, 2 Del. Law. 54 (Spring 1984). In Delaware, unreported decisions of the Court of Chancery traditionally have had persuasive authority. Appeals from decisions of the Court of Chancery are decided by the Supreme Court of Delaware. Del. Const. art. IV, § 11, cl. 4.
standard of review." The court must also decide which party, the challenging shareholder or the board, will have the burden of proof with respect to the issues involved in the case.

Delaware courts have played a preeminent role in defining fiduciary duties because of the significant number of major corporations incorporated in Delaware. In recent years, increased shareholder scrutiny of board decisions has resulted in many cases brought by shareholders challenging board decisions. In turn, the Delaware courts have recently decided a number of cases which discuss and clarify the basic duties of Delaware directors.

This Article is intended to be a primer for the practitioner or student who seeks the basic rules of Delaware corporate law when a shareholder challenges a board's decision. Because the variety of shareholder challenges are as diverse as the shareholders themselves, this Article is written in two parts. In Part I, we outline the rules applicable in the majority of cases in which boards' decisions are challenged. As noted below, the Delaware courts presume that the board's decision was proper and in the best interests of the corporation, unless the shareholder can show a breach of the board's fiduciary duties of care, loyalty and good faith. If the shareholder rebuts the court's presumption of propriety, known as the "business judgment rule," then the court will apply a stricter standard of review and require the board to show that its decisions were "entirely fair" to the shareholders.

In Section II of this Article, we discuss the basic fiduciary duties of care, loyalty and good faith owed by board members to their shareholders and the protections afforded to the board by the business judgment rule. Section III addresses how shareholders can rebut the business judgment rule. In addition, this section discusses the variety of arguments available to the shareholder challenging a board's decision.

Section IV of this Article discusses the necessity, adequacy and effect of disclosures made by the board to the shareholders when the board seeks shareholder approval of a board decision.

2. For a discussion of the duty of care, see infra notes 22-33 and accompanying text.
3. For a discussion of the duty of loyalty, see infra notes 34-49 and accompanying text.
4. For a discussion of the duty of good faith, see infra notes 50-55 and accompanying text.
5. For a discussion of rebutting the business judgment rule presumption, see infra notes 19-75 and accompanying text.
6. For a discussion of liability due to lack of disclosure, see infra notes 80-108 and accompanying text.
V discusses the fiduciary duties and potential liabilities of shareholders who control the board either in fact or in effect.\(^7\)

Finally, we discuss the procedural rules governing most types of corporate litigation. Section VI discusses the issues that arise when a shareholder seeks to assert a derivative claim on the corporation's behalf.\(^8\) Such claims frequently, but not always, are made against directors for alleged violations of their fiduciary duties. Section VII of this Article discusses how the standard of review and burden of pleading and proof can shift depending on the procedural status of the dispute.\(^9\)

In Part II, which will be published in a forthcoming issue of this Law Review, we discuss, among other things, the standard of review and burden of proof when the board adopts defensive measures to protect the corporation from a takeover or when the board decides to sell the company. We will also discuss the effect independent board approval or shareholder ratification can have on the standard of review and the burden of proof issues.

We note at the outset that this Article is not intended to be a treatise on the duties of directors under Delaware law or advice for all practitioners on the best litigation tactic for all situations. We have made no effort to discuss all possible nuances of each topic. Given the myriad of situations and almost endless permutations, such exploration would be virtually impossible. Rather, this Article is intended to be a primer on the basic rules governing shareholder challenges to a board's decision. The ultimate goal of this Article is to enable the student and practitioner to understand the fundamentals in order to appreciate, and take advantage of, the nuances which experienced lawyers utilize to win close cases.

II. \textbf{SHAREHOLDER CHALLENGES TO BOARD BUSINESS DECISIONS—DIRECTORS' DUTIES TO THE CORPORATION AND THE BUSINESS JUDGMENT RULE}

\textbf{A. The Business Judgment Rule}

Generally, the board of directors has the sole responsibility to manage the business and affairs of a Delaware corporation.\(^10\) This

\(^7\) For a discussion of the potential liabilities of directors, see \textit{infra} notes 109-16 and accompanying text.

\(^8\) For a discussion of the derivative challenges to board action, see \textit{infra} notes 117-200 and accompanying text.

\(^9\) For a discussion of understanding the shifting litigation burdens, see \textit{infra} notes 201-71 and accompanying text.

\(^10\) \textit{Del. Code Ann. tit. 8, § 141(a)} (1974 & Supp. 1994) ("The business and affairs of every corporation organized under this chapter shall be managed by or
responsibility comes with the concomitant fiduciary obligation to protect the corporation and act in its, and its shareholders', best interest. Delaware directors owe three fundamental duties to the

under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."; see also Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993) [hereinafter Cede II] ("Our starting point is the fundamental principle of Delaware law that the business and affairs of a corporation are managed by or under the direction of its board of directors."); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1988) (holding directors have ultimate responsibility for managing business and affairs of corporation).

Although managerial discretion traditionally resides in the board of directors, § 141(a) of the Delaware General Corporation Law contemplates the ability of the shareholders to adopt a different corporate governance structure in the certificate. See Del. Code Ann. tit. 8, § 141(a) (1974 & Supp. 1994) which states:

If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by any such person or persons as shall be provided in the certificate of incorporation.

Id. In addition, if a corporation qualifies as, and elects to be, a statutory close corporation pursuant to subchapter XIV of the Delaware General Corporation Law, shareholders may displace the board of directors as the corporation’s managing body. Id. § 351 ("The certificate of incorporation of a close corporation may provide that the business of the corporation shall be managed by the stockholders of the corporation rather than by a board of directors."). In such a case, the shareholders are subject to the same duties and obligations as the board of directors. Id.

Of course, many important fundamental decisions are reserved to the shareholders and the board agreeing on a course of action. These organic decisions include fundamental corporate changes such as mergers, amendments to the certificate of incorporation and dissolution. Significantly, one of the shareholders’ sole prerogatives is the ability to elect and, in many cases, remove board members. Id. § 141(k).

11. Cede II, 634 A.2d at 360 ("[I]n managing the business and affairs of a corporation), directors are charged with an unyielding fiduciary duty to protect the interests of the corporation and to act in the best interest of its shareholders."); Levine v. Smith, 591 A.2d 194, 200 (Del. 1991) ("[T]he directors’ exercise of their managerial power in all its aspects ‘is tempered by fundamental fiduciary obligations owed by the directors to the corporation and its shareholders.’" (quoting Kaplan v. Peat, Marwick, Mitchell & Co., 540 A.2d 726, 729 (Del. 1988))); Mills, 559 A.2d at 1280 ("Not only do [the duties of care and loyalty] demand that corporate fiduciaries absolutely refrain from any act which breaches the trust reposed in them, but also to affirmatively protect and defend those interests entrusted to them."); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (concluding board of directors owes duty to protect "corporate enterprise, which includes stockholders, from harm reasonably perceived, irrespective of its source"); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (concluding directors have affirmative duty to protect financial interests and "proceed with a critical eye in assessing information"); Aronson v. Lewis, 473 A.2d 805 (Del. 1984) (declaring power to manage business and affairs of corporation "carries with it certain fundamental fiduciary obligations to the corporation and its shareholders"); Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939). In Guth, the Delaware Supreme Court concluded:

Public policy . . . has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing any-
corporation and the stockholders: the duty of care, the duty of loyalty and the duty of good faith.\textsuperscript{12}

A shareholder, dissatisfied with a board decision, can challenge the decision on the ground that the board breached one of its fiduciary duties when it made the decision. In a suit challenging a board’s decision, the shareholder may challenge the decision directly and request that the court issue an injunction preventing the board from carrying out the decision or requiring the board to make a different decision. In certain cases, the shareholder may simply seek damages against the board for harm to the corporation caused by the allegedly improper board decision.

When a shareholder challenges a board decision, two fundamental questions typically shape the controversy. First, the court must determine how closely it will scrutinize the board’s decision. This is frequently referred to as the standard of review. Second, the court must decide which party, the challenging shareholder or the board, will have the burden of proof with respect to the issues involved in reviewing the board’s decision.

Judicial concerns arose that a very stringent review of all board business decisions was too demanding and inappropriate.\textsuperscript{13} In response to these concerns, courts developed a doctrine known as the business judgment rule to give boards of directors significant pro-

\textsuperscript{12} Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1373 (Del. 1995) (discussing triad of fiduciary duties) (citing Aronson, 473 A.2d at 812 (holding directors have duty to inform themselves of all material information reasonably available and duty to act with requisite care)); Cede II, 634 A.2d at 361 (discussing triad of fiduciary duties); Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 64 (Del. 1989) (discussing relationship between business judgment rule and triad of duties); Van Gorkom, 488 A.2d at 872 (discussing director duty of care).

\textsuperscript{13} Courts and commentators have given several reasons for granting wide latitude to business judgments made by corporate directors. First, the corporate statute provides that boards, not shareholders or the courts, are empowered to manage and direct the business and affairs of corporations. Second, many of the board’s decisions involve value judgments (i.e., what businesses should a corporation pursue, what risks are acceptable, what returns are desired) which may involve complex and perhaps conflicting methods and goals. Third, because shareholders choose who their directors will be, they assume the risk that occasionally the director, acting on their behalf, may make decisions that the shareholder would not have made. Fourth, the market polices the quality of directorate choices through the stock price; good management tends to push the price of a stock higher than poor management. Fifth, portfolio diversification lessens the risks to shareholders of poor director choices. Courts and legislators recognize that one group must have the final say with respect to corporate decisions. In the Delaware corporate world, that entity is almost always the board.
tection and discretion in making business decisions. The business judgment rule provides the starting point for the appropriate standard of review and burden of proof in cases in which a shareholder challenges a board’s business decision.

The business judgment rule has both procedural and substantive aspects.15 Procedurally, it acts as an evidentiary presumption that the directors have acted in accordance with their three fundamental fiduciary duties. The Delaware courts have frequently stated that the business judgment rule is a “premise that in making a business decision, the directors of a corporation acted on an informed basis [i.e., with due care], in good faith and in the honest belief that the action taken was in the best interest of the company.”16 Thus, in litigation challenging a board’s business decision, the court initially presumes that the board fulfilled all of its fiduciary duties when it made the decision.17 From a procedural perspective, the challenging shareholder has the initial burden to

14. Cede II, 634 A.2d at 360 (“The business judgment rule] operates to preclude a court from imposing itself unreasonably on the business and affairs of a corporation.”) (citations omitted). In Cede II, the court concluded that the rule “posits a powerful presumption in favor of actions taken by the directors in that a decision made by a loyal and informed board will not be overturned by the courts unless it cannot be ‘attributed to any rational business purpose.’” Id. at 361 (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)); see Citron, 569 A.2d at 64 (concluding business judgment rule protects directors and decisions); Mills, 559 A.2d at 1279 (concluding court “should decline to evaluate the wisdom and merits of a business decision [made by the board] unless sufficient facts are alleged with particularity, or the record otherwise demonstrates, that the decision was not the product of an informed, disinterested, and independent board”); Unocal, 493 A.2d at 954 (holding court should not “substitute its judgment for that of the board” unless board failed to satisfy its fiduciary obligations); Van Gorkom, 488 A.2d at 872 (“The business judgment rule exists to promote the full and free exercise of the managerial power granted to Delaware directors.” (citing Zapata Corp. v. Maldonado, 430 A.2d 779, 782 (Del. 1981))); Sinclair Oil, 280 A.2d at 720 (“A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment.”); A.C. Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986) (suggesting business judgment rule is “a recognition of the allocation of responsibility made by § 141(a) of the General Corporation Law and of the limited institutional competence of the courts to assess business decisions”).

15. Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162 (Del. 1995) [hereinafter Cede III] (discussing substantive and procedural aspects of business judgment rule); Cede II, 634 A.2d at 360 (noting business judgment rule “operates as both a procedural guide for litigants and a substantive rule of law” (citing Citron, 569 A.2d at 64)); see also Unitrin, 651 A.2d at 1373 (discussing presumption of business judgment rule and procedure for rebutting presumption).

16. E.g., Cede II, 634 A.2d at 360 (stating business judgment rule presumes corporate directors act with due care, good faith and loyalty) (quoting Aronson, 473 A.2d at 812) (alteration in original).

17. Id. at 361 (noting business judgment rule provides powerful presumption
show that the board’s decision was not proper because the board violated one or more of its three fundamental duties to the corporation. In other words, the shareholder must rebut the business judgment rule’s presumption of propriety.

Substantively, if the business judgment rule attaches because the shareholder is unable to show that the board violated one of its duties to the corporation, the board’s decision will be upheld unless the decision is irrational.¹⁸ Since the decision is initially presumed to be proper, the burden of proof is on the shareholder to show that the decision was irrational. Thus, the business judgment rule protects a business decision made by a board from attack and protects the directors from liability for the decision unless the shareholder can rebut the business judgment rule.¹⁹

B. Duty of Care When No Business Judgment is Made

For the business judgment rule to attach, the board must actually make a business judgment involving the business affairs of the corporation. A conscious decision of the board to act or not to act constitutes a business judgment.²⁰ When the directors fail to act without making a decision or abdicate their managerial responsibilities, however, the business judgment rule does not apply because no business judgment is made.²¹ In such cases, the directors might be liable for a breach of their general duty of care. The standard of review, however, differs from cases in which the board does make a business judgment.

Delaware has no statute delineating the board’s duty of care. Instead, the courts have stated that the board’s duty of care requires that “directors . . . in managing corporate affairs are bound to use

director decisions made by loyal and informed board will not be overturned if related to rational business purpose).

¹⁸. For a discussion of rationality, see infra notes 56-64 and accompanying text.

¹⁹. E.g., Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 45 n.17 (Del. 1994) (noting where business judgment rule “is applicable and the board acted with due care, in good faith, and in honest belief that they were acting in the best interest of stockholders,” courts give great deference to director decisions); Aronson, 473 A.2d at 812 (holding absent abuse of discretion, courts respect directors’ decisions).

²⁰. E.g., Grimes v. Donald, 673 A.2d 1207, 1214 (Del. 1996) (en banc) (noting when independent and informed board acts in good faith they have made business judgment); Aronson, 473 A.2d at 813 (“[A] conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment and enjoy the protections of the rule.”).

²¹. See Aronson, 473 A.2d at 813 (stating business judgment rule has no impact where directors have “abdicated their functions, or absent a conscious decision, failed to act”).
that amount of care which ordinarily careful and prudent men would use in similar circumstances." Case law is unsettled on the degree of culpability required to impose liability. Although authority exists that liability attaches for simple negligence when the board makes no business judgment, at least one commentator has concluded that duty of care liability is imposed in such cases only if the directors were grossly negligent in failing to act.


Graham involved a derivative action claiming director liability for the board's failure to act against employee activity which violated Federal anti-trust laws. Graham, 188 A.2d at 127. Originally, the complaint alleged that the directors either knew of the activity or knew of facts that should have put them on notice of the activity violating the anti-trust laws. Id. After the court determined that there was no evidence of knowledge, the plaintiff shareholders claimed "the directors are liable as a matter of law by reason of their failure to take action designed to learn of and prevent [the illegal] activity on the part of [the company's] employees." Id. The court found that the directors were not liable for their failure to act. Id. at 131.

23. Compare 1 Balotti & Finkelstein, supra note 22, § 4.8, at 4-201 to 4-204 (1993 Supp.) (concluding gross negligence is "probably" the standard) and E. Norman Veasey & William E. Manning, Codified Standard—Safe Harbor or Uncharted Reef?: An Analysis of the Model Act Standard of Care of Corporations with Delaware Law, 35 Bus. Law. 919, 927-29 (1980) (making "educated guess" gross negligence standard but also noting distinction between ordinary and gross negligence makes little practical difference) with Rabkin, 1987 WL 28436, at *3 (finding proper standard to be ordinary negligence) and S. Samuel Arsh, Fiduciary Responsibilities of Directors, Officers & Key Employees, 4 Del. J. Corp. L. 652, 659 (1979) (reviewing standard in Graham and concluding ordinary negligence is applicable standard).

The Delaware Supreme Court has not clearly indicated whether it would apply a gross negligence or ordinary negligence standard in a nonfeasance or abdication situation. The debate arises because the ordinary person standard announced in Graham is an ordinary negligence standard. After stating the standard, the court went on to give the following examples in which it would find that the standard had not been met: "If [a director] has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him." Graham, 188 A.2d at 130. The commentators and cases which have concluded that the appropriate degree of culpability is gross negligence have focused on the examples the court in Graham used because they all involve situations that would support a gross negligence finding. On the other hand, the commentators who espouse the ordinary negligence standard focus on the ordinary prudent person standard enumerated in Graham and the fact that the examples are just that,
The liability of directors for failure to exercise proper supervision or control over corporate affairs will depend on the particular facts and circumstances of each case. The variables that the court considers in determining whether a board met the ordinary prudent person standard and should have taken action in a particular situation include: the size of the corporation, its geographical location, the number of individuals employed, the type of business engaged in, the general degree of supervision and knowledge of the board with respect to corporate matters, and the gravity and knowledge of the board concerning the specific matter that the board did not act upon.

Even assuming that a challenging shareholder establishes that the ordinary prudent person standard has not been met and the directors were negligent in failing to act, the shareholder must also prove causation and damages. Moreover, even if the challenging shareholder establishes all of the elements of a duty of care claim, section 102(b)(7) of the Delaware General Corporation Law permits a corporation to relieve its directors from any monetary liability for a breach of duty of care if the corporation's certificate of incorporation contains an exculpatory provision.

examples. Of course, the examples would also result in liability under an ordinary negligence test.

24. *Graham*, 188 A.2d at 130; Boeing Co. v. Shrontz, No. CIV.A.11273, 1992 WL 81228, at *4 (Del. Ch. Apr. 10, 1992) (stating corporate director's liability for corporate losses depends on circumstances). In *Graham*, for example, the court found that the directors were not liable for neglect of duties because the corporation employed over 30,000 people located across the country. *Graham*, 188 A.2d at 130. Because of the sheer size of the corporation, the directors could not be expected to have knowledge of every little aspect of corporate action. *Id.*


Directors are permitted to reasonably rely in good faith on information, reports and statements provided by board committees, officers, employees and experts as long as the reliance is reasonable and in good faith. Del. Code Ann. tit. 8, § 141(e) (1974 & Supp. 1994).

26. See *Cede II*, 634 A.2d 345, 370-71 (Del. 1993) (holding proof of injury is not required for breach of fiduciary duty claim, but is required for tort action of negligence).


[The certificate of incorporation may contain a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director (i) for any breach of the director's duty of loyalty to the corporation or its stockholders, (ii) for acts or omissions not in good faith or
C. Duty of Care When Business Decision is Made

As noted above, if the board makes a business judgment, the business judgment rule provides that the board is presumed to have met its fiduciary obligations when it made the decision. One of the ways a shareholder can rebut that presumption is by showing that the board breached its duty of care.

A shareholder can establish that the board violated its duty of care by showing that the business decision was made in either an uninformed or misinformed manner. In Delaware, the duty of care requirement focuses on the procedure that the board followed in reaching its decision. Specifically, the board’s duty of care requires that the board obtain all material information reasonably available to it when making the decision.

In Delaware, mere negligence does not rebut the business judgment rule presumption that the board adequately informed itself (acted with due care) before making the business decision. The Delaware courts have determined that gross negligence of the board must be established in order for a shareholder to rebut the business judgment rule based on a breach of the duty of care. Thus, to rebut the business judgment rule’s presumption, a challenging shareholder must establish that the board was grossly negligent in failing to obtain, or give due consideration to, all material information reasonably available to it concerning the decision.

which involve intentional misconduct or a knowing violation of law, (iii) under section 174 of this Title, or (iv) for any transaction from which the director derived an improper personal benefit.

Id. For a further analysis of § 102(b)(7), see infra notes 103-105.

28. Cede II, 634 A.2d at 369-70 (holding duty of care element of business judgment rule formed by duty of directors to act on informed basis); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (holding challenger may rebut business judgment rule by showing business judgment was uninformed); Aronson v. Lewis, 473 A.2d 805, 812 (holding challenger may rebut business judgment rule by showing directors did not inform themselves of all material information reasonably available).

29. Cede II, 634 A.2d at 367 (holding directors have duty to inform themselves of all material information reasonably available) (citing Aronson, 473 A.2d at 812); Van Gorkom, 488 A.2d at 872.

30. Tomczak v. Morton Thiokol, Inc., No. CIV.A.7861, 1990 WL 42607, at *12 (Del. Ch. Apr. 5, 1990) (“In the corporate context, gross negligence means ‘reckless indifference to or a deliberate disregard of the whole body of stockholders’ or actions which are ‘without the bounds of reason.’” (quoting Allaun v. Consolidated Oil Co., 147 A. 257, 261 (Del. Ch. 1929); Gimbel v. Signal Companies, Inc., 316 A.2d 599, 615 (Del. Ch.), aff’d, 316 A.2d 619 (Del. 1974)); Van Gorkom, 488 A.2d at 873 (holding gross negligence is proper standard for determining whether directors meet duty of care); Aronson, 472 A.2d at 812 (holding appropriate standard is gross negligence).

31. Van Gorkom, 488 A.2d at 872 (holding challenging party must rebut pre-
The leading case in which the challenging shareholder overcame the business judgment rule’s presumption that the directors acted with due care is Smith v. Van Gorkom.32 In Van Gorkom, the Supreme Court of Delaware found that the directors were grossly negligent because they did not adequately inform themselves of all the material information surrounding the sale of their company to a third party.33

D. Duty of Loyalty

Another way in which a challenging shareholder can rebut the presumption of informed business judgment); Aronson, 473 A.2d at 812 (holding burden of establishing facts to rebut presumption is on challenger).

32. 488 A.2d 858 (Del. 1985).

33. Id. The facts of Van Gorkom center around Trans Union, a diversified holding company whose railcar leasing business generated an annual cash flow of hundreds of millions of dollars. Id. at 864. Trans Union, however, “had difficulty in generating sufficient taxable income to offset increasingly large investment tax credits (ITCs).” Id. Trans Union’s Board was comprised of outside directors with extremely impressive backgrounds and inside directors with many years of experience. Id. at 880 n.21. Jerome W. Van Gorkom, Trans Union’s Chairman and Chief Executive Officer, decided that a leveraged buy-out was a possible solution to its tax credit problem. Id. at 865.

Van Gorkom met with Jay Pritzker, a “well-known corporate takeover specialist” to discuss the leveraged buy-out of Trans Union. Id. at 866. Van Gorkom proposed a price of $55 per share to Pritzker. Id. The court noted that “the record is devoid of any competent evidence that $55 per share represented the per share intrinsic value of the Company.” Id. Pritzker was interested in the proposal. Id. at 867.

Although senior management reacted negatively to the proposal, Van Gorkom took the proposal to a Special Meeting of the Trans Union board during which he gave a 20 minute oral presentation on the proposed merger. Id. at 867-68. According to the court, “[c]opies of the proposed Merger Agreement were delivered too late for study before or during the meeting.” Id. at 868. Furthermore, the court stated that “Van Gorkom did not disclose to the Board . . . the methodology by which he alone had arrived at the $55 figure.” Id. Attorney James Brennan advised the Board that “they might be sued if they failed to accept the offer and that a fairness opinion was not required as a matter of law.” Id. Trans Union’s Chief Financial Officer, Donald Romans, told the Board among other things, “that his studies did not indicate either a fair price for the stock or a valuation of the Company.” Id. at 868-69. Trans Union’s President, Bruce Chelberg, “supported Van Gorkom’s presentation and representations.” Id. at 869.

After a two hour meeting, and “[b]ased solely upon Van Gorkom’s oral presentation, Chelberg’s supporting representations, Romans’ oral statement, Brennan’s legal advice, and their knowledge of the market history of the Company’s stock,” the directors approved the proposed Merger Agreement. Id.

The court found that the board breached their duty of care. The majority decision brought a scathing dissent. The corporate bar’s reaction to the decision was unfavorable. Bayless Manning, Reflections and Practical Tips on Life in the Boardroom After Van Gorkom, 41 Bus. Law. 1 (1985). Ultimately, the Delaware legislature responded to the decision by permitting corporations to have a provision in their certificate which limits the monetary liability of directors for breaches of the duty of care. Id.
business judgment rule is by showing that the board breached its duty of loyalty. The duty of loyalty component of the business judgment rule presumes that the board members who made the challenged decision had no conflict of interest that would affect their ability to make a decision in the best interests of the corporation. The Delaware Supreme Court has carefully scrutinized situations that involve potential conflicts of interest and has admonished that:

"Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. . . . A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there be no conflict between duty and self-interest." 34

Delaware courts will not find a violation of the duty of loyalty if at least a majority of the board is independent and disinterested. 35 Because the business judgment rule creates an initial presumption that the board's decision is proper and the board had no duty of loyalty problem, the burden is on the shareholder to establish that a majority of the directors were interested or not independent. A director is not independent if the director's decisions are based on any material considerations or influences other than the merits of the decision to the corporation. 36 A director is interested in a


36. Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1375 (Del. 1995) (stating director acts independently when judgment based on merits to corpora-
transaction if the director stands on both sides of the transaction or derives a material personal financial benefit from it that is not shared by the corporation or its stockholders.37

One of the common situations in which challenging shareholders are able to rebut the business judgment rule based on director interest occurs when the board member (or a controlling shareholder) stands on both sides of the transaction.38 In that situation, the directors or the controlling shareholders are essentially negotiating with themselves. Interested director transactions39 and parent/subsidiary mergers exemplify this type of transaction.40

A challenging party can also rebut the business judgment rule based on a duty of loyalty problem by showing that a director receives a substantial personal benefit from the transaction not received by the shareholders as a group.41 Other types of situations

37. *Cede II*, 634 A.2d at 362 (“Classic examples of director self-interest in a business transaction involve either a director appearing on both sides of a transaction or a director receiving a personal benefit from a transaction not received by the shareholders generally.”); *see also Nixon*, 626 A.2d at 1375 (holding director on both sides of transaction violated duty of loyalty); *Aronson*, 473 A.2d at 812 (holding director is interested if on both sides of transaction); *Weinberger*, 457 A.2d at 710 (holding director on both sides of transaction breaches duty of loyalty); *Sterling* v. *Mayflower Hotel Corp.*, 99 A.2d 107, 110 (Del. 1952) (same).

38. For a further discussion of director interestedness, see *supra* note 37 and accompanying text.

39. Section 144 of the Delaware General Corporation Law defines an interested director transaction as a “contract or transaction between a corporation and one or more of its directors . . . or between a corporation and any other corporation, partnership, association, or other organization in which one or more of its directors . . . are directors or officers, or have a financial interest.” Del. Code Ann. tit. 8, § 144 (1974 & Supp. 1994).


41. *Cede II*, 634 A.2d at 362; *see Nixon*, 626 A.2d at 1375 (“I find it inherently unfair for [the directors] to be purchasing key man life insurance in order to provide liquidity for themselves while providing no method by which [shareholders] may liquidate their stock at fair value.” (citation omitted)); *Gilbert* v. *El Paso Co.*, 575 A.2d 1191, 1146 (Del. 1990) (concluding board members did not “receive any special benefit which was not also extended to all shareholders”); *Aronson*, 473
which could also substantiate a finding of a disqualifying self-interest (i.e., disloyalty) include entrenchment motives and the selling of one's vote.\textsuperscript{42}

Recently, the Delaware Supreme Court held that a director's self-interest must be material or substantial in order to disqualify that director on the basis of disloyalty.\textsuperscript{43} In ascertaining whether a director's interest is material, the Delaware Supreme Court unequivocally rejected an objective reasonable person standard and approved a subjective actual person standard.\textsuperscript{44} The reasonable person standard asks whether a reasonable person would have been affected by the conflict. Under the subjective actual person standard adopted by the Delaware Supreme Court, the question becomes whether the director making the decision was, in fact, affected by the demonstrated conflict.\textsuperscript{45}

In short, there must be a form of self-interest which is material or substantial enough to actually affect the judgment of the board member and cause that board member to vote differently from the way a disinterested director would have voted. The business judgment rule will be rebutted if the challenging party establishes that at least a majority of the board making the decision had an actual disqualifying self-interest.

\textsuperscript{42} \textit{Cede II}, 634 A.2d at 362 (stating self-interest exists when directors receive personal benefit from transaction not received by shareholders).

\textsuperscript{43} \textit{Id.} at 363-66 (stating to show interest, shareholder must meet two-part test).

\textsuperscript{44} \textit{Cede III}, 663 A.2d 1156, 1167 (Del. 1995) (adopting "actual person" standard); \textit{Cede II}, 634 A.2d at 364 (rejecting "reasonable person" standard).

\textsuperscript{45} \textit{Cede III}, 663 A.2d at 1167. The Chancellor in \textit{Cede III} (affirmed by the Delaware Supreme Court) indicated that the test would be whether the director was or would likely be affected by the evidence of self-interest in such a way that the director with the self-interest behaved differently than a reasonable (i.e., disinterested and independent) director would have acted. \textit{Id.} (citing Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1151 (Del. Ch. 1994), aff'd, 663 A.2d 1156 (Del. 1995)). The Chancellor noted that, in his opinion, a decision that a director was not disloyal under a reasonable person standard normally would lead to the same result if a subjective actual person standard was used. \textit{Id.} at 1168 n.22. According to the Court of Chancery, "if a judge employing a reasonable person standard concluded that in fact a director's judgment was affected by a factor or interest that would not have affected a reasonable person, it would be surprising if he would conclude that nevertheless there was no material conflict." \textit{Id.} (citing Cinerama, 663 A.2d at 1152).
A disqualifying self-interest on the part of one or more directors, but less than a majority of the board, does not automatically rebut the business judgment rule's presumption of board loyalty.46 If the challenging party establishes an actual disqualifying self-interest in at least one, but less than a majority of directors, the business judgment rule can still be rebutted. Such rebuttal is possible only if the challenging party shows that the interested director "controls or dominates the board as a whole or [that] the interested director failed to disclose his interest in the transaction to the board and a reasonable board member would have regarded the existence of the material interest as a significant fact in the evaluation of the proposed transaction."47 This test requires a fact-intensive analysis of the control or domination exerted by the interested director or the materiality of that director's failure to disclose his interest on the board's decision.48

To summarize, the business judgment rule presumes and protects a decision made by an informed, neutral board. The business judgment rule is rebutted when the board is neither neutral nor properly informed. The board is considered not to be neutral if: (1) a majority of the board is interested; (2) a majority of the board is affected by another director's or controlling shareholder's self-interest; (3) a majority of the board is dominated by an interested director or controlling shareholder; or (4) an interested director manipulates the decision-making process by failing to disclose material information to an otherwise disinterested majority of the board.49

46. Code III, 663 A.2d at 1170 (holding approval by disinterested or independent board subjects decision to business judgment rule in light of duty of loyalty); Code II, 634 A.2d at 364 (rejecting contention that less than majority of board found to be interested, without evidence of disloyalty, is sufficient to rebut business judgment rule).

47. Code III, 663 A.2d at 1168 (quoting Cinerama, 663 A.2d at 1153).

48. Code II, 634 A.2d at 364 ("We agree with defendants that the question of when director self-interest translates into board disloyalty is a fact-dominated question, the answer to which will necessarily vary from case to case."); see Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 64 (Del. 1989) (concluding issue of whether board's decision was protected by business judgment rule is fact-dominated).

49. Code III, 663 A.2d at 1170 n.25 (citations omitted); see Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 42 n.9 (Del. 1994) (concluding if majority of directors are interested, board is not neutral decision-making body); Heineman v. Datapoint Corp., 611 A.2d 950, 955 (Del. 1992) (stating if interested director dominates majority of board, board is not sufficiently "independent"); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1279 (Del. 1989) (concluding courts should refrain from reviewing "the wisdom and merits of a business decision unless ... the decision was not the product of an informed, disinterested, and independent board"); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (com-
E. Duty of Good Faith

The business judgment rule presumes that directors act in good faith. Another way in which a challenging shareholder can rebut the business judgment rule is by showing that the board did not act in good faith.

Although courts frequently state that good faith is required for a board to benefit from the protection of the business judgment rule and plaintiffs often plead a lack of good faith, very few reported decisions discuss what constitutes good faith. One reason for the dearth of decisions is that the good faith requirement often overlaps with the fiduciary duties of loyalty and due care. In cases where the duties overlap, the courts are usually inclined to rely upon the well-defined duties of care and loyalty rather than the more amorphous concept of good faith.

A decision is made in good faith if it was made "in the honest belief that the action taken was in the best interests of the company." Over time, courts have given meaning to the concept of good faith primarily by discussing the type of conduct that constitutes bad faith. For example, bad faith exists "where the decision is so beyond the bounds of reasonable judgment that it seems essentially inexplicable on any [other] ground." Courts also have noted that bad faith could exist if the board had an improper mental state or an improper motive, such as entrenchment.

menting protection under business judgment rule requires disinterested and informed board of directors).

50. Aronson, 473 A.2d at 812 (noting presumption that directors act in good faith when making business decisions); see also Cede III, 663 A.2d at 1159 (holding that in order for shareholder to rebut business judgment rule presumption, shareholder has burden to show breach of good faith); Unitrin v. American Gen. Corp., 651 A.2d 1361, 1373 (Del. 1993) (stating presumption stands unless bad faith); Citron, 569 A.2d at 64 (stating "presumption initially attaches to a director-approved transaction within a board’s conferred or apparent authority in the absence of any evidence of 'fraud, bad faith or selfdealing in the usual sense of personal profit or betterment'” (quoting Growbow v. Perot, 539 A.2d 180, 187 (Del. 1988)); Arsh, supra note 23, at 660 (stating business judgment rule will not attach if "directors' authorization of the transaction was not in good faith").

51. Aronson, 473 A.2d at 812 (stating business judgment rule presumes directors acted “in good faith and in the honest belief that the action taken was in the best interests of the company”) (citing Kaplan v. Centex Corp., 284 A.2d 119, 124 (Del. Ch. 1971); Robinson v. Pittsburgh Oil Refinery Corp., 126 A. 26 (Del. Ch. 1924)); Block et al., supra note 22, at 36 (“[G]ood faith . . . requires conduct . . . 'in the honest belief that the action taken was in the best interests of the company.’” (quoting Aronson, 473 A.2d 805, 812 (Del. 1984)));


53. Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, 624 A.2d
Courts have also found fraudulent conduct, misconduct, abuse of discretion and gross negligence to constitute bad faith. Recently, the Delaware Supreme Court held that bad faith focuses on the state of mind of the actor, observing: "[B]ad faith . . . implies the conscious doing of a wrong because of dishonest purpose or moral obliquity: . . . it contemplates a state of mind affirmatively operating with furtive design or will."

F. Rational Business Purpose

If the business judgment rule is applicable and has not been rebutted, the board's decisions "will not be disturbed if they can be attributed to any rational business purpose." The rational business purpose test enables a shareholder to successfully challenge a board's decision, when the directors acted with good faith, due care and loyalty, but had no rational business purpose. The shareholders challenging the decision have the burden of showing an irrational business purpose. This burden can be met by showing

1199, 1208 (Del. 1993) (defining bad faith by "party's tortious state of mind"); Guth v. Loft, 5 A.2d 503, 510 (Del. 1939) (stating self-interest is violation of good faith requirement); see also Cheff v. Mathes, 199 A.2d 548, 556 (Del. 1964) (stating presumption of good faith rebutted by improper motive to retain control).

54. See Barkan v. Armstead Indus., 567 A.2d 1279, 1288 (Del. 1989) (holding good faith is belief board acted in best interests of corporation); In re J.P. Stevens & Co. Shareholders Litig., 542 A.2d 770, 780-81 (Del. Ch. 1988) (holding bad faith is "judgment that seems essentially inexplicable on any ground other than bad faith").

55. Desert Equities, 624 A.2d at 1199 n.16 (citing BLACK'S LAW DICTIONARY 72 (5th ed. 1983)).

56. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 719 (Del. 1971) (citing Unocal Corp. v. Mesa Petroleum Co., 453 A.2d 954 (Del. 1983)); see also In re Unitrin, Inc. Shareholders Litig., 651 A.2d 1361, 1374 (Del. 1995) (holding business judgment rule shields directors from personal liability where court concludes decision based on rational business purpose); Cede II, 634 A.2d 945, 961 (Del. 1993) ("The [business judgment rule] poses a powerful presumption in favor of actions taken by the directors in that a decision made by a loyal and informed board will not be overturned by the courts unless it cannot be 'attributed to any rational business purpose.'" (quoting Sinclair, 280 A.2d at 720)); Levine v. Smith, 591 A.2d 194, 207 (Del. 1991) (stating where rational business purpose exists, courts will not substitute their judgment for board's).

57. A. Gilchrist Sparks, III, Fiduciary Obligations in the Corporate Boardroom: Recent Developments in Substantive Business Judgment Rule, 61 N.C. L. REV. 534, 587-88 (1983) (holding rational basis requirement "is designed to take care of the occasional outrageous corporate decision that somehow meets all the other criteria of the business judgment rule"); E. Norman Veasey, Duty of Loyalty: The Criticality of the Counselor's Role, 45 BUS. LAW. 2065, 2071 (1990) (equating egregious decision or gross abuse of discretion with irrational business purpose); see also Welch & Turezyn, supra note 41, § 141.26 (1996) (stating court can review business decision to determine if decision is so far beyond reasonable judgment that cannot be explained except by bad faith).

58. Williams v. Geier, 671 A.2d 1368, 1384 (Del. 1996) (stating presumption
that the decision is based on fraud, abuse of discretion, waste or impropriety. 59

Bad faith and lack of rational purpose overlap with the concepts of waste and corporate gift. 60 A claim of waste will be upheld only if the shareholder shows that "the consideration received by the corporation was so inadequate that no person of ordinary sound business judgment would deem it worth the consideration the corporation paid." 61 A shareholder makes a successful gift claim if the board transfers assets of the corporation and receives no benefit in return or the transfer was made for an improper purpose. 62 When the business judgment rule presumption of a valid board action attaches to a challenged transaction, the court will invalidate the action upon a finding of waste or excessive gift just as it would for irrationality. 63 In fact, we know of no case that applies

stands unless shareholder can prove burden that transaction is not based on rational business purpose).

59. Schreiber v. Pennzoil Co., 419 A.2d 952, 956 (Del. Ch. 1980); 1 BALOTTI & FINKELSTEIN, supra note 22, § 4.7, at 4-57 (stating liability for irrational business decisions can be based on bad faith, abuse of discretion, illegality or lack of rational business purpose); see also Grobow v. Perot, 539 A.2d 180, 189 (Del. 1988) (noting absent fraud or unfairness, business judgment rule applies).

60. Steiner v. Meyerson, No. CIV.A.18139, 1995 WL 441999, at *5 (Del. Ch. July 19, 1995) (mem.). According to the court in Steiner, the waste theory represents a theoretical [situation] very rarely encountered in the world of real transactions. There surely are cases of fraud; of unfair self-dealing and, much more rarely negligence. But rarest of all . . . [and] possibly non-existent would be the case of disinterested business people making non-fraudulent deals (non-negligently) that meet the legal standard of waste.

Id.


The second prong of Aronson addresses the circumstance where a majority of the directors, although disinterested and independent, nonetheless approve a transaction that may not merit the protection of the business judgment rule, either because (a) the directors acted without appropriate due care, or (b) the transaction, on its face, appears to be so egregious or "unsound" as to create a reasonable doubt that the business judgment rule's protective presumptions apply. In this case the plaintiff does not contend that the directors acted without due care; rather, his claim is that the revised exchange offer . . . [is] corporate waste.

Id. (Citations omitted).

62. Michelson v. Duncan, 407 A.2d 211 (Del. 1979) (stating gift is lack of consideration; waste is diversion of corporate assets for improper or unnecessary purpose).

63. Grimes v. Donald, 673 A.2d 1207, 1214 (Del. 1996) (en banc) ("[A business] judgment normally will receive the protection of the business judgment rule unless the facts show that such amounts . . . constitute waste or could not otherwise be the product of a valid exercise of business judgment." (citing Saxe, 184 A.2d at 610)); Citron v. E.I. DuPont de Nemours & Co., 584 A.2d 490, 501 (Del. Ch. 1990)
the rationality standard to overrule a board decision unless gift, waste or lack of good faith was found.64

III. EFFECT OF THE BUSINESS JUDGMENT RULE ON THE STANDARD OF REVIEW AND THE BURDEN OF PROOF

As noted above, the shareholder challenging a business decision made by the board has the initial burden of rebutting the business judgment rule's presumption of valid board action. In order to rebut the business judgment rule presumption, the challenging shareholder will, depending on the procedural posture of the case, present evidence or plead facts that could support the conclusion that the directors have violated one or more of the three fundamental fiduciary duties.65

If the challenging shareholder is unable to rebut the business judgment rule because he fails to present persuasive facts that the board breached any of its three primary fiduciary duties, then the substantive component of the business judgment rule provides that the business judgment is protected unless it was not rational.66 The challenging party has the extremely difficult burden of showing that the board's decision was irrational.

On the other hand, if the shareholder presents evidence that the directors breached any one of the three fundamental fiduciary

(Stating where business judgment rule attaches, judicial review is limited to issues of waste or gift) (citing Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987)).

64. As the Delaware Supreme Court recently stated:

It is to be remembered that, in cases where the business judgment rule is applicable and the board acted with due care, in good faith, and in the honest belief that they are acting in the best interests of the stockholders . . . the Court gives great deference to the substance of the directors' decision and will not invalidate the decision, will not examine its reasonableness, and will not substitute our views for those of the board if the latter's decision can be attributed to any rational business purpose. Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 45 (Del. 1994) (citing Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 949 (Del. 1985) (citations omitted)).

65. Code II, 634 A.2d 345, 361 (Del. 1993) ("To rebut the rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty—good faith, loyalty or due care."); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (stating "the party attacking a board decision as uninformed must rebut the presumption that its business judgment was an informed one"); see Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 64 (Del. Ch. 1988) (concluding burden rests with claimant to rebut presumption through evidence of director self-interest, lack of good faith or failure to exercise due care) (citing Van Gorkom, 488 A.2d at 872).

66. For a discussion of the rational business purpose test, see supra notes 56-64 and accompanying text.
duties, the business judgment rule is rebutted and no longer protects the board’s decision from close scrutiny. Rebutting the business judgment rule, however, does not per se invalidate the decision or result in automatic board liability. Rather, rebutting the business judgment rule shifts the burden of proof to the directors. It also changes the standard of review to a higher level of judicial scrutiny in which the directors have the burden of establishing that the challenged transaction was entirely fair to the corporation.

The Delaware Supreme Court has defined what constitutes entire fairness:

The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces 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. The latter aspect of fairness relates to 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. However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness. However, in a non-fraudulent transaction we recognize that price may be the preponderant consideration outweighing other features of the merger.

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67. Cede III, 663 A.2d 1156, 1162 (Del. 1995) (holding burden shifting does not create per se liability on defendant directors); Cede II, 634 A.2d at 371 (same).

68. Cede III, 663 A.2d at 1162 (holding where plaintiffs rebut business judgment rule, directors must prove “entire fairness”); Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1371 n.7 (Del. 1995) (noting entire fairness applies when business judgment rule rebutted); Cede II, 634 A.2d at 361 (same); Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993) (holding where plaintiffs rebut business judgment rule, director’s actions are reviewed under “entire fairness” standard); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1988) (stating interested directors must show entire fairness of transaction); Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (holding when directors are on both sides of transaction they must show “their utmost good faith and the most scrupulous inherent fairness of the bargain”).

69. Weinberger, 457 A.2d at 710. If the contested transaction involves the sale of the company, the “fair price” element of the entire fairness standard “requires the board of directors to demonstrate ‘that the price offered was the highest value reasonably available under the circumstances.’” Cede III, 663 A.2d at 1163 (quoting Cede II, 634 A.2d at 361).
The fair dealing component of the entire fairness inquiry incorporates the board’s duty of care. In evaluating whether the board has dealt fairly with the corporation, the procedure that the directors followed in making the challenged decision is very important. The court reviews whether the board manipulated the timing of the transaction for its own benefit and not solely for the stockholders’ benefit.\(^7\) Further, the court considers whether there was any unfairness in the manner in which the transaction was initiated or negotiated.\(^7\) The Delaware Supreme Court has indicated that if the negotiation of the transaction is conducted by an independent negotiator, such as an independent committee, this is a significant indication that the transaction was entirely fair.\(^7\)

Even though the challenging shareholder, in rebutting the business judgment rule, has established that at least one of the three fundamental duties has been breached, each of the discrete duties “retains independent substantive significance” in the entire fairness analysis.\(^7\) It is possible that a board can breach one or more of its duties and still demonstrate entire fairness; perfection is not required.\(^7\) In deciding whether the board has met its burden

\(^7\) *Cede III*, 663 A.2d at 1172. The court concluded that “the case sub judice is not similar to one in which a fiduciary manipulated the timing of a transaction to benefit itself at the stockholder’s expense.” *Id.; see* Rabkin v. Philip A. Hunt Chemical Corp., 498 A.2d 1099, 1105 (Del. 1985) (noting trial court accepted plaintiff’s contention that majority stockholder “breached its fiduciary duty of fair dealing by purposely timing the merger, and thereby unfairly manipulating it”); *Weinberger*, 457 A.2d at 711 (concluding concept of fair dealing “embraces 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”) (emphasis added); *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 599 (Del. Ch. 1986) (holding merger transaction “was pursued and authorized by the MGM Grand board at this time because it suited [defendant’s] plans and . . . not because the board determined that this was a particularly propitious moment to sell the Company”).

\(^7\) *Cede III*, 663 A.2d at 1172 (stating fair dealing aspect requires court to examine how transaction was initiated and negotiated); *Weinberger*, 457 A.2d at 711 (same).

\(^7\) *Cede III*, 663 A.2d at 1172 (holding arm’s-length negotiation is strong evidence of entire fairness); *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 937-38 (Del. 1985) (same); *Weinberger*, 457 A.2d at 712 (concluding that approval by majority of minority was meaningless because, among other things, minority was unaware of rushed timetable for ensuing transaction).

\(^7\) *Cede III*, 663 A.2d at 1164 (footnote omitted).

\(^7\) *Id.* at 1165. In *Cede III*, the court noted:

[S]ince the evidence that defeated the procedural presumption of the business judgment rule does not establish liability per se, a substantive finding of entire fairness is only possible after examining and balancing the nature of the duty or duties the board breached vis-a-vis the manner in which the board properly discharged its other fiduciary duties.

*Id.* (emphasis added). If perfection were the standard, then rebutting the busi-
of entire fairness, the court balances the breach or breaches committed by the board with the manner in which the board properly performed its other duties. In reaching a conclusion on whether the board acted with entire fairness, the court takes into account both what the board did right and what it did wrong.

If the board does not meet its burden to show that the transaction was entirely fair, then the shareholder still must establish causation and damages. Damages are not necessarily limited to the difference between what the corporation received and what the corporation would have received if the board had not breached its fiduciary duties. The court has the power to award all types of equitable relief including rescissory damages. Moreover, if the

ness judgment rule would lead to per se liability since by definition the challenging party established that the board violated at least one of the three fundamental duties. Such a finding would of course preclude a finding of perfection. Cede III and other cases make it absolutely clear that one or more of the duties can be breached in a manner which rebuts the business judgment rule and the directors can still meet their burden of entire fairness by a showing that even giving due consideration to the established breach, the cumulative actions of the board justify a finding of entire fairness. Id. at 1180. Such was the case in Cede III itself where even though the board violated its duty of care, which had the effect of rebutting the business judgment rule and shifting the burden on the directors to prove entire fairness, the court ultimately found that the directors had met their burden of showing entire fairness. Id.

75. Cede II, 634 A.2d 345, 371 (Del. 1993). The court in Cede II made it clear that causation and damages are considered only after the liability of the board is determined when it declared that the Court of Chancery “committed fundamental error” in "inject[ing] into the duty of care element a burden of proof of resultant injury or loss.” Id. In other words, causation and damages are irrelevant as to whether the business judgment rule has been rebutted or even strictly speaking whether the transaction was entirely fair to the corporation. Id. The Supreme Court observed that: “This Court has consistently held that the breach of duty of care, without any requirement of proof of injury, is sufficient to rebut the business judgment rule.” Id. (emphasis added); see Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1267, 1280-81 (Del. 1988) (concluding any breach of fiduciary duty, “standing alone,” defeats standard of fairness); Smith v. Van Gorkom, 488 A.2d 858, 893 (Del. 1985) (suggesting proof of breach of duty of care was enough to rebut presumption of business judgment rule).

76. Cede II, 634 A.2d at 371 (concluding “the measure of any recoverable loss by Cinerama under an entire fairness standard of review is not necessarily limited to the difference between the price offered and the ‘true’ value as determined under appraisal proceedings”). According to the Delaware Supreme Court, out of pocket or benefit of the bargain losses are not the only form of equitable relief. See Weinberger, 457 A.2d at 714 (holding “the Chancellor’s powers are complete to fashion any form of equitable and monetary relief as may be appropriate, including rescissory damages”). In Cede II, the court concluded that rescissory damages can be incorporated into a fair price calculation if the elements are: “(1) susceptible to proof; and (2) appropriate under the circumstances [of the case].” Cede II, 634 A.2d at 371 (citing Weinberger, 457 A.2d at 714); Lynch v. Vickers Energy Corp., 429 A.2d 497, 501-02 (Del. 1981). The court in Lynch stated:

On the present state of affairs, we conclude that a fair result can be accomplished without interfering with the present corporate structure
corporation's certificate contains a provision which complies with section 102(b)(7) of the Delaware General Corporation Law eliminating the board's liability for breaches of the duty of care, the challenging shareholder will not be able to recover damages for duty of care breaches.\(^77\)

The Delaware Supreme Court has recognized that "[b]ecause the effect of the proper invocation of the business judgment rule is so powerful and the standard of entire fairness so exacting, the determination of the appropriate standard of judicial review frequently is determinative of the outcome of [the] litigation."\(^78\) Consequently, if the challenging party is unable to rebut the business judgment rule, the challenging party will most likely lose because it will be extremely difficult for him to prove that the board's decision cannot be attributable to any rational business purpose. If the challenging party is successful in rebutting the business judgment rule, however, the challenging party will most likely win the liability portion of the case because the board usually will not be able to meet the onerous burden of establishing that its decision was entirely fair. If the board meets its burden and demonstrates that the decision it made was entirely fair to the corporation, then injunctive relief will be denied and the directors will not be liable.

IV. LIABILITY FOR LACK OF DISCLOSURE

When seeking stockholder action, directors and controlling shareholders\(^79\) owe a fiduciary obligation to disclose all material facts known to them.\(^80\) This duty of disclosure is derived from the

through a rescission order. That can be accomplished by ordering damages which are the monetary equivalent of rescission and which will, in effect, equal the increment in value that Vickers enjoyed as a result of acquiring and holding Trans Ocean stock in issue. That is consistent with the basis for liability which is the law of the case, and it is a norm applied when the equitable remedy of rescission is impractical. . . . "[R]ecision [sic] calls for cancellation of the bargain, and the return of the parties to the status quo ante, where this is impossible because of the disposal or retirement of the stock, then equivalent value of the stock at the time of resale or at the time of judgment, should be the proper measure of damages." 

\(\text{Id. at 501-02 (quoting Myzel v. Fields, 386 F.2d 718, 742 (8th Cir. 1967)).}\)

\(^{77}\) For a discussion of board liability, see supra notes 67-76, infra notes 98-108 and accompanying text.

\(^{78}\) \textit{Cede III}, 663 A.2d at 1163 n.8 (citing \textit{Mills}, 559 A.2d at 1279 (quoting AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986))).

\(^{79}\) For a discussion of what constitutes a controlling shareholder, see infra section V.

\(^{80}\) \textit{In re} Santa Fe Pac. Corp. Shareholder Litig., 669 A.2d 59, 66 (Del. 1995)
primary duties of care and loyalty.

The failure of the board to disclose all material facts when it seeks shareholder approval may constitute either a breach of the duty of care or the duty of loyalty. It will be a breach of the duty of loyalty only when the failure to disclose occurs in a transaction that would otherwise be subject to an entire fairness standard of review because of duty of loyalty violations. In a transaction where duty of loyalty problems are implicated, the duty to disclose is an element of the fair dealing prong of the entire fairness standard. In a transaction which is not subject to an entire fairness analysis, failure to disclose is a breach of the board's duty of care.

In order for a breach of the duty of disclosure to occur, the alleged omission or misrepresentation must be material.81 The definition of "materiality" in Delaware is well-settled. In Rosenblatt v. Getty Oil Co.,82 the Delaware Supreme Court adopted the standard for materiality previously used by the United States Supreme Court in TSC Industries Inc. v. Northway, Inc.,83 a case involving securities fraud claims brought under section 10(b) and Rule 10(b)(5) of the Securities Exchange Act of 1934. In TSC Industries, the United States Supreme Court defined materiality as follows:

An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . What the standard [contemplates] is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must

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81. In re Santa Fe, 669 A.2d at 66; Arnold, 650 A.2d at 1277 (citing Stroud, 606 A.2d at 84); Shell, 606 A.2d at 114.
82. 493 A.2d 929 (Del. 1985).
be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.\textsuperscript{84}

When determining whether an omission or misrepresentation is material, Delaware courts decide whether the information would be material from the perspective of a reasonable stockholder.\textsuperscript{85}

Directors and controlling stockholders must fully disclose all the material facts they know and supplement previously disclosed information if the board thereafter learns of new material facts after the prior disclosure.\textsuperscript{86} The board, however, is not required to disclose every material fact to stockholders in all situations.\textsuperscript{87} Facts that are generally known to shareholders need not be specifically

\textsuperscript{84} Id. at 449. See also Lynch Communications' Sys., 669 A.2d at 88 (noting TSC Industries/Rosenblatt standard); In re Santa Fe, 669 A.2d at 66 (same); Arnold, 650 A.2d at 1277 (same); Zirn, 621 A.2d at 778-79 (same).

\textsuperscript{85} Lynch Communications Sys., 669 A.2d at 88 (holding materiality is objective standard); Arnold, 650 A.2d at 1277 (citing Zirn, 621 A.2d at 779 (noting reasonable shareholder is appropriate standard)); Shell, 606 at 114 (holding proper standard determined from viewpoint of reasonable shareholder). This requirement follows from the materiality test developed in TSC Industries, which focuses on whether the omission of material information would have substantially affected the reasonable shareholder's decision-making abilities. TSC Indus., 426 U.S. at 449. The question is not whether the information would actually change the shareholder's decision, but whether the information would be relevant to him or her. E.g., Arnold, 650 A.2d at 1277 ("Courts should not assess the qualitative importance of a particular item.") (citations omitted); Zirn, 621 A.2d at 779; Shell, 606 A.2d at 114 ("While it need not be shown that an omission or distortion would have made an investor change his overall view of a proposed transaction, it must be shown that the fact in question would have been relevant to him." (quoting Barkan v. Amsted Indus., 567 A.2d 1279, 1289 (Del. 1989))).

The court has found several types of omissions to be material. Arnold, 650 A.2d at 1281 (holding omission of genuine auction bid in relaying of history of merger negotiation is material); Shell, 606 A.2d at 115 (holding cash flow under-statement of one billion dollars from oil reserves is material omission); Lynch v. Vickers Energy Corp., 383 A.2d 278, 281 (Del. 1978) (holding ceiling price and ceiling asset value material). Conversely, the court has found other omissions to be immaterial. In re Santa Fe, 669 A.2d at 66 (holding omission of board's zeal in negotiating transaction and information comparing and contrasting merger to hypothetical immaterial); Arnold, 650 A.2d at 1282 (holding investment advisor's forecasted value, based on uncertain variables, need not be disclosed because too speculative to be material); Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 847 (Del. 1987) (holding absent actual agreement omissions of corporation's efforts to arrange mergers are immaterial); Michelson v. Duncan, 407 A.2d 211, 222 (Del. 1979) (holding alleged terms and intent of stock option plan immaterial).

\textsuperscript{86} Arnold, 650 A.2d at 1276, 1280 (holding once directors made partial disclosure, "they had an obligation to provide . . . an accurate, full, and fair characterization . . . of events") (citations omitted).

disclosed.\textsuperscript{88} In addition, a board may withhold material information that could mislead a shareholder.\textsuperscript{89} When withholding information on this basis, directors are required to carefully balance the benefits that would be gained from disclosure against the harm it could cause.\textsuperscript{90} Directors also have no obligation to speculate about the future\textsuperscript{91} or engage in self-flagellation.\textsuperscript{92} Furthermore, disclosure of highly sensitive information may be conditioned upon the shareholders agreeing to a reasonable confidentiality agreement.\textsuperscript{93}

In reviewing nondisclosure claims, the courts place more emphasis on what the shareholders know than on the form in which they receive the information. The directors are not required to make the best or optimal disclosure, but are required to inform shareholders fully and fairly of all material facts pertaining to the transaction.\textsuperscript{94} In \textit{In re Santa Fe Pacific Corp. Shareholder Litigation},\textsuperscript{95} the Delaware Supreme Court held that disclosure which sufficiently apprises shareholders of all pertinent issues, without making material misstatements, satisfies the duty of disclosure even though the directors failed to disclose all available information.\textsuperscript{96}

Delaware law does not appear to require disclosure of material

\textsuperscript{88} \textit{Lynch Communications Sys.}, 669 A.2d at 89 (citing Seibert v. Harper & Row Publishers, Inc., No. CIV.A.6699, 1984 WL 21874 (Del. Ch. Dec. 5, 1984)). In \textit{Lynch Communications Sys.}, the Delaware Supreme Court held that although more specific language in a proxy statement may have been more informative to shareholders in explaining corporate options, such additional, specific disclosure was not necessary to adequately describe the material facts affecting the shareholders. \textit{Id.}

\textsuperscript{89} \textit{Id.} (noting information board recognizes as being unreliable or potentially misleading to investor may be withheld by board) (citing Weinberger v. Rio Grand Indus., 519 A.2d 116, 128-29 (Del. Ch. 1986)).

\textsuperscript{90} \textit{Arnold}, 650 A.2d at 1279 (stating materiality requires balancing of possible harm against potential benefit).

\textsuperscript{91} \textit{Id.}

\textsuperscript{92} Stroud v. Grace, 606 A.2d 75, 84 n.1 (Del. 1992) (stating board not required to engage in self-flagellation) (citations omitted).

\textsuperscript{93} \textit{Id.} at 89 ("If the board withheld information in these special circumstances, it would still bear the burden of proving that: (1) the withheld information was confidential; and (2) the board only withheld the material confidential information from shareholders, who having been given notice and opportunity, failed to execute a reasonable confidentiality agreement.").

\textsuperscript{94} \textit{See Zirn v. VLI Corp.}, No. CIV.A.9488, 1995 WL 362616, at *4 (Del. Ch. June 12, 1995) ("[W]hile all material information in a company's possession must be disclosed when the board seeks shareholder action, the law ought guard against the fallacy that increasingly detailed disclosure is always material and beneficial disclosure. In some instances the opposite will be true.").

\textsuperscript{95} 669 A.2d 59 (Del. 1995).

\textsuperscript{96} \textit{Id.} at 66. The court, considering the adequacy of disclosures contained in a proxy statement, held that a statement which apprises shareholders of pertinent facts is sufficient to overcome a breach of disclosure claim, regardless of whether or not the directors could have made a better disclosure. \textit{Id.}
information about general material developments affecting the company's business, unless the board affirmatively seeks the vote of the shareholders in a transaction related to that aspect of the company's business. When shareholder approval of a transaction is not sought, no disclosure is required and the board will have no liability for failure to disclose properly even if disclosure is made. For example, in Kahn v. Roberts, the board attempted to repurchase a portion of its own stock in a transaction in which shareholder approval was not required or sought. Even though the board made incomplete and misleading disclosures about the transaction in the corporation's annual report, the Vice-Chancellor found no breach of the duty of disclosure. This holding in Kahn, however, appears to conflict with the generally accepted tort principle that once a fiduciary makes a disclosure, he has a duty to ensure that the disclosure is complete and truthful, regardless of whether shareholder action is sought.

The duty of disclosure requires not only that directors disclose all material facts within their possession, but also requires that shareholders or directors who ratify board action be fully informed

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The state law duty of candor arises when the board elects to or has a duty to seek shareholder action. . . . If the board does not seek shareholder action at a meeting, through consent, in a tender or exchange offer, or otherwise, it has, in my opinion, no distinctive state law duty to disclose material developments with respect to the company's business.

Raskin, 1990 WL 193326, at *5. However, federal security laws requiring complete disclosure may govern in some situations where a transaction does not require shareholder approval, even though Delaware law will not require disclosure. Roberts, 1995 WL 745056, at *8-9.


99. Id. at *9.

100. See Arnold v. Society for Sav. Bancorp, Inc., 650 A.2d 1270, 1280 (Del. 1994) (holding once directors made partial disclosure of material facts, they were under obligation to provide shareholders with complete and accurate portrayal of material information); Kahn v. Roberts, No. CIV.A.12524, 1994 WL 70118, at *2 (Del. Ch. Feb. 28, 1994) (stating once directors decide voluntarily to make disclosure where shareholder approval is not needed, they become subject to duty of full disclosure of all material facts); Freedman v. Restaurant Assoc., No. CIV.A.9212, 1990 WL 135923, at *8 (Del. Ch. Sept. 21, 1990) (same).

Although the Delaware opinions suggest that there would be no liability for not disclosing under fiduciary principles, there could still be a potential cause of action for equitable fraud if the party receiving the false or incomplete information reasonably relied on that information to its detriment. See, e.g., Zirn v. VLI, Corp., 621 A.2d 773, 778, 783 (Del. 1993).
of all material facts regarding the transaction. Problems can arise when material facts exist that the board should have known but did not. Effective shareholder ratification requires the full disclosure of all material facts that the board knows or should have known.

As noted above, the certificate of incorporation can contain a provision that protects the board from monetary liability for breaches of the duty of care, presumably including those arising from inadequate disclosure. By its terms, section 102(b)(7) will not protect any director who committed a breach of the duty of loyalty, failed to act in good faith or engaged in an act of intentional misconduct. Because this section only protects directors for duty of care violations, not duty of loyalty breaches, bad faith or

101. Michelson v. Duncan, 407 A.2d 211, 220 (Del. 1979) (stating shareholder ratification is only valid where shareholders are fully informed); see also Smith v. Van Oordt, 488 A.2d 858, 872, 893 (Del. 1985) (holding directors owe duty to fully inform themselves of all material facts relating to transactions affecting corporation and shareholders as part of their duty of care).

102. Yiannatis v. Stephanis, 653 A.2d 275, 280 (Del. 1995) (noting ratification can only occur if stockholders are fully informed); Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) (same); Weinberger v. United Fin. Corp. of Cal., No. CIV.A.5915, 1983 WL 20290, at *12 (Del. Ch. Oct. 13, 1983) ("There must be full disclosure of all germane facts in order to have a meaningful stockholder ratification."). The burden of proof rests on the party claiming ratification to establish that it made meaningful disclosure. E.g. Yiannatis, 653 A.2d at 280; Welch & Turezyn, supra note 41, §144.5.2, at 295 (noting burden rests on party claiming ratification).

103. Since the duty of disclosure was recognized in Delaware law when §102(b)(7) was enacted, the drafters probably intended the section to act as a potential shield against claims of breach of the duty of disclosure derived from due care violations. The court in Arnold found that the language of the statute was ambiguous and that examination of legislative history regarding the scope of §102(b)(7) was unnecessary. Arnold, 650 A.2d at 1286-87. Because §102(b)(7) provides that breaches of fiduciary duties are protected except for breaches of loyalty, and because the fiduciary duty of disclosure was recognized by the courts and legislature when §102(b)(7) was enacted, §102(b)(7) must be read to bring the duty of disclosure within its protections. Id.

104. Id. at 1287 (stating under §102(b)(7), directors liable for acts in bad faith or internal misconduct); see also Emerald Partners v. Berlin, No. CIV.A.9600, 1995 WL 600881, at *7 (Del. Ch. Sept. 22, 1995) (stating protections of §102(b)(7) apply to omissions by directors made in good faith belief that they were immaterial or so speculative as to be considered potentially misleading to reasonable investors).

Although §102(b)(7) can bar individual director liability, it is possible that a director could waive the protection afforded by such a provision. See Arnold, 650 A.2d at 1289. In Arnold, the court did not directly state that the protections of §102(b)(7) could be waived, but rather, assumed that waiver was possible only because the parties had agreed to the concept. Id. & 1289 n.38. Accepting the parties' stipulations that §102(b)(7) protections could be waived under Delaware law, the court in Arnold stated that to waive the protections of §102(b)(7), the director must assert such intention clearly and unambiguously. Id. at 1288.
intentional misconduct, it is important to determine whether the failure to disclose breached the duty of care or duty of loyalty. A section 102(b)(7) provision would protect directors from liability for nondisclosures in the former case, not the latter.105

Delaware courts have held that damages need not be proven to make a prima facie case of a breach of the duty of disclosure.106 In fact, Delaware courts have developed a virtual per se rule that awards at least nominal damages for a breach of the duty of disclosure.107 Of course, Delaware courts will also award actual damages, if proven, in recognition of the value of the right of the stockholder to make informed decisions regarding corporate affairs.108

Thus, the duty of disclosure can impact a shareholder challenge of a board decision in a number of ways. Failure to disclose material facts will rebut the business judgment rule's presumption of propriety. A disclosure violation usually results in a virtual per se breach of fiduciary duty and at least some liability on the board's part. Full disclosure is also a prerequisite to effective shareholder ratification.

V. LIABILITY FOR OTHER FIDUCIARIES: DE FACTO & DE JURE CONTROLLING STOCKHOLDERS

In certain situations, a stockholder will have fiduciary obligations very similar to a director's duties. A stockholder will owe fiduciary duties to the corporation and other shareholders if he has either de jure or de facto control over corporate matters.109 A

105. Cede III, 663 A.2d 1156, 1163 & n.18 (Del. 1995) (noting cases prior to adoption of § 102(b)(7) did not determine if disclosure breach fell under duty of loyalty or care); Arnold, 650 A.2d at 1287 (“[C]laims alleging disclosure violations that do not otherwise fall within any exception are protected by Section 102(b)(7).”); Zrin v. VLI Corp., 621 A.2d 773, 783 (Del. 1992) (noting legislative history indicates § 102(b)(7) shields directors in breach of care and disclosure cases, but not in breach of loyalty cases).

106. See Oberly v. Kirby, 592 A.2d 445, 463 (Del. 1991) (explaining proof of special damages need not be shown in duty of loyalty actions because such actions often embrace disclosure claims as well).

107. Weinberger v. UOP, Inc., No. CIV.A.5642, 1985 WL 11546, aff'd, 497 A.2d 792 (Del. 1985). In Weinberger, the court stated that plaintiffs should be compensated for wrongs done to them even though valuation of the damage incurred cannot be easily ascertained. Id. at *9.

108. In re Tri-Star Pictures, Inc. Litig., 634 A.2d 319, 334 (Del. 1993). In In re Tri-Star, the court found that nondisclosure by the board led to a diminution in the value of the plaintiffs' shares, a result that may not have occurred had the shareholders been presented with adequate disclosure. Id.

109. Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987) (stating "shareholder owes fiduciary duty only if it owns a majority interest and exercises control over the business affairs of the corporation") (citing Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 958 (Del. 1985); Aronson v. Lewis, 473
shareholder is a de jure controlling shareholder if he owns more than fifty percent of the voting shares in the corporation.\textsuperscript{110}\footnote{\textsuperscript{110}A shareholder who owns less than a majority of the voting stock can be a de facto controlling shareholder if the shareholder exercises actual control over the business affairs of the corporation.\textsuperscript{111}} A shareholder who owns less than a majority of the voting stock can be a de facto controlling shareholder if the shareholder exercises actual control over the business affairs of the corporation.\textsuperscript{111}

\begin{quote}

Several factors exist for determining whether a stockholder controls a corporation and, therefore, owes other stockholders fiduciary duties. These factors include:

1. The magnitude of [the stockholder’s] ownership interest.
2. The number of [the stockholder’s] nominees on the board.
3. The degree of independence demonstrated by [the stockholder’s] nominees and other directors.
4. A comparison of how the stockholder and other stockholders have voted on various matters.
5. The degree to which the interests of the stockholder have affected corporate acts.
6. The overall relationship between the stockholder and the corporation’s directors and management.

Pease, supra at 455-56 (quoting Steven J. Rothschild & Keith R. Sattesahn, “\textit{All Germane Facts with Complete Candor}—Delaware’s Disclosure Duty, in \textit{DELAWARE LAW FOR CORPORATE LAWYERS & RECENT DEVELOPMENTS} 392 (PLI 1985)).

\textsuperscript{110}Ivanhoe, 535 A.2d at 1344 (stating shareholder who owns majority owes fiduciary interest duty); see In re Wheelabator Technologies, Inc. Shareholders Litig., 663 A.2d 1194, 1204-05 (Del. Ch. 1995) (stating board members in \textit{Stroud v. Grace}, 606 A.2d 75 (Del. 1992), who owned majority of corporation’s stock were de jure controlling stockholders). In Weinberger, the court applied the entire fairness standard to a cash-out merger involving a corporation and its 50.5% shareholder. Weinberger v. UOP, Inc., 457 A.2d 701, 710-11 (Del. 1983). The court applied the entire fairness test, rather than the business judgment rule, to the proposed merger, thereby implicitly recognizing that a 50.5% stockholder possessed de jure control over corporate affairs. \textit{Id.} Similarly, the court in \textit{Stroud} stated that the directors, as holders of a majority of the outstanding stock, controlled the affairs of the corporation, and proceeded to use the entire fairness standard of review which typically applies to determine the propriety of a transaction between a corporation and controlling stockholder. \textit{Stroud}, 606 A.2d at 90.

\textsuperscript{111}Ivanhoe, 535 A.2d at 1344 (stating shareholder who exercises control owes fiduciary duty); Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 70 (Del. 1989) (“For a dominating relationship to exist in the absence of controlling stock ownership, a plaintiff must allege domination by a minority shareholder through actual control of corporate conduct.” (citing Kaplan v. Centex Corp., 284 A.2d 119, 122-23 (Del. Ch. 1971))); see also Kahn v. Lynch Communication Sys., 638 A.2d 1110, 1114 (Del. 1994) (noting ownership of less than majority of stock alone is insufficient to establish shareholder control (citing \textit{Citron}, 569 A.2d at 70)); Gilbert v. El Paso Co., 490 A.2d 1050, 1055 (Del. Ch. 1984) (citing Ososky v. J. Ray McDermott & Co., Inc., 725 F.2d 1057 (2d Cir. 1984)); \textit{Arason}, 473 A.2d at 815-16 (holding ownership of 47% of stock of publicly held corporation does not constitute control absent allegation by particularized facts that 47% stockholder domi-
De facto control exists only where the minority shareholder dominates corporate decision-making through the actual exercise of control over corporate action.\textsuperscript{112} The mere potential for control by a minority stockholder is insufficient to constitute de facto control over corporate affairs.\textsuperscript{113} For example, the presence of a super-majority provision in the certificate of incorporation may support a finding that a stockholder who owns less than a majority of a corporation’s stock exercises control over corporate affairs.\textsuperscript{114} Similarly, 

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tated and controlled corporation’s board of directors). \textit{Kaplan}, 284 A.2d at 122-23 (stating term “control” implies “a direction of corporate conduct in such a way as to comport with the wishes or interests of the corporation (or persons) doing the controlling”) (citations omitted).
\end{quote}

\textsuperscript{112} \textit{See Lynch Communication Sys.}, 638 A.2d at 1115 (stating controlling stock ownership may exist when minority interest stockholder exercises “actual control” over corporation by dominating corporate affairs); \textit{In re Sea-Land}, 1984 WL 49126, at *3 (stockholder owes fiduciary duties only if stockholder “exercised actual domination and control over [the corporation’s] directors”); \textit{Kaplan}, 284 A.2d at 123 (stating terms “control” and “domination” imply actual exercise of conduct by stockholder in accordance with stockholder wishes for corporation direction); Pease, \textit{supra} note 109, at 454 (stating mere power to control is not sufficient to trigger fiduciary duty of disclosure, rather actual exercise of power is necessary).

\textsuperscript{113} \textit{Zlotnick} v. Newell Cos., No. CIV.A.7246, 1984 WL 8242, at *2 (Del. Ch. July 30, 1984) (holding “[c]ontrolling stock ownership may exist even in the absence of a numerical majority but in such event there must be domination by a minority shareholder through actual exercise of direction over corporate conduct” (citing Liboff v. Allen, No. CIV.A.2669, 1975 WL 1961 (Del. Ch. Jan. 14, 1975); \textit{Kaplan}, 284 A.2d at 119)).

Applying this principle, the Chancery Court in \textit{Zlotnick} held that a 33% shareholder who had arguably paid a control premium, was nevertheless not a de facto controlling stockholder because the stockholder did not exercise actual control over corporate affairs. \textit{Zlotnick}, 1984 WL 8242, at *2. The court rejected the plaintiff’s claim that one could infer that the 33% stockholder had obtained control over the corporation because it had paid $2.5 million over market value for the stock, the excess constituting payment of a control premium. \textit{Id.} The court determined that the 33% ownership, on its own, did not constitute control, and that the price paid for stock had no relation to whether stock ownership was used to influence corporate policy. \textit{Id.} The “lurking threat emanating from substantial stock ownership” is not enough, standing alone, to indicate that a stockholder exercises control over corporate affairs. \textit{Id.} Although the stockholder may have paid a premium for the stock in order to gain control, until it exercises such ownership in a way that it gains control over corporate affairs, or it works to the detriment of the other shareholders, the stockholder merely possesses a potential for control and owes no fiduciary duty to the other shareholders. \textit{Id.}

\textsuperscript{114} \textit{Lynch Communication Sys.}, 638 A.2d at 1114-15 (holding supermajority provision allowed minority shareholder to exercise control); \textit{see also} Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1977, 1983 (Del. 1995) (holding in light of 75% supermajority provision in corporate charter and adoption of poison pill by corporation, 14.9% stockholder could achieve control over corporate affairs through proxy contest when less than 100% turnout could be expected); Citron, 569 A.2d at 70 (holding minority stockholder may still exercise control if that stockholder dominates corporation through actual control of corporation’s existence) (citing \textit{Kaplan}, 284 A.2d at 122-23).

In \textit{Lynch Communication Sys.}, the 43.3% stockholder, Alcatel Corporation (Alcatel), had agreed not to increase its stock ownership in Lynch above 45% for a
the existence of voting agreements which result in the shareholders exercising actual control over corporate matters can create a controlling stockholder situation. On the other hand, a stockholder making a tender offer for a majority of the corporation's voting stock, despite his potential for control over corporate conduct if the offer is successful, will not be deemed to have acquired control un-

period of five years in return for the inclusion of the supermajority provision. Lynch Communications Sys., 638 A.2d at 1112. In 1986, Lynch determined that it would be in the corporation's best interests to expand into the field of fiber optics technology and identified a target company. Id. Alcatel disapproved of the choice and recommended a combination with an indirect subsidiary of Alcatel's parent company. Id. An independent committee was formed and subsequently recommended that Alcatel's proposed combination be denied. Id. at 1115. After the five year period expired, Alcatel responded to the independent committee's recommendation by offering to acquire the remaining 56.7% of Lynch shares not in its possession for $14 per share. Id. Alcatel entered into negotiations with the independent committee and made a final offer of $15.50 per share, stating that if that proposal were not accepted, Alcatel would proceed with an unfriendly tender offer at a lower price. Id. Based on Alcatel's "threat," the independent committee unanimously recommended that the Lynch board approve the $15.50 per share merger. Id. A representative for Alcatel told a member of Lynch's independent committee: "You must listen to us. We are 43 percent owner. You have to do what we tell you." Id. The court determined that the negotiations between Alcatel and the independent committee represented Alcatel's leverage over Lynch's operations, demonstrating that Alcatel knew that the supermajority provision allowed it to control Lynch's business conduct. Id. at 1114-15. Thus, the court concluded that due to the supermajority provision, the Lynch board was "handcuffed" by Alcatel's equity position and that the Lynch board had accepted the merger proposal solely because of Alcatel's position as a significant stockholder. Id. Even though Alcatel possessed a minority interest in Lynch, the court held that it exercised actual control over Lynch and dominated its corporate affairs. Id.

115. In re Tri-Star Pictures, Inc. Litig., 634 A.2d 319, 328 (Del. 1993). In In re Tri-Star, Coca-Cola was the largest single shareholder, holding 36.8% of Tri-Star's outstanding stock. Id. at 321. However, it proceeded to enter into voting agreements with Home Box Office (HBO), which owned 9% of Tri-Star common stock, Technicolor, Inc. (Technicolor), which owned 7.2% of Tri-Star common stock, and Rank American, Inc. (Rank), which owned 3.6% of Tri-Star common stock, to effectively exercise control over 56.6% of Tri-Star common stock. Id. at 321-22, 328. The court stated that as a result of the voting agreements Coca-Cola "affirmatively attempted to dictate the destiny of Tri-Star." Id. at 328. Along with the implementation of voting agreements, Coca-Cola and HBO had entered into a shareholder agreement whereby they agreed to support each other's choices for election to the Tri-Star board. Id. at 328. The court saw this agreement as further evidence of Coca-Cola's control. Id. Additionally, because Tri-Star's seven directors were either senior executives, affiliates or substantial stockholders in Coca-Cola, the court concluded that Coca-Cola exercised control over Tri-Star's affairs. Id. at 328-29.

Because the threshold for control is a stockholder's ability to dictate the destiny of the particular corporation, the existence of voting agreements, designed and controlled by a "minority" shareholder, can put the shareholder in a position where he or she can effectively control the business decisions of the corporation. Id. In such a case, the stockholder assumes a fiduciary duty to all of the corporation's stockholders. Id.
VI. DERIVATIVE CHALLENGES TO BOARD ACTION

Decision-making power concerning corporate litigation generally resides solely in the board. In certain situations, a board may be reluctant to assert a corporate claim that could result in director liability. In these situations, the law permits a shareholder to assert the corporate claim. Shareholder lawsuits that assert claims on behalf of the corporation are called “derivative actions.” Derivative actions permit shareholders to sue the parties, including directors and controlling shareholders, who caused injury to the corporation.

A derivative action is two suits in one. First, the derivative action requires that the shareholder establish standing to assert the

116. See Gilbert v. El Paso Co., 490 A.2d 1050, 1055-56 (Del. 1990) (holding offeror does not control of corporate affairs when sufficient number of shares is deposited, but rather acquires control only after offeror owns those shares).

117. See, e.g., Levine v. Smith, 591 A.2d 194, 200 (Del. 1991) (holding decision to litigate or refrain from litigation is management decision given to board unless the court finds the action was arbitrary or capricious); Spiegel v. Buntrock, 571 A.2d 767, 773 (Del. 1990) (same); see also Zapata Corp. v. Maldonado, 430 A.2d 779, 782 (Del. 1981) (“[D]irectors are responsible for deciding whether to engage in derivative litigation.”).

118. Levine, 591 A.2d at 200 (noting derivative suit is remedy for conflicts between director’s duties to manage and shareholder’s claim of right to enter derivative claim); Kaplan v. Peat, Marwick, Mitchell & Co., 540 A.2d 726, 730 (Del. 1988) (noting that shareholders’ ability to institute suit inherently impinges on directors’ power to manage affairs of corporation).

119. See, e.g., Heineman v. Datapoint Corp., 611 A.2d 950, 952 (Del. 1992) (holding derivative suit is equitable remedy where shareholder asserts claim on behalf of corporation); Levine, 591 A.2d at 200 (same); Spiegel, 571 A.2d at 773 (holding director may file derivative action to redress harm to corporation); Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984) (noting derivative suit enables shareholders to sue in corporate name where board refuses to assert claim); Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) (same).

In some situations, a stockholder wishing to avoid the procedural hurdles of a derivative action may be able to bring a direct action. While a derivative action is brought based on a harm done to the corporation, a direct action is brought for harm done to the individual stockholder, separate from injuries done to the stockholders collectively. Although it is often difficult to determine whether a claim is direct or derivative, the courts have attempted to distinguish the two. The recent en banc decision of the Delaware Supreme Court in Grimes v. Donald, 673 A.2d 1206 (Del. 1996), gives important insight into the difference between derivative and direct actions.

120. See, e.g., Spiegel, 571 A.2d at 773 (stating derivative suit is “suit by shareholders to compel corporation to sue”); Aronson, 473 A.2d at 811 (noting two prongs of shareholder derivative suit); Zapata, 430 A.2d at 784 (same).
claim on the corporation's behalf. A board can contest standing by filing a motion to dismiss pursuant to Delaware Chancery Court Rule 23.1.

Courts are sensitive to the possibility that shareholders might abuse the derivative action by bringing a strike suit or bringing a suit that is not in the best interests of the corporation. The derivative action, brought and controlled by a stockholder, necessarily impinges on the board's general plenary responsibilities concerning corporate litigation. Thus, Delaware Chancery Court Rule 23.1

A. Standing to Sue

In derivative litigation, the initial question is whether the shareholder has standing to sue on behalf of the corporation. A board can contest standing by filing a motion to dismiss pursuant to Delaware Chancery Court Rule 23.1.

Courts are sensitive to the possibility that shareholders might abuse the derivative action by bringing a strike suit or bringing a suit that is not in the best interests of the corporation. The derivative action, brought and controlled by a stockholder, necessarily impinges on the board's general plenary responsibilities concerning corporate litigation. Thus, Delaware Chancery Court Rule 23.1

121. Levine, 591 A.2d at 200 (stating that in derivative suit, shareholder asserts claim on behalf of corporation).
122. Aronson, 473 A.2d at 811-12 (stating second phase derivative action is suit by shareholders on behalf of corporation).
123. Katz v. Bregman, 431 A.2d 1274, 1275 (Del. Ch. 1981) (noting in addition to being shareholder, plaintiff in derivative action must have standing). In determining whether the shareholder is a suitable plaintiff, the court will consider a number of factors including: economic antagonisms between representatives and the class; the remedy sought by the plaintiff in the derivative litigation; indications that the named plaintiff was not the driving force behind the litigation; the existence of other litigation pending between the plaintiff and defendant; the relative magnitude of plaintiff's personal interests as compared to his or her interest in the derivative action itself; the plaintiff's vindictiveness toward the defendant; and the degree of support the plaintiff was receiving from the shareholders he or she purportedly represents. See Davis v. Comed, Inc., 619 F.2d 588, 593-94 (6th Cir. 1980) discussing who is suitable derivative plaintiff); Emerald Partners v. Berlin, 564 A.2d 670, 673 (Del. Ch. 1989) (noting plaintiff in derivative action must be qualified to serve in fiduciary capacity); Youngman v. Tahmoush, 457 A.2d 376, 379-80 (Del. Ch. 1983) (same).
124. Rule 23.1 states in pertinent part:
In a derivative action brought by 1 or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall allege that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiff's share or membership thereafter devolved on the plaintiff by operation of law. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort.
125. See, e.g., Spiegel v. Buntrock, 571 A.2d 767, 773 (Del. 1990) (noting de-
and the judicial decisions concerning derivative actions require shareholders to exhaust intracorporate remedies before suing derivatively.126 Derivative shareholder plaintiffs must make a pre-suit demand on the board to assert the underlying claim or show that such a demand would be futile.127

Frequently, conflicts of interest for the board arise because the shareholder’s claim is that the directors have breached their fiduciary obligations to the corporation. In ascertaining whether the board is capable of making an unbiased determination regarding the lawsuit, the court will look beyond the fact that the directors are simply named as defendants and try to ascertain whether the directors have a significant risk of exposure to liability on the underlying claim.

Derivative suit “‘could, if unrestrained, undermine the basic principle of corporate governance that the decisions of a corporation—including the decision to initiate litigation—should be made by the board of directors or the majority of shareholders’” (quoting Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 531 (1984)); Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984) (noting that derivative action impinges on managerial freedoms of directors); Aronson, 473 A.2d at 811 (same).

In Boeing Co. v. Shrontz, No. CIVA.11273, 1992 WL 81228 (Del. Ch. Apr. 20, 1992), the Delaware Chancery Court addressed the issue of whether, in one cause of action involving multiple plaintiffs, the plaintiffs could avoid choosing between including a demand and losing their right to assert demand futility by pleading both a demand refused and demand excused case. Id. at *5. In Boeing, one plaintiff made demand on the board, which was ultimately refused. Id. The other plaintiff made no demand and claimed demand was excused because the board was interested in a matter involving illegal activities of Boeing employees. Id. The plaintiffs argued that even though the board refused one plaintiff’s demand, the claims should nevertheless survive because the other plaintiff had not made demand and had therefore properly pled demand futility. Id.

Recognizing that the principles of Spiegel applied to the case, the Chancery Court ruled that the plaintiffs acted improperly regarding the requirements of demand. Id. The court explained:

The law, as set forth in Spiegel, should make it clear that the demand requirement is not a mere procedural formality. Plaintiffs cannot use either of the devices suggested here to, in essence, cover all the bases. The Spiegel court held that stockholders must make a choice either to make demand or attempt to establish demand futility. To accept plaintiffs’ argument would be to ignore Spiegel.

Id.

126. In implementing Rule 23.1, Delaware courts have consistently maintained that the exhaustion of intracorporate remedies is not a mere procedural formality, but is a rigorous requirement for establishing the plaintiff’s standing to sue on behalf of the corporation.

127. Del. Ch. Ct. R. 23.1; see also Spiegel, 571 A.2d at 773 (noting that Rule 23.1 promotes this alternative dispute resolution in recognition of directors’ role in managing business and affairs of corporation); Pogostin, 480 A.2d at 624 (“Rule 23.1 exists at the threshold to prevent abuse and to promote intracorporate dispute resolution.”); Aronson, 473 A.2d at 811-12 (noting Rule 23.1 demand requirement insures stockholder attempts intracorporate remedies before resorting to litigation); Zapata Corp. v. Maldonado, 430 A.2d 779, 786 (Del. 1981) (discussing role of Rule 23.1).
The shareholder desiring to assert a claim on the corporation’s behalf has two mutually exclusive choices. First, the shareholder can demand that the board cause the corporation to file the claim. If the demand is refused by the board, the shareholder can still bring a derivative action by showing that the board’s refusal to bring the suit was improper. These are known as “demand refused” cases.

On the other hand, the shareholder can choose not to make a pre-suit demand on the board. In this situation, the shareholder will have standing to bring the derivative action by establishing that making a demand would have been futile because the board has conflicts of interest which would prevent it from making an unbiased decision with respect to the demand. These are known as “demand futile” or “demand excused” cases.

In summary, a shareholder will have standing in a demand refused case if: (a) the shareholder makes a demand on the board; (b) the board chooses not to sue; and (c) the shareholder’s complaint establishes that the board’s decision not to sue is not protected by the business judgment rule. In a demand excused case, a shareholder will have standing if: (a) the shareholder does not make a demand; and (b) the shareholder’s complaint establishes that the demand is excused because the board has a conflict of interest that prevents it from making an unbiased decision whether to sue.

In determining whether a board improperly refused the de-

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128. See Grimes v. Donald, 673 A.2d 1207, 1214 (Del. 1996) (en banc) (noting once demand is made, shareholder loses right to bring demand excused case).
129. Id. at 1216 (noting derivative action available where shareholder can show board improperly failed to bring suit).
130. Id. (stating derivative suit can be brought when shareholder can prove demand would have been futile).
131. See Levine v. Smith, 591 A.2d 194 (Del. 1991). Levine is a recent case in which the Delaware Supreme Court has taken a comprehensive look at derivative actions and the issue of shareholder demand on a board of directors.

In Levine, the court was presented with two derivative actions that were consolidated. Id. at 199-200. In one case, the plaintiff shareholders failed to make demand on the board, in the other case, the plaintiff made a demand which had in turn been refused by the board. Id. at 199. Both cases revolved around General Motors’ (GM) decision to repurchase its shares held by H. Ross Perot as well as Perot’s shares in Electronic Data Systems Corporation (EDS), a wholly owned subsidiary of GM. Id. at 198-99. In one claim, the plaintiff did not make demand on the board, nor did the plaintiff plead particularized facts establishing that demand should be excused as being futile. Id. at 199. In the other claim, the plaintiff made written demand on the GM board to rescind the repurchase of Perot’s stock. Id. The board voted unanimously to reject the plaintiff’s demand. Id. The plaintiff then initiated discovery, which was followed by the defendants’ motion to dismiss the complaint under Delaware Court of Chancery Rule 23.1. Id.
mand or if the demand would have been futile if made, Delaware courts consider only the well-pleaded facts in the complaint. The court will only consider particularized factual allegations; conclusory allegations (notice pleadings) will not suffice.

The particularized facts pleaded must create a reasonable doubt that: (1) the board improperly refused the demand or (2) if no demand was made, the board was capable of making an unin- 

132. Spiegel v. Buntrock, 571 A.2d 767, 774 (Del. 1990) (holding that in de- 
ciding motion to dismiss for failure to make demand under Rule 23.1, courts are restricted to complaint); Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984) (concluding "court reviews the factual allegations of the complaint"); Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984) (noting "alleged wrong is substantively reviewed against the factual background alleged in complaint").

In Levine, the plaintiff relied on the court's earlier holding in Zapata for support that he was entitled to limited discovery. Levine, 591 A.2d at 208. In denying discovery, the court recognized that Zapata was a demand excused case and that the court in Aronson stated that "unless a special committee of the board has moved to dismiss, the issue of demand futility must be determined on the basis of the share- 

133. See, e.g., Grimes v. Donald, 673 A.2d 1207, 1216 (Del. 1996) (en banc) ("In filing a derivative suit, a stockholder must allege either that the board re-
jected his pre-suit demand . . . or allege with particularity why the stockholder was justified in not having made the effort to obtain board action."); Rales v. Blasband, 634 A.2d 927, 931 (Del. 1993) (noting well-pleaded facts are deemed true, but conclusory allegations are not true); see Seminaris v. Landa, 662 A.2d 1350, 1355 (Del. Ch. 1995) (finding plaintiffs failed to plead sufficient facts with particularity, but instead alleged "in a conclusory manner that the other directors 'looked the other way'").

Rule 23.1 pleading demands are more stringent than those required to survive a Rule 12(b)(6) motion under the Delaware or Federal Rules of Civil Procedure because the court may only consider the well-pleaded, particularized facts in the complaint. Levine, 591 A.2d at 207; see also Allison v. General Motors Corp., 604 F. Supp. 1106, 1112 (D. Del. 1985) (noting Rule 23.1 represents "a marked departure from the 'notice' pleading philosophy" governing Federal Rules of Civil Procedure), aff'd, 782 F.2d 1026 (3d Cir. 1985); Levine, 591 A.2d at 210 (stating Rule 23.1 requires plaintiff to plead with particularity and, therefore, is exception to notice pleading of Federal Rules).
dominately factual issue,” and is subject to an abuse of discretion standard on appeal. Recently, the Delaware Supreme Court stated that "reasonable doubt" means that "there is a reason to doubt" and it is counterpart to the concept of reasonable belief.

Significantly, no discovery is allowed in a typical case. Thus, the shareholder must rely on the facts known or information obtained from the media or public records. In addition, shareholders may also obtain relevant information by requesting to inspect the books and records of the corporation pursuant to section 220 of the Delaware General Corporation Law. The lack of discovery,

134. Grimes, 673 A.2d at 1216 n.15 ("Such a test implicates a determination by the court of chancery which involves "essentially a discretionary ruling on a predominately factual issue." (quoting Grobow v. Perot, 539 A.2d 180, 186 (Del. 1988) ("Reasonable doubt must be decided by the trial court on a case-by-case basis."))); see also Heineman v. Datapoint Corp., 611 A.2d 950, 952 (Del. 1992) (determining if pleading creates reasonable doubt that factual issue exists); Levine, 591 A.2d at 204-05 (same).

The Delaware Court of Chancery also explained that: [T]he demand excused test employs a "reasonable doubt" standard and unavoidably calls upon the trial court to make a decision that, while discretionary in the strong sense of that term which implies some area of unreviewable good faith judgment, is discretionary in the weaker sense of requiring decision that is highly particular and involves informed judgment.


135. Heineman, 611 A.2d at 952 (noting determination as to whether plaintiff has effectively pleaded futility "involve[es] essentially a discretionary ruling on a predominately factual issue" and is subject to review only for abuse of discretion (quoting Grobow, 539 A.2d at 186)).

136. Grimes, 673 A.2d at 1216. Additionally, the court stated: [O]versely, the concept of reasonable doubt is akin to the concept that the stockholder has a "reasonable belief" that the board lacked independence or that the transaction was not protected by the business judgment rule. The concept of reasonable belief is an objective test and is found in various corporate contexts.

Id. at 1217 n.17 (citations omitted).

137. Id. at 1215 n.11 ("Although derivative plaintiffs . . . are not entitled to discovery . . . they have many avenues available to obtain information bearing on the subject of their claims."); Rules, 634 A.2d at 935 (noting discovery is not permitted to assist plaintiffs in complying with Rule 23.1); Levine, 591 A.2d at 208-10 (holding discovery is not entitled to discovery in demand futile case); Grobow, 539 A.2d at 186 ("[A] Rule 23.1 motion normally precedes rather than follows discovery."); Pogostin, 480 A.2d at 625 (noting plaintiff must plead without the benefit of discovery).

138. Grimes, 673 A.2d at 1216 ("For example, there is a variety of public sources from which the details of a corporate act may be discovered, including the media and governmental agencies . . . "); Rules, 634 A.2d at 934-35 n.10 (stating plaintiff can use public sources such as media reports and federal agency filings).

139. In Grimes, the court added that "[i]n addition, a stockholder who has met the procedural requirement and has shown a specific proper purpose may use the summary procedure embodied in [Del. Code Ann. tit. 8, § 220] (1974 & Supp.
the reasonable doubt standard and the requirement that only the particularized facts in the complaint will be considered by the court to determine standing tip the scales decidedly in favor of the board when it moves to terminate derivative litigation.

B. Demand Refused by the Board

As litigation decisions are generally within the board’s sole pur-view, Rule 23.1 normally requires a shareholder to make a demand on the board that the corporation assert the claim.140 If the shareholder makes such a demand, courts have held that the board is conclusively presumed to be disinterested and independent with respect to their ability to make unbiased decisions concerning the litigation.141 Consequently, if the board refuses the shareholder’s demand, the court will allow a derivative action to proceed only if the shareholder adequately pleads that the board’s refusal is not protected by the business judgment rule because the board lacked good faith or did not exercise due care.142 By making a demand

1994) to investigate the possibility of corporate wrongdoing.” Grimes, 673 A.2d at 1215 n.11.

140. Del. Ch. Ct. R. 23.1; see also Grimes, 673 A.2d at 1218 (“In no event may a corporation assume a position of neutrality and take no position in response to the demand.”) (citation omitted); Rules, 634 A.2d at 935 (stating once stockholder files demand letter, directors must, in good faith, inform themselves of facts relating to litigation and alternatives available before responding to demand); Yaw v. Talley, No. CIV.A.12882, 1994 WL 89019, at *7 (Del. Ch. Mar. 2, 1994) (mem.) (discussing necessity of demand upon board); Heineman v. Datapoint Corp., 611 A.2d 950, 950-52 (Del. 1992) (noting in usual case shareholder must make demand upon board to seek redress); Seibert v. Harper & Row Publishers, Inc., No. CIV.A.6639, 1984 WL 21874 (Del. Ch. Dec. 5, 1984) (noting three elements are generally required to make “demand”: (i) the identity of the alleged wrongdoers, (ii) the wrongdoing they allegedly perpetrated and the resultant injury to the corporation, and (iii) the legal action the shareholder wants the board to take on the corporation’s behalf); Allison v. General Motors Corp., 604 F. Supp. 1106, 1112-13 (D. Del. 1985) (discussing shareholder duties in making demand).

141. Rules, 634 A.2d at 935 n.12 (noting shareholder making demand concedes directors are independent and disinterested); Levine, 591 A.2d at 212-13 (re-affirming director independence and lack of self-interest is conceded in demand made case); Spiegel v. Buntrock, 571 A.2d 767, 774-75 (Del. 1990) (holding that if shareholder makes demand, he or she waives ability to assert demand is futile and subjects board action to review under business judgment rule).

142. Levine, 591 A.2d at 212 (“When a board refuses a demand, the only issues to be examined are the good faith and reasonableness of its investigation.”) (quoting Spiegel, 571 A.2d at 777)). E.g., Spiegel, 571 A.2d 774-76 (noting that courts apply business judgment rule to board’s decision to refuse demand); Aronson v. Lewis, 479 A.2d 805, 813 (Del. 1984) (noting courts apply business judgment rule in reviewing board’s refusal to act on shareholder’s demand); Zapata Corp. v. Maldonado, 430 A.2d 779, 784 n.10 (Del. 1981) (“When stockholders, after making demand and having their suit rejected, attack the board’s decision as improper, the board’s decision falls under the ‘business judgment’ rule and will be respected if the requirements of the rule are met.”).
and thereby conceding loyalty, the shareholder is unable to rely upon any possible breach of the duty of loyalty for purposes of establishing the shareholder's standing to sue derivatively. Thus, in order to be able to sue derivatively in demand refused cases, the shareholder must plead particularized facts creating a reasonable doubt that the board's decision to refuse the demand was made with due care or in good faith.\textsuperscript{143}

\textbf{C. Demand Excused Cases Generally}

An important exception to the demand requirement is that demand will be excused when it would be futile.\textsuperscript{144} Essentially, in demand excused cases, the courts review whether the board can make an unbiased business judgment with respect to the litigation.\textsuperscript{145} Demand is excused only if the board is so completely under the influence of an officer or director that the board's discretion is "sterilized."\textsuperscript{146}

In order to show that demand is futile, a shareholder must plead particularized facts creating a reasonable doubt that, even if

\begin{footnotesize}
\begin{enumerate}
\item Grimes, 673 A.2d at 1220 (noting shareholder who makes pre-suit demand is required to "plead with particularity why the Board's refusal to act on the derivative claims was wrongful" (citing Levine, 591 A.2d at 211)); Levine, 591 A.2d at 210 ("The reasons underlying the adoption in Aronson of the 'reasonable doubt' test to a claim of demand futility have equal application to standing of a derivative plaintiff to maintain a claim of wrongful refusal of demand.").
\item Grimes, 673 A.2d at 1216 (stating basis for excusal would be: "(1) a majority of the board has a material financial or familial interest; (2) a majority of the board is incapable of acting independently for some other reason such as domination or control; or (3) the underlying transaction is not the product of a valid exercise of business judgment" (footnotes omitted)); Heineman, 611 A.2d at 952 (explaining circumstances in which demand is futile); Levine, 591 A.2d at 205-08 (stating when majority of board has financial interest, lacks due care or independence, demand would be futile); Aronson, 473 A.2d at 814 (noting where board is under influences which sterilize decision, demand is futile); Zapata, 430 A.2d at 784 (stating exception to demand requirement is futility which exists when board members are influenced and cannot properly conduct litigation).
\item See Heineman, 611 A.2d at 952 (holding where demand is futile, courts excuse demand requirement). In Heineman, the shareholder brought suit alleging corporate waste and breach of fiduciary duty, originating out of four transactions, each approved by the board. \textit{Id.} at 951. The court explained that "though [the plaintiff] is not required to plead a prima facie case of breach of fiduciary duty in order to avoid the demand requirement, once [the plaintiff] does make such allegations he has carried his burden and demand is excused." \textit{Id.} at 953.
\item McKee v. Rogers, 156 A. 191 (Del. Ch. 1931). In \textit{McKee}, the court stated: [A] stockholder may sue in equity in his derivative right to assert a cause of action in behalf of the corporation, without prior demand upon the director to sue, when it is apparent that a demand would be futile, that the officers are under an influence that sterilizes discretion and could not be proper persons to conduct the litigation. \textit{Id.} at 193.
\end{enumerate}
\end{footnotesize}
demand had been made, the board's decision to refuse the demand would be protected by the business judgment rule. In other words, the question is whether the board could have made an unbiased decision regarding a demand, if one had been made. Significantly, by not making the demand, the shareholder has not conceded that the board is disinterested and independent. Thus, in order to have standing in a demand excused case, the shareholder must plead particularized facts that create a reasonable doubt that: (1) a majority of the board is disinterested and independent or (2) the challenged transaction was the subject of a proper business judgment. Where the plaintiff adequately pleads either alternative of this two prong test, demand is excused because making a demand would have been futile.

When conducting the first inquiry, the court determines whether there is a reasonable doubt that a majority of the directors are interested or not independent. If the plaintiff pleads facts sufficient to create reasonable doubt that the transaction in question involves a majority of board members who are either interested or lack independence, the business judgment rule would not protect

147. Crimes, 673 A.2d at 1216 ("One ground for alleging with particularity that demand would be futile is that a 'reasonable doubt' exists that the board is capable of making an independent decision to assert the claim if demand were made." (footnote omitted)); Rales v. Blasband, 634 A.2d 927, 933 (Del. 1993) (noting reasonable doubt standard); Heinein, 611 A.2d at 952 (same); Levine, 591 A.2d at 205-07. In Levine, the court stated:

[I]n a claim of demand futility, there are two alternative hurdles, either of which a derivative shareholder complainant must overcome to successfully withstand a Rule 23.1 motion. . . . [However], [w]hen the challenged transaction is approved by a board, the majority of whom are outside, nonmanagement directors, "a heavy burden falls on [plaintiffs] to avoid resuit demand."

Id. (quoting Grobow v. Perot, 539 A.2d 180, 190 (Del. 1988)); Spiegel v. Buntrock, 571 A.2d 767, 774 (Del. 1990) (discussing reasonable doubt standard); Grobow, 539 A.2d at 186 (same); Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984) (holding if Chancery Court is satisfied plaintiff has alleged facts which, taken as true, establish reasonable doubt as to either element, then its inquiry ends as the plaintiff has established demand futility); Aronson, 473 A.2d at 814 ("[The trial court] must make two inquiries, one into the independence and disinterestedness of the directors and the other into the substantive nature of the challenged transaction and the board's approval thereof."). In Abajian, the court noted that the legal test regarding an allegation of demand futility asks:

Whether accepting the specific facts pleaded as true, they create a reasonable doubt that the board's judgment attacked as constituting a wrong will not qualify for business judgment protection. That judgment may ultimately fail to qualify for business judgment deference because it is found to be the product of a board that is not disinterested and independent or because, even if the board appears disinterested, its process was such as to disqualify its judgment for that deference.

the board's decision to refuse a demand if one had been made and
demand futility is established.\textsuperscript{148}

The tests for determining whether a director is interested or
lacks independence are the same as the tests for other business
judgment rule cases.\textsuperscript{149} A director is interested in a transaction if
the director seeks to entrench his or her position or stands on both
sides of the transaction and derives a material, personal or financial
benefit not shared by the corporation or the stockholders.\textsuperscript{150} Re-
cently, the Delaware Supreme Court seemed to expand interested-
ness to include a material familial interest.\textsuperscript{151} A director lacks
independence if the director's decisions are based on considera-
tions or influences other than the merits of the decision.\textsuperscript{152} For
example, a director is not independent if the director is beholden
to one of the principals in the transaction in a way that affects the
director's independent judgment.\textsuperscript{153}

\textsuperscript{148} Grimes, 673 A.2d at 1219 n.25 (noting where board did not act indepen-
dently, business judgment rule does not attach) (citing Kahn v. Lynch
Communications Sys., 638 A.2d 1110, 1120-21 (Del. 1994)); Grobow,
539 A.2d at 188 (holding plaintiffs must "plead particularized facts demon-
strating either a financial interest or entrenchment" on part of directors);
Aronson, 473 A.2d at 815 (stating where interested board action exists, busi-
ness judgment rule does not attach and futility is established).

\textsuperscript{149} For a further discussion of interestedness or lack of indepen-
dence, see supra notes 35-49 and accompanying text.

\textsuperscript{150} Pogostin, 480 A.2d at 624 ("Directorial interest exists whenever divided
loyalties are present, or a director either has received, or is entitled to receive, a
personal financial benefit from the challenged transaction which is not equally
shared by the stockholders."); Aronson, 473 A.2d at 812 (noting plaintiff must show
board to be dominated by officer or director so discretion is "sterilized")). The
Rules court summarized the law of Aronson and its progeny as follows:

Directorial interest exists whenever divided loyalties are present, or a di-
rector has received, or is entitled to receive, a personal financial benefit
from the challenged transaction which is not equally shared by the stock-
holders. The question of independence flows from an analysis of the fact-
ual allegations pertaining to the influences upon the directors' perfor-
mance of their duties generally, and more specifically in respect to
the challenged transaction.

Rules, 634 A.2d at 933 (citing Pogostin, 480 A.2d at 624); see also Grobow,
539 A.2d at 188 (stating interestedness may be shown through entrench-
ment).

\textsuperscript{151} Grimes, 673 A.2d at 1216 (noting basis for excusal would be majority of
board has material financial or familial interest) (citing Aronson, 473 A.2d at
815); see also American Law Institute, Principles of Corporate Governance:
Analysis and Recommendations § 1.23(a)(2), at 25 (1994) (defining interested
director as one who "has a business, financial, or familial relationship with a party
to the transaction").

\textsuperscript{152} For a discussion of director independence, see supra notes 35-36 and
accompanying text.

\textsuperscript{153} Grimes, 673 A.2d at 1216 (stating basis for excusal is when majority of
board is incapable of acting independently). In Aronson, the court held that in
order to overcome the presumption of independence, the plaintiff cannot merely
allege that a director was chosen by or "elected at the behest of those controlling
Naming a director as a defendant and asserting claims against that director is not enough to make the director interested or not independent. Similarly, the director’s approval of the underlying challenged transaction, absent a breach of a fiduciary duty of the director in making that decision, is insufficient to establish that the director is interested or lacks independence. Furthermore, owning stock, even a majority of stock, or earning a fee for being a director does not make a director interested. Similarly, being nominated or elected by a controlling shareholder does not establish that a director lacks independence. In order to overcome the business judgment rule presumption of independence based on influence of a controlling person over a director, the plaintiff must allege that the director is “beholden to the controlling person.”

Even if the shareholder does not create a reasonable doubt that a majority of the board is disinterested or independent, the

the outcome of a corporate election. . . . It is the care, attention and sense of individual responsibility to the performance of one’s duties, not the method of election, that generally touches on independence.” Aronson, 473 A.2d at 816. According to the court in Aronson, “[i]ndependence means that a director’s decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences.” Id. Where a plaintiff claims demand futility, he or she must allege particularized facts “manifesting a direction of corporate conduct in such a way as to comport with the wishes or interests of the corporation (or persons) doing the controlling.” Id. (quoting Kaplan v. Centex Corp., 284 A.2d 119, 123 (Del. Ch. 1971)). When a plaintiff shareholder claims that the board is not independent, the plaintiff must show that the board is either dominated by a director or officer who supports the involved transaction or that the board is so under that director’s or officer’s influence that the board’s discretion has been “sterilized.” Id. at 814.

154. Id. at 815. In Aronson, the court noted:

[T]he mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterestedness of directors, although in rare cases a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists.

Id.; see also Seminaris v. Landa, 662 A.2d 1350, 1354 (Del. Ch. 1993) (noting director faced substantial likelihood of personal liability, but defendant’s actions were not so egregious as to merit finding substantial likelihood of liability existed).

155. Aronson, 473 A.2d at 817.

156. Id. at 816; Grobow v. Perot, 539 A.2d 180, 190 (Del. 1988) (holding director ownership of 0.8 percent of stock was insufficient to establish director interest).

157. Heineman v. Datapoint Corp., 611 A.2d 950, 955 (Del. 1992) (“Allegation[s] that directors are dominated and controlled, standing alone, does not meet the demand futility standard.” (citing Aronson, 473 A.2d at 816)).

court then moves to the second inquiry. Here, the court determines whether, based on the allegations of the complaint alone, the plaintiff has established a reasonable doubt that the challenged decision would be protected by the business judgment rule. Thus, the challenging shareholder must allege facts which are sufficient to create a reasonable doubt that the directors breached their duty of care, good faith or duty of loyalty with respect to the underlying board decision being challenged by the shareholder. The analysis is very similar to any attack on a business judgment. In this situation, however, the challenging shareholder can only rely upon particularized facts in the pleadings and must only create a reasonable doubt concerning whether the business judgment rule would be applicable.

D. Demand Excused When Board Not Involved in Challenged Transaction

In *Rales v. Blasband*, the Delaware Supreme Court first recognized the possibility that the two-step analysis should not apply in a demand excused case when the board considering the demand did not make the business decision being challenged in the derivative suit. In *Rales*, the court described three scenarios where the two-tiered analysis would be inappropriate: (1) where the board of a corporation made a business decision, but a majority of the directors who made that decision have since been replaced; (2) where the subject of the derivative suit is not a business decision of the board; and (3) where, as in *Rales*, the decision being challenged was made by the board of a different corporation. In each of these situations, the board facing the shareholder's demand did not make the particular decision at issue in the derivative suit.

*Rales* involved a double derivative suit in which a shareholder of the parent corporation attempted to assert a cause of action on behalf of the subsidiary corporation without making pre-suit demand on the parent's board. The parent's board did not make

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159. *Levine*, 591 A.2d at 206 (reinforcing requirement that plaintiff plead particularized facts to create reasonable doubt); *Grobow*, 539 A.2d at 187 (stating plaintiffs must plead particularized facts to rebut presumption of business judgment rule); *Aronson*, 473 A.2d at 812 (same).
160. 634 A.2d 927 (Del. 1993).
161. *Id.* at 933.
162. *Id.* at 954.
163. *Id.* at 930-31. The question before the court in *Rales* was whether the shareholder of the parent corporation adequately demonstrated demand futility in order to assert a cause of action on behalf of the subsidiary. *Id.* at 950. The actions spawning this litigation occurred after Easco Hand Tools, Inc. ("Easco") entered
the decisions that were the subject of the derivative action; rather, the decisions were made by the subsidiary's directors. Thus, the court declined to apply the two-tiered test for standing and held that in situations where the board did not make a business decision in the underlying transaction, a derivative suit was appropriate only if the board reviewing the demand would be incapable of making a disinterested and independent determination of whether to pursue the litigation. By adopting this one-step analysis, the court recognized that "[w]here there is no conscious decision by directors to act or refrain from acting, the business judgment rule [the second part of the two-step inquiry] has no application."

into a merger agreement with the Danaher Corporation ("Danaher") to become a wholly-owned subsidiary of Danaher. Id. The question of demand futility arose because the Rales brothers, named defendants, were directors of Easco at the time of the merger. Id. In addition, the brothers owned 52% of Easco's common stock and 44% of Danaher stock. Id. Furthermore, the brothers were, at all times, directors, officers and shareholders of Danaher and Easco. Id.

Id. at 933. The court determined that because the directors of Danaher had not made a decision regarding the substance of the challenged transaction, the Aronson test could not be applied in full. Id. "'The . . . business judgment inquiry of Aronson focuses on the substantive nature of the challenged transaction and the board's approval thereof.'" Id. (quoting Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984)).

In creating a different test for situations in which the board to whom demand would be made was not involved in the challenged decision, the court explained: "What, in the end, is relevant [in demand excused situations] is not whether the board that approved the challenged transaction was or was not interested in that transaction but whether the present board is not disabled from exercising its right and duty to control corporate litigation." Id. at 934 n.8 (quoting Harris v. Carter, 582 A.2d 222, 230 (Del. Ch. 1990)). In addition, the court noted that in deciding whether a board of directors can consider a demand under the Rales standard, the reviewing court should investigate whether the board followed a two-step process that involves: (1) the directors determining the best way to adequately inform themselves of the facts relating to the alleged wrongful transaction, including conducting an investigation reasonably and in good faith, and (2) the board weighing its alternatives, including making a determination as to the advisability of commencing legal action. Id. at 935.

Id. at 933 (citing Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984)). The court noted, however, that because Rales involved a double derivative suit, the plaintiff was required to satisfy the Aronson two-tiered analysis with respect to the subsidiary's board in order to establish the futility of demanding suit on that board. Id. at 934. The court required the plaintiff to satisfy the Aronson inquiry because the subsidiary board entered into the alleged wrongful transactions. Id. Thus, under Aronson, the Rales plaintiffs were required to show that the subsidiary's board was interested and not independent and thus, would not have been able to make an objective, neutral determination with respect to whether demand should be refused. Id.

In determining that the Aronson two-tiered analysis applied to the subsidiary board's decision to enter into the financial arrangements, the court rejected the defendant's argument that a standard test should apply in order to deter strike suits. Id. The court rejected the defendant's recommendation that, in this and other demand excused cases, the court adopt either a universal demand requirement or a requirement that the plaintiff demonstrate a reasonable probability of
E. Independent Litigation Committees

In response to either a shareholder demand or a derivative lawsuit commenced without demand, the board may want to evaluate whether the claim the shareholder desires to pursue is in the best interests of the corporation. A board, perceiving their lack of independence in reviewing a shareholder’s claim or desiring to ensure an unbiased evaluation, may form a special committee of disinterested and independent directors to decide whether the litigation is in the best interests of the corporation. Like all board decisions, the special committee’s decision is subject to judicial review. To date, the Delaware Supreme Court has only decided cases involving special committee decisions made after the shareholder’s derivative suit has been filed; the Delaware Supreme Court has not yet reviewed a special committee’s pre-suit analysis of a shareholder demand.

In Zapata Corp. v. Maldonado, the Delaware Supreme Court first discussed the formation and role of a board’s independent litigation committee and formulated a standard of review for the decision.

success. Id. The court found that neither approach would decrease the possibility of strike suits in greater numbers than adherence to the Aronson precedent. Id. at 934-35.

In Seminaris v. Landa, 662 A.2d 1350 (Del. Ch. 1995), the shareholder claimed that various board members conspired with the former Chairman of the Board to disseminate misleading and inaccurate information about the corporation’s financial condition and participated in the misrepresentation of signing misleading statements. In the alternative, the plaintiff also alleged that the board failed to take steps to stop the Chairman from making the misrepresentations concerning the corporation’s financial conditions. Id. at 1352, 1354. The shareholder initiated suit because the former Chairman of the Board made a public statement that the corporation would report a $250,000 profit for the reporting period. Id. at 1352. The chairman’s figure, however, significantly overstated the profit amount. Id. at 1354-55. In Seminaris, the Delaware Chancery Court applied the Rules standard because the corporation’s board did not make any business judgment with respect to the challenged transaction. Id. at 1354. The threshold question in Seminaris was whether to apply the Rules one-step test or the traditional two-tiered analysis. The Vice Chancellor applied Rules, finding that the shareholder failed to allege that the board made a conscious decision to take (or not to take) any specific action with respect to the alleged improper activity. Id. Accordingly, the court decided that the Rules one-step test, rather than the Aronson two-step test applied to the situation because the “plaintiff [did] not challenge any specific board action that approved or ratified . . . alleged wrongdoings.” Id. Applying the Rules standard, the court found that the plaintiff did not plead particularized facts creating a reasonable doubt that, as of the time the complaint was filed, a majority of the board of directors was independent or disinterested. Id. According to the court, the plaintiff had only established the likelihood that the former Chairman of the Board would be personally liable for his misrepresentations, but he had resigned from the board before the plaintiff had brought the derivative action. Id. Additionally, the court found that the plaintiff’s allegations of a conspiracy among directors lacked support. Id.

166. 430 A.2d 779 (Del. 1981).
sions of such special committees. In Zapata, a shareholder commenced a derivative action without first making a demand on the board, claiming that such demand would have been futile.\textsuperscript{167} Four years after the shareholder filed suit, the board created an “Independent Investigation Committee” composed of two newly-appointed directors to investigate whether the corporation should move to dismiss the plaintiff’s claims.\textsuperscript{168} After investigation, the committee determined that a motion should be filed to dismiss the shareholder’s claims.\textsuperscript{169}

In its review of the motion to dismiss, the court recognized that Delaware General Corporation Law allows a board to delegate decision-making authority, including derivative power to file a motion to dismiss the litigation to a committee.\textsuperscript{170} The court held that the board may delegate its decision-making authority in this area to a committee composed of disinterested directors even though a majority of the whole board is tainted by disqualifying self-interests.\textsuperscript{171} If such a committee is appointed and, after investigation, determines that the litigation is not in the corporation’s best interest, the committee may cause the corporation to file a motion to dismiss. The motion should include a written record of the committee’s investigation, findings and recommendations.\textsuperscript{172}

In deciding whether to grant a board’s motion to dismiss, the courts focus on the propriety of the committee’s decision. Since the board’s committee has made a business decision, it would normally be entitled to the presumption of the business judgment rule. In this context, however, the courts are sensitive to the fact that presumably the shareholder had standing to bring the derivative

\textsuperscript{167} Id. at 780. The plaintiff stated that demand would have been futile because all of the directors named as defendants in the action had allegedly played a role in the challenged acts. Id.

\textsuperscript{168} Id. at 781. The Committee’s determination was considered to be “final, . . . not . . . subject to review by the Board of Directors and . . . in all respects . . . binding upon the Corporation.” Id. When the Independent Committee was formed, four of the defendant directors were no longer on the board. Id.

\textsuperscript{169} Id.

\textsuperscript{170} Id. at 782. According to the court, “the board entity remains empowered under § 141(a) to make decisions regarding corporate litigation. The problem is one of membership disqualification, not the absence of power in the board.” Id. at 786.

\textsuperscript{171} Id. Relying upon § 141(c) of the Delaware General Corporation Law, the court found that the law was designed to allow disinterested directors to act on behalf of the board, regardless of the interest of the majority of the board. Id. The court noted “[w]e do not think that the interest taint of the board majority is per se a legal bar to the delegation of the board’s power to an independent committee composed of disinterested board members.” Id.

\textsuperscript{172} Id. at 788.
claim initially and that the true independence of the board is somewhat suspect. On the other hand, the courts are also aware of the fact that the derivative action may not always be in the best interest of the corporation and independent board members may be the best parties to weigh the costs and benefits of the litigation to the corporation. In order to balance these competing interests, the Delaware Supreme Court in Zapata was unwilling to give the board committee the benefit of the business judgment rule but was also unwilling to permit the shareholder to go forward with derivative litigation inimical to the corporation’s best interest. In striking the balance, the court designed a two-step test to determine the propriety of an independent committee’s decision to terminate the derivative suit in the corporation’s best interest.

First, the court must “inquire into the independence and good faith of the committee and the bases supporting its conclusions.”173 The burden is on the board to establish the committee’s independence, good faith and reasonable investigation.174 Unlike other demand excused or demand refused cases, the shareholder is entitled to discovery limited to these issues.175 The court will deny the motion if it finds any genuine issue of material fact concerning the committee’s independence, reasonable bases for its conclusions, good faith or any other deficiencies in the process followed by the committee.176

Second, the court may, in its discretion, apply its own business judgment in order to determine whether the motion to dismiss should be granted.177 The Zapata court stated that this step “provides . . . the essential key in striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation’s best interests as expressed by an independent investigating committee.”178 This second step may result in the denial of

173. Id. Essentially, the court treats the corporation’s motion to dismiss like a motion for summary judgment, determining whether there is a genuine issue as to a material fact. Id. The two-tiered analysis permits the court to make a determination as to whether such a genuine issue exists regarding the independent committee’s ability to make a reasonable, good faith decision concerning the recommendation to terminate the litigation. Id. at 789.
174. Id. at 788.
175. Id.; see also Szeto v. Schiffer, No. CIV.A.12994, 1993 WL 513229, at *3 (Del. Ch. Nov. 24, 1993) (mem.) (noting limited discovery is available to investigate board independence and good faith).
176. Zapata, 430 A.2d at 787.
177. Id. at 789.
178. Id.; see Kaplan v. Wyatt, 499 A.2d 1184, 1191 (Del. 1995) (holding second step is discretionary); WILLIAM L. CARY & MELVIN A. EISENBERG, CORPORATIONS 1069 (7th ed. 1995) (noting that given importance that Aronson court ascribed to
a motion to dismiss even when the committee established the decision was the product of a legitimate business judgment. According to the court, "[t]he second step is intended to thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation's interest."  

Since Zapata, the Delaware courts have addressed special committees in a variety of different contexts. In Abbey v. Computer & Communications Technology Corp.,¹⁸¹ a shareholder made demand on the board. The board did not immediately respond to the demand primarily because the corporation's general counsel was on vacation, a fact known by the shareholder.¹⁸² Impatient with the board's delay in responding to the demand, the shareholder brought a derivative action before receiving a response from the board.¹⁸³ Shortly after the shareholder instituted the derivative second step (i.e. "essential in striking the balance") it seems anomalous that second step is discretionary).

179. Zapata, 430 A.2d at 789.

180. Id. In Zapata the court discussed its two-tiered test and presumed demand futility. According to the court, a reviewing court must "consider and weigh how compelling the corporate interest in dismissal is when faced with a non-frivolous lawsuit." Id.

Although the injection of the court's "own business judgment" seems contrary to the basic policies behind the business judgment rule, it has been used in other analogous situations where it was necessary to provide an additional level of protection to stockholders. See Del. Ch. Ct. R. 23(e) (requiring court approval of settlement or dismissal of class action); Norman Veasey, Seeking a Safe Harbor from Judicial Scrutiny of Directors' Business Decisions—An Analytical Framework for Litigation Strategy and Counseling Directors, 37 Bus. Law. 1247 (1982) (noting that Chancery Court must use its judgment in deciding whether to approve settlements in derivative actions). The reviewing court's independent business judgment review of a special litigation committee's report to dismiss a derivative action seems justified on the basis that the ability of a special committee to be truly independent is often questionable. See, e.g., Joy v. North, 692 F.2d 880, 888 (2d Cir. 1982) (noting federal court's concern over structural bias arising because independent committee is typically nominated and appointed by defendant directors), cert. denied, 460 U.S. 1051 (1983); see also John C. Coffee, Jr. & Donald E. Schwartz, The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform, 81 Colum. L. Rev. 261, 273-77 (1981) (stating special litigation committee "too easily tamed and held hostage, either by explicit agreement or . . . by the expectations of the rest of the board").

181. 457 A.2d 368 (Del. Ch. 1983).

182. Id. at 370.

183. Id. After making demand on the board, the plaintiff received a letter from the board stating that it would be unable to review the demand until corporate general counsel returned from vacation. Id. Counsel returned after the ten day deadline given to the board by the plaintiff in her demand letter. Id. Even though the plaintiff knew that consideration of demand would be delayed, she filed suit five days before corporate counsel was due to return from vacation. Id.
suit, the board added a new independent director to the board and formed a one-member independent committee (comprised of the new director) to investigate the plaintiff’s claim. The committee immediately filed a motion to dismiss the derivative claim based on the shareholder’s failure to comply with the presuit demand requirement of Rule 23.1.

In Abbey, the court held that the board, by forming a special committee with complete decision-making authority after the derivative suit had been filed, had conceded that the board was not independent. Therefore, the court concluded that demand was excused on that basis. The court indicated, however, that the board would not have conceded futility had it moved to dismiss the action while simultaneously appointing a special committee to investigate the shareholder’s claims. The court reasoned that in that situation the board would have reserved its final decision-making power and the court’s review of the decision to terminate the litigation under the Zapata standard would then be inappropriate. Nevertheless, in Abbey, the court permitted the independent committee to complete its investigation and then disclose its find-

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184. *Id.* at 370-71. The board adopted a resolution adding a new, disinterested director to the board, naming him as the sole member of the independent litigation committee which was charged with conducting a full investigation into the demand, making the committee’s findings and determinations final and not subject to board review. *Id.* at 371. The one-member independent committee retained independent counsel and began its investigation. *Id.* Several days later, the corporation and the individual defendants filed a motion to dismiss the suit for failure to comply with Rule 23.1, and in the alternative, to stay the proceedings until the committee released its report. *Id.*

185. *Id.*

186. *Id.* at 373. In Abbey, the court stated that:

[B]y divesting itself of any power to make a decision on the pending suit, and by adding a new and independent director and by designating him as a Special Litigation Committee of one with the final and absolute authority to make the decision on behalf of the corporation, the incumbent board of directors, in effect, conceded that the circumstances alleged in the complaint justified the initiation of the suit by the plaintiff [without pre-suit demand].

*Id.*

187. *Id.* at 374.

188. *Id.* The court concluded that:

In such a case, the board would not be empowering the committee to invoke the new Zapata procedure and to move for a dismissal of the suit in its own right on behalf of the corporation. It would not be surrendering its § 141(a) authority to an independent committee which, [under Zapata], is now permitted only in a situation where the board, or a majority thereof, is disqualified under the circumstances alleged in the complaint.

*Id.*
ings subject to the two-part Zapata test. The court followed this procedure because a party to the lawsuit cannot conduct discovery while an independent committee investigates a demand claim.

In Seminaris v. Landa, the shareholder argued that demand was excused because the board, by appointing a special litigation committee before the board moved to dismiss the shareholder’s derivative suit for failure to make a demand, had conceded that it was not independent. The court rejected the shareholder’s assertion for two reasons. First, the shareholder relied upon Levine v. Smith, which was a demand refused case, not a demand excused case. Second, the court noted that Levine itself had clearly stated that “a disinterested board of directors does not waive its right to control derivative litigation merely by delegating that control to a special committee.”

The court in Seminaris also looked to Rales where the Vice-Chancellor had explained that in order to find that the board conceded demand futility, the shareholder must allege particularized facts that support a factual determination that the board intended to concede demand. In Seminaris, the court held that the shareholder failed to make the required showing because he did not allege any facts demonstrating that the board considered itself incapable of making an impartial decision other than the fact that

189. Id.
190. Id. at 375. According to the court, “[i]f Zapata is to be meaningful, then it would seem that such an independent committee, once appointed, should be afforded a reasonable time to carry out its function. It would likewise seem reasonable to hold normal discovery and other matters in abeyance during this interval.” Id.
191. 662 A.2d 1350 (Del. Ch. 1995).
192. In Seminaris, the plaintiff argued that under Levine, the board conceded that demand was futile by appointing a special committee comprised solely of outside directors before the board moved to dismiss the plaintiff’s complaint for failure to make a demand. Id. The plaintiff contended that Levine suggests that appointing a special committee in response to derivative litigation establishes a concession by the board that demand would have been futile. Id. at 1353.
194. Seminaris, 662 A.2d at 1353.
195. Id.
196. Id. (citing Spiegel v. Buntrock, 571 A.2d 767 (Del. 1990)).
it had appointed a special litigation committee. Accordingly, the court found that the board had not conceded that it was interested and the shareholder bore the burden of showing that demand was excused under the Rales one-step test.

Seminaris and Abbey seem to be inconsistent. The court in Abbey was willing to presume that the board conceded interestedness simply by appointing an independent committee. Seminaris, on the other hand, required that the shareholder demonstrate that the board was, in fact, interested. We think Seminaris is consistent with the Supreme Court's approach in Levine and Spiegel v. Buntrock. We believe, however, that even under the court's approach in Seminaris, a court would find the board in Abbey interested under the facts of that case. In other words, we think that the Supreme Court would not view the appointment of an independent committee alone as a concession by the board that it was interested.

VII. UNDERSTANDING THE SHIFTING BURDENS DEPENDING UPON PROCEDURAL POSTURE OF THE CASE

In challenges to directors' business decisions, a shareholder has the burden of moving forward with evidence sufficient to state a prima facie case and bears the initial burden of proof to provide the court with the quantum of evidence necessary, at that stage of the proceeding, to defeat the presumptions of the business judgment rule. The shareholder must meet its burden of proof and rebut the business judgment rule at each stage of the case. If the shareholder rebuts the business judgment rule at each stage, the board will bear the burden of proof of demonstrating the entire fairness of the director's business decisions.

In shareholder litigation, the procedural posture of the case determines the quantum of evidence necessary and where the burden of proof lies. While the burden of moving forward with the case and establishing a prima facie case will always rest with the

197. Id. The court distinguished Seminaris on its facts from Abbey v. Computer & Communications Technology, 457 A.2d 362, 373 (Del. Ch. 1980). In Abbey, the board responded to a derivative lawsuit by adding a new independent director and appointing him to a one-member special litigation committee. Id. In Seminaris, however, the board of directors appointed current members of its own board to the newly-created special litigation committee. Seminaris, 662 A.2d at 1353. Furthermore, the plaintiff failed to allege any facts showing an interest for some board members, but not for the members of the special litigation committee. Id.

198. Id.

199. 571 A.2d 767 (Del. 1990).

200. For a further discussion of the facts and the court's holding in Abbey, see supra notes 181-90 and accompanying text.
plaintiff, the procedural posture of the case can shift the burden of proof to the defendant. Accordingly, parties must structure their pleadings, discovery, proof and argument to conform to the Delaware courts' procedural rubric. In the following sections, we discuss various common pretrial proceedings and the effect of the procedural posture on the types of pleading or proof permitted, the amount of proof required and which party bears the burden of proof on the issues that typically arise in shareholder challenges to directors' decisions.

A. Temporary Restraining Order

A temporary restraining order prevents irreparable harm (generally, but not always, by maintaining the status quo) until such time as the court conducts an evidentiary hearing on the preliminary injunction or the injunction is otherwise dissolved.\(^{201}\) There are two types of temporary restraining orders. A prohibitive injunction prevents the board from taking action that would result in irreparable harm, while a mandatory injunction requires the board to take action to prevent irreparable harm to the corporation or its stockholders.\(^{202}\) During the pendency of a temporary restraining order, the parties typically conduct necessary discovery and the defendant (corporation or board) responds to the allegations of the challenging party before the preliminary injunction hearing.\(^{203}\)

In order to obtain a temporary restraining order, the moving party must file a verified complaint in the Court of Chancery and a petition (motion) for a temporary restraining order that requests immediate relief.\(^{204}\) Ordinarily, the movant will also provide affidavit:

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204. Del. Ch. Ct. R. 65(b). The rule reads in pertinent part:

(b) Temporary Restraining Order; Notice; Hearing; Duration. A temporary restraining order may be granted without written or oral notice to the adverse party or the adverse party's attorney only if (1) it clearly appears from specific facts shown by affidavit or by the verified complaint that immediate and irreparable injury, loss or damage will result to the
vits in support of his request for a temporary injunction. The petition for a temporary restraining order is forwarded immediately to the Register in Chancery who schedules a conference or hearing with as much notice as possible to all parties. A temporary restraining order may be granted without notice if the movant certifies that he has made good faith, unsuccessful efforts to give notice and provides persuasive reasons why the movant would be irreparably harmed by the delay which would result from giving notice.

The Chancery Court, in ruling upon a petition for a temporary restraining order, must accept the allegations in the movant's complaint, petition and supporting affidavits as true. A temporary restraining order entered without notice must not exceed ten days, unless the court extends this period for good cause shown as of record. Ordinarily, a movant for a temporary restraining order will also seek leave to take expedited discovery immediately to prepare for the preliminary injunction hearing.

applicant before the adverse party or the adverse party's attorney can be heard in opposition, and (2) the applicant's attorney certifies to the Court in writing the efforts, if any, which have been made to give the notice and the reasons supporting the attorney's claim that notice should not be required. Every temporary restraining order granted without notice shall be indorsed with the date and hour of issuance; shall be filed forthwith in the office of the Register in Chancery and entered of record; shall define the injury and state why it is irreparable and why the order was granted without notice; and shall expire by its terms within such time after entry, not to exceed 10 days, as the Court fixes, unless within the time so fixed the order, for good cause shown, is extended for a like period or unless the party against whom the order is directed consents that it may be extended for a longer period. In case a temporary restraining order is granted without notice, the motion for a preliminary injunction shall be set down for hearing at the earliest possible time and takes precedence of all matters except older matters of the same character; and when the motion comes on for hearing the party who obtained the temporary restraining order shall proceed with the application for a preliminary injunction and, if the party who obtained the temporary restraining order does not do so, the Court shall dissolve the order. On 2 days' notice to the party who obtained the temporary restraining order without notice or on such shorter notice to that party as the Court may prescribe, the adverse party may appear and move its dissolution or modification and in that event the Court shall proceed to hear and determine such motion as expeditiously as the ends of justice require.

Id. 205. Id.

206. Id.


208. DEL. CH. CT. R. 65(b). For the text of Rule 65(b), see supra note 204.

209. See GM Sub Corp. v. Liggett Group, 415 A.2d 473, 477 (Del. 1980) (noting that "[t]he order of the Vice Chancellor temporarily restraining GM Sub from proceeding with the tender offer also permitted discovery on an expedited basis").
To obtain a temporary restraining order, the movant bears the burden of proving that: (1) imminent, irreparable injury will occur prior to a full hearing if the order is not issued; (2) the merits of the complaint "appear to have sufficient weight and plausibility to justify a short interference" with the defendant's rights; and (3) in balancing the equities, the risks of irreparable injury to the movant if the order is not granted are greater than the injury suffered by the defendant if the order is granted.210 First, in determining whether the movant has met its burden of proof with respect to the presence of irreparable harm, the movant must show that there is no adequate remedy at law.211 The injury must also be shown to be immediate or imminent, and actual, not hypothetical.212 If the injury which would result is substantial enough, however, the court may not require a showing of immediate or imminent harm.213 Second, the movant must usually show that a colorable claim exists.214 A colorable claim exists if the movant demonstrates that the claim has "sufficient weight" and "plausibility" to justify the interference with the defendant's rights for a short period of time.215 Third, the movant must demonstrate that the equities warrant temporary restraints.216 In balancing the equities, the court determines whether the risks of injury to the movant, if the order is not

210. Carson Pirie Scott & Co. v. Gould, No. CIV.A.14359, 1995 WL 419980, at *3 (Del. Ch. July 12, 1995) (stating temporary restraining order granted where imminent irreparable injury may occur, where there is sufficient weight to justify interference and where order is less of risk than irreparable injury); see also Raptor Sys. Inc. v. Pensak, No. CIV.A.13614, 1994 WL 512526, at *2 (Del. Ch. Sept. 12, 1994) (noting plaintiff seeking status quo order under Del. Code Ann. tit. 8, § 225 must establish: (1) order will avoid imminent irreparable harm; (2) there is reasonable likelihood of success on merits; and (3) harm to plaintiff outweighs harm to defendant).

211. Carson Pirie, 1995 WL 419980, at *8 (noting plaintiff must show "imminent injury that, if it occurs cannot be effectively remedied later, after trial of the issues, by the award of money damages or the shaping of equitable relief").

212. Id. (rejecting plaintiff's claim of irreparable injury because effect of allegations of improper actions on plaintiff was too speculative).

213. See Panamanian Sec., Inc. v. Punta Alegre Sugar Corp., 146 A.2d 808, 810 (Del. Ch. 1958) (concluding defendant's motion for temporary restraining order was deficient because there was no showing of urgent need and stating, "I do not believe that the restraining order only issues when the threat is imminent").


215. Id.; cf. Carson Pirie, 1995 WL 419980, at *3-4 (finding plaintiff did not establish "colorable" claim when effect of alleged wrongful conduct was "highly speculative"); see also Cottle, 1988 WL 10415, at *2 (comparing standard of proof in temporary restraining orders and preliminary injunctions); UIS Inc. v. Walbro Corp., No. CIV.A.9323, 1987 WL 18108, at *1 (Del. Ch. Oct. 6, 1987) (same). For a further discussion of the standard of review at the preliminary injunction stage, see infra notes 230-244 and accompanying text.

granted, are greater than the injury suffered by the defendant, if
the restraint is imposed.217

The most important factor is the threat of irreparable injury
occurring before an evidentiary hearing is held.218 Courts focus on
this factor and often grant temporary restraining orders, even if
the other two factors are not conclusively shown.219 If the court
issues the temporary restraining order, the movant must provide
security (bond) for the payment of costs and damages incurred by
any party who has been wrongfully enjoined or restrained.220 The
court has wide discretion in determining the amount of the
bond.221

After entry of a temporary restraining order, the enjoined
party may move for dissolution or modification of the injunction.
The court must hear and determine the motion as soon as possi-
ble.222 To dissolve a temporary restraining order, the enjoined
party has the burden of proof that the court improvidently granted
the temporary restraining order by showing that one of the ele-

469169, at *3 (Del. Ch. Aug. 26, 1994) ("[I]t is always appropriate for a court of
equity to ask what will occur if that extraordinary remedy is not issued.").

217. Carson Perie, 1995 WL 419980, at *3 ("A court will risk interference with
the business judgment of a board of directors (even interference for the short
period contemplated by a temporary restraining order) only when threatened ir-
reparable injury will justify that step and that injury outweighs threatened injury to
the party enjoined."); Cottle, 1988 WL 10415, at *3 (noting in balancing interests of
parties, court should grant temporary restraining order unless court is persuaded
"that the risk of harm in granting the remedy is greater than the risk to plaintiff in
denying it").

218. Cottle, 1988 WL 10415, at *3 ("The essential predicate for issuance of the
remedy is a threat of imminent irreparable injury."); see also Del. Ch. Ct. R. 65(b)
(noting that showing of irreparable injury is prerequisite to recovery).

219. Cottle, 1988 WL 10415, at *2-3 (recognizing focus of temporary re-
straining order is "not importantly upon an assessment of the probability of suc-
cess, but is primarily upon the injury to the plaintiff"); see also U/S, 1987 WL 18108,
at *2 (noting "one cannot at this stage responsibly form any tentative judgment
about the relative merits of [the plaintiff's] positions," and also noting that central
inquiry was threat of immediate, irreparable injury).

220. Del. Ch. Ct. R. 65(c). Rule 65(c) provides in pertinent part:
(c) Security. No restraining order . . . shall issue except upon the giving
of security by the applicant, in such sum as the Court deems proper, for
the payment of such costs and damages as may be incurred or suffered by
any party who is found to have been wrongfully enjoined or restrained.
Any security given as a condition to the issuance of a restraining order
shall also constitute security for any preliminary injunction subsequently
issued and requiring security.
Id. See Levin v. Metro-Goldwyn Mayer, Inc., 221 A.2d 499, 505 (Del. Ch. 1966)
(noting bond must be posted as security to party later found to be wrongfully
enjoined).

221. Levin, 221 A.2d at 505.

222. Del. Ch. Ct. R. 65(b) (noting motion must be heard "as the ends of
justice require").
ments for a temporary restraining order does not exist.\textsuperscript{223} The en-
joined party must deny the material allegations of the complaint
and petition with specificity.\textsuperscript{224} The court's initial decision with re-
spect to a temporary restraining order is not binding at any other
stage of the proceeding.\textsuperscript{225}

The temporary restraining order, granted upon notice, will last
only as long as necessary for the parties to prepare for the prelimi-
nary injunction hearing.\textsuperscript{226} During the pendency of the temporary
restraining order, the parties usually conduct expedited discovery
to prepare for the preliminary injunction hearing.\textsuperscript{227} Expedited
discovery can include depositions, interrogatories, and document
requests. As in all litigation, the parties frequently will disagree as
to the permissible scope of discovery. Discovery issues are then re-
solved through tools such as motions to compel and protective
orders.\textsuperscript{228}

As a practical matter, many cases settle at this stage of the litiga-
tion. The production of documents and deposition testimony gives
the parties information that enables them to realistically evaluate
the factual strengths and weaknesses of their cases. Furthermore,
in deciding discovery disputes, the Chancery Court's rulings are
often indicative of how the court will ultimately rule on the merits.
Thus, the combination of information obtained in discovery from
the parties and the court's discovery rulings themselves frequently
push the parties to settle weak cases or force plaintiffs to voluntarily
dismiss weak cases.\textsuperscript{229}

\begin{itemize}
  \item \textsuperscript{223} Lionel Corp. v. Klein, 106 A.2d 525, 526 (Del. Ch. 1954) (noting en-
  joined party meets burden by denying material obligations of complaint with same
clearness and certainty with which they were charged).
  \item \textsuperscript{224} Id. (denying motion to vacate preliminary injunction on basis that de-
  fendant did not specifically deny material allegations in complaint).
  \item \textsuperscript{225} Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1303 (Del. 1987)
  (denying temporary restraining order, but granting preliminary injunction).
  \item \textsuperscript{226} See Carson Pirie Scott & Co. v. Gould, No. CIV.A.14359, 1995 WL 419980,
at *3 (Del. Ch. July 12, 1995) (noting temporary restraining order is short in
  duration).
  \item \textsuperscript{227} See GM Sub Corp. v. Liggett Group, 415 A.2d 473, 477 (Del. 1980) (not-
  ing after temporary restraining order was issued, expedited discovery was per-
  mitted); Arbitrium Handels AG v. Johnson, No. CIV.A.13056, 1994 WL 586828, at *1
  (Del. Ch. Sept. 23, 1994) (explaining Chancery Court ordered expedited discovery
  after entering temporary restraining order).
  \item \textsuperscript{228} The Chancery Court rules governing discovery, Rules 26 to 37, are virtu-
  ally identical to their counterparts in the Federal Rules of Civil Procedure.
  \item \textsuperscript{229} Sometimes, a plaintiff may move to voluntarily dismiss weak claims pur-
  suant to Chancery Court Rule 41(a)(2). Generally, a court will grant a voluntary
dismissal by a plaintiff unless the defendant will suffer "plain legal prejudice." Draper
  To determine whether a defendant would suffer "plain legal prejudice," the

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B. Preliminary Injunction

While a temporary restraining order enables the parties to conduct necessary discovery and prevent irreparable harm during that discovery, a preliminary injunction prevents irreparable harm prior to a trial on the merits. A preliminary injunction hearing, the movant is required to meet his burden of proof. Witnesses are not generally called to testify at a preliminary injunction hearing. Instead, in order to establish his right to a preliminary injunction, the movant introduces deposition testimony, affidavits, documents, other uncontested facts and briefs supporting the movant's position on the relevant legal and factual issues.

There are two types of preliminary injunctions. A prohibitory injunction prevents a party from taking action, while a mandatory injunction compels a party to take action. A shareholder seeking either type of preliminary injunction bears the burden of proving the following: (1) a reasonable probability of success on the merits at trial; (2) irreparable harm if the injunction is not granted; and (3) that in balancing the equities, the risk of injury to the movant if the injunction is not granted outweighs the injury suffered by the opposing party if the order is granted. Sometimes, in balancing

court in Draper stated a variety of factors including: (1) the defendant's effort and expense in trial preparation; (2) the plaintiff's excessive delay and lack of diligence in prosecuting the action; or (3) whether there has been sufficient explanation of the reason for a plaintiff to voluntarily dismiss the case. Id. Accordingly, the Delaware courts have allowed voluntary dismissal even after defendants filed a motion for summary judgment. Id.

250. See, e.g., Cohn v. Crocker Nat'l Corp., 490 A.2d 569, 570 (Del. Ch. 1985) (stating that in deciding preliminary injunction petition, courts are required to make predictions on legal merits of case, and thus, become de jure decision makers of case, which in turn can avoid need for trial because of enhanced prospects of settlement or voluntary dismissal).


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the equities, the court will expressly consider the public interest.\footnote{233} With respect to shareholder challenges of board decisions, the most important element to obtain a preliminary injunction is whether the shareholder has demonstrated a reasonable probability of success on the merits.\footnote{234}

To succeed on an application for a mandatory preliminary injunction, however, the movant must clearly establish that he or she is entitled to relief.\footnote{235} Because the court will be granting what amounts to final relief on an interim basis,\footnote{236} the court will grant a mandatory preliminary injunction only where there is no genuine

\footnote{233} Giammargo v. Snapple Beverage Corp., No. CIV.A.13845, 1994 WL 672719, at *2 (Del. Ch. 1985) (noting court must weigh public interest of efficient justice in decision whether to grant preliminary injunction); Newell Co. v. Wm. E. Wright Co., 500 A.2d 974, 975 (Del. Ch. 1985) (noting public interest is consideration in granting preliminary injunction).

\footnote{234} Glazer v. Zapata Corp., 658 A.2d 176 (Del. Ch. 1993); Home Shopping Network, Inc. v. Liberty Media Corp., No. CIV.A.12868, 1993 WL 172971, at *11 (Del. Ch. May 19, 1993) (noting that there were no disclosure violations and no "business combinations" in violation of § 203). In re Unitrin, Inc. Shareholders Litig., No. CIV.A.13656, 1994 WL 698483 (Del. Ch. Oct. 13, 1994), rev'd on other grounds, Unitrin, 651 A.2d 1361 (Del. 1995) is instructive on this issue. The court, after finding likelihood of success on the merits, found that depriving shareholders of the opportunity to accept a potentially higher offer for their stock is irreparable. The Vice Chancellor further found that a repurchase of stock which may later be improper will create irreparable harm as "it will be extremely difficult, if not impossible to compensate fully those shareholders who sold their stock or to restore them to the status quo." \textit{Id.} at *11. \textit{See also} Blasius Indus. Inc. v. Atlas Corp., 564 A.2d 651, 657 (Del. Ch. 1988) (showing of interference with shareholder franchise creates irreparable harm); \textit{compare} Chadha v. Szeto, No. CIV.A.13210, 1993 WL 498186 (Del. Ch. Nov. 18, 1993) and Unitrin, 651 A.2d at 1361 (holding in ambiguous factual circumstances, court has broad power to fashion equitable remedy until such time as there has been trial on merits of complaint) \textit{with} Dolgoff v. Projectavision, Inc., No. CIV.A.14805, 1996 WL 91945, at *9 (Del. Ch. Feb. 29, 1996) (holding even though director may be improperly in office, extraordinary remedy of preliminary injunction is inappropriate) (citing Columbia Pictures Indus., Inc. v. Kerkorian, No. CIV.A.6394 (Del. Ch. Dec. 16, 1980)).

Recently, Chancellor Allen indicated that even if the movant cannot establish that the balancing of the equities would weigh in favor of granting a preliminary injunction, the injunction can nevertheless be granted if the movant has clearly established the violation of an important right. First Olefins Ltd. Partnership v. American Olefins, Inc., No. CIV.A.14707, 1996 WL 209719, at *8 (Del. Ch. Mar. 1, 1996) ("Only the clearest violation of an established and important right would allow a court of equity to consider the issuance of an injunction in such circumstances.")

\footnote{235} Steiner v. Simmons, 111 A.2d 574, 575 (Del. 1955) (noting plaintiff must establish entitled relief prior to mandatory injunction being granted); Chadha, 1993 WL 498186, at *2 (noting plaintiff must establish legal right to invoke preliminary injunction); Stahl v. Apple Bancorp, Inc., 579 A.2d 1115, 1120 (Del. Ch. 1990) (stating plaintiff seeking mandatory preliminary injunction must establish legal right he seeks to enforce or protect).

\footnote{236} Alliance Gaming Corp. v. Bally Gaming Int'l, Inc., No. CIV.A.14440, 1995 WL 523548, at *9 (Del. Ch. Aug. 11, 1995) (noting courts are particularly
dispute with respect to a material fact.\textsuperscript{237} Thus, the standard becomes essentially a summary judgment standard and the court will only award a mandatory preliminary injunction in a clear case.\textsuperscript{238} In many situations the grant or denial of a preliminary injunction is the end of the case as a practical matter. Many of the cases challenging board decisions never go to trial due to the time sensitive nature of many board decisions and the difficulty of undoing a transaction once it is complete.

In demonstrating the likelihood of success on the merits, the shareholder bears the initial burden of establishing that the board violated at least one of its triad of fiduciary duties, thereby rebutting the business judgment rule's presumption of valid board action.\textsuperscript{239} If the shareholder meets this burden, the burden of proof shifts to the directors to demonstrate the entire fairness of their actions.\textsuperscript{240}

hesitant to enter mandatory injunctive relief “in an ongoing contest for control while the facts are in flux and constantly evolving”).


\textsuperscript{238} Steiner, 111 A.2d at 575 (noting mandatory preliminary injunction not granted unless right to relief is clearly established); Si-Lake, 1994 WL 728824, at *4; Stahl, 579 A.2d at 1115; Kingsbridge, 1989 WL 89449, at *4 (noting grant of mandatory preliminary injunction requires plaintiff meeting standard required for summary judgment).

\textsuperscript{239} Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1371 (Del. 1995) (tying injunction standard of “reasonable success on the merits” to summary judgment standard of “undisputed genuine issues of material fact”). In Kidsco Inc. v. Dinsmore, 674 A.2d 485 (Del. Ch.), aff’ed, 670 A.2d 1338 (Del. 1995), plaintiff moved both for summary judgment and a preliminary injunction. \textit{Id.} at 485. The court found that, if plaintiff’s basic premise as to summary judgment was correct, “injunctive relief must follow as a matter of course.” \textit{Id.} at 492. The court denied injunctive relief because the plaintiff failed to establish probable success on the merits of any of their claims. \textit{Id.}

\textsuperscript{240} Civil III, 663 A.2d 1156, 1162 (Del. 1995) (stating once shareholder rebuts presumption, burden shifts to directors to prove entire fairness); Unitrin, 651 A.2d at 1371; Weinberger v. UOP, Inc., 457 A.2d 701, 710-11 (Del. 1983).

The court in \textit{Unitrin} discussed that the burdens of proof in the preliminary injunction hearing also shift to the board if shareholders can plead and show board approval of a transaction resulting in sale of control or adoption of defensive measures in response to a threat for corporate control. \textit{Unitrin}, 651 A.2d at 1371. In this context, the directors must then meet, even in the injunction hearing, the enhanced judicial scrutiny imposed upon them by Delaware law. \textit{Id.} If the directors satisfy the enhanced scrutiny in the injunction hearing, the shareholders must then show that the business judgment rule does not apply because of a breach of the duties of loyalty, care or good faith. \textit{Id.} If however, the directors fail to meet the enhanced scrutiny, they will then bear the burden of proof that their actions were entirely fair. \textit{Id.} Fuller analysis of these issues is reserved for Part II of this Article and will not be addressed in this first part.
If the shareholders fail to rebut the business judgment rule or the directors meet their burden of proof with respect to entire fairness, the court will deny the preliminary injunction because the shareholder failed to establish the likelihood of success on the merits. If the shareholder successfully rebuts the business judgment rule and thereby shifts the burden to the directors with respect to the likelihood of success on the merits, the stockholder still carries the burden of proving irreparable injury and that the balance of the equities favors granting the preliminary injunction. Thus, even if a shareholder establishes a likelihood of success on the merits, the court will deny an injunction when it threatens far more harm than it would prevent.

Either party may seek immediate appellate review of the grant, denial, dissolution or modification of a preliminary injunction. On appeal, the Delaware Supreme Court reviews the entire record to determine whether the Chancery Court's findings are supported by the record and are the product of an orderly and logical deductive process.

C. Motion to Dismiss the Complaint

If the complaint does not request injunctive relief, the defendant frequently responds to the complaint by filing a motion to dismiss the complaint pursuant to Chancery Court Rule 12(b)(6). The purpose of this motion is to test whether the allegations of the complaint, which are assumed to be true for purposes of the motion, state a claim for relief. This motion is filed within twenty days of service of the complaint.

As with its federal rule counterpart, the Delaware pleading rules require only notice pleading. A motion to dismiss for fail-

245. Del. Ch. Ct. R. 12(b)(6). Of course, the Delaware courts will first review the court's personal jurisdiction prior to examining the merits of the pleading. See Solomon v. Pathe Communications Corp., 672 A.2d 35, 40 (Del. 1996) ("As a general rule, jurisdictional matters should be decided before substantive matters." (citing Branson v. Exide Electronics Corp., 625 A.2d 267, 268 (Del. 1993))).
247. Wells Fargo & Co. v. First Interstate Bancorp, Nos. CIV.A.14696, 14623, 1996 WL 32169, at *11 (Del. Ch. Jan. 18, 1996) (noting rules are "very sympathetic to plaintiffs"); see Solomon, 672 A.2d at 39 ("Delaware courts have recognized that the standard to be used to evaluate a Chancery Rule 12(b)(6) motion is less strin-
ure to state a claim will not be granted unless it appears that the plaintiff is not entitled to relief under any set of facts that could be proved in support of the plaintiff's claim. Complaints alleging breach of fiduciary duties must allege facts from which one could reasonably conclude that the directors violated their fiduciary duties. All well-pleaded allegations in the complaint must be accepted as true. The complaint must fairly apprise the defendants of the facts that warrant the relief sought by the plaintiff. The court will not make inferences or assume conclusions of law or fact to be true without specific allegations of facts supporting the inferences or conclusions.

248. Garza v. TV Answer, Inc., No. CIV.A.12784, 1993 WL 77186, at *1 (Del. Ch. Mar. 11, 1993) ("[A] complaint may not be dismissed unless it appears to a reasonable certainty that the plaintiff could not be entitled to relief under any set of facts.")

249. Kahn v. Dairy Mart Convenience Stores, G.P., No. CIV.A.12489, 1994 WL 89010, at *2 (Del. Ch. Mar. 1, 1994) (concluding "directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty—good faith, loyalty or due care") (quoting Code II, 634 A.2d 345, 361 (Del. 1993)); Garza, 1993 WL 77186, at *5 (holding breach established by pleading that majority shareholders "fixed the value of shares being offered themselves below their real value in furtherance of the individual defendants' scheme to impair the value of [plaintiff's] holdings in the Company and to dilute his interest therein and to enhance the value of their own holdings"). In Garza, the complaint simply alleged that the directors themselves owned 75% of the stock and that a stock offering was made on a pro rata basis to all shareholders except the plaintiff, at a price deliberately set below the value of plaintiff's stock. Garza, 1993 WL 77186, at *2-3. The court held that the complaint sufficiently alleged that a benefit was not shared with all shareholders equally, the directors had a personal financial interest in the transaction, and the business judgment rule would not protect the directors' decisions. Id. at *5-7.

A complaint, however, which merely alleges that the board did not negotiate a sufficient tender offer and elected not to dispute certain actions did not state a claim for breach of the duty of care. Solomon, 672 A.2d at 39 (noting absent pleading of facts, not conclusions, from which there could be drawn reasonable inference that there was coercion or lack of adequate disclosure, court will dismiss challenge to fairness of board's transactions).

250. Del. Ch. Ct. R. 10(c); Mann v. Oppenheimer & Co., 517 A.2d 1056, 1059 (Del. 1986) (stating motion to dismiss that relies solely on arguments or other materials outside of complaint will be denied, but may be treated as motion for summary judgment); Weinberger, 457 A.2d 701 (Del. 1983); Garza, 1993 WL 77186, at *4 (noting facts outside complaint cannot be considered on motion to dismiss); Porter v. Texas Commerce Bancshares, No. CIV.A.9114, 1989 WL 120358, at *7 n.2 (Del. Ch. Oct. 12, 1989).

251. Rabkin v. Philip A. Hunt Chem. Corp., 498 A.2d 1099, 1104 (Del. 1985) (stating allegations must be more than mere conclusions); Loudon v. Archer-Dan-
The courts will apply a more stringent standard for complaints alleging breach of the duty of disclosure. Very similar to fraud complaints, a complaint alleging breach of a duty of disclosure must plead specific facts sufficient to state an actionable disclosure claim. Specific damages or injury arising from the breach of the duty of disclosure, however, need not be pleaded with particularity to withstand a motion to dismiss.

Additionally the court may permit the shareholder to amend a deficient complaint. If the complaint cannot be amended to meet the motion to dismiss standard, the court will dismiss the complaint. Although the denial of a motion to dismiss generally cannot be appealed because it is not a final order, the grant of a motion to dismiss is immediately appealable and is subject to a de novo standard of review on appeal.

D. Motion for Judgment on the Pleadings

A motion for judgment on the pleadings presents another opportunity for the Chancery Court to review the legal sufficiency of the complaint. After the pleadings are closed, and before a summary judgment motion has been made, any party may move for


252. For a discussion of the duty of disclosure, see supra notes 80-108 and accompanying text.

253. In re Santa Fe Pac. Corp. Shareholder Litig., 669 A.2d 59, 65 (Del. 1995) (stating “[n]on-disclosure claims must provide some basis for a court to infer that the alleged omissions were material”) (citation omitted).


judgment on the pleadings. The court applies the same standard for a motion for judgment on the pleadings as it would for a motion to dismiss pursuant to Chancery Court Rule 12(b)(6).

E. Motion for Summary Judgment

Typically, the last chance to dismiss claims prior to trial is in a motion for summary judgment. In rare instances, the court will exercise its power to grant summary judgment sua sponte when the "state of the record is such that the non-moving party is clearly entitled to such relief." According to the Chancery Court, "[a] motion for summary judgment will be granted only where there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law." Any doubts regarding the existence of an issue of material fact will be resolved, and all reasonable factual inferences will be drawn, against the party moving for summary judgment. Inferences in favor of the movant must be supported by evidence (as opposed to mere assertions or allegations) to prove each element of the claim. The court will deny a motion for summary judgment if affidavits raise a material factual issue or if "there has been no opportunity for discovery.

Upon a motion for summary judgment filed by the board, the shareholder must be prepared to establish, through deposition tes-
timony, affidavits and documents, that genuine issues of material fact exist which must be resolved at trial. Sufficient pleading of a breach of fiduciary duty is largely a matter of providing enough notice within the guidelines of established precedent.\footnote{266} In response to a summary judgment motion, however, the Delaware courts will review the information obtained during discovery to ensure that a genuine dispute of material fact requires a trial.\footnote{267} Courts will enter summary judgment after careful review of the undisputed facts, applying the business judgment rule's presumptions.\footnote{268} Although the stated standard for summary judgment in Delaware is virtually identical to that applied by federal courts, Delaware courts seem to apply a stricter standard in fact than their federal counterparts.

Only the grant of summary judgment can be appealed immediately.\footnote{269} The Delaware Supreme Court's review of the Chancery Court's grant of summary judgment is de novo.\footnote{270} Therefore, the

\footnote{266} See Emerald Partners v. Berlin, No. CIV.A.8700, 1995 WL 600881, at *7 (Del. Ch. Sept. 22, 1995) (mem.) (recognizing while complaint can recite facts that raise question as to defendant directors' breach, plaintiff must demonstrate genuine issue of material fact to defeat summary judgment motion).

\footnote{267} See In re Sea-Land Corp. Shareholders Litig., 642 A.2d 792, 794 (Del. Ch. 1993) (reviewing "extensive discovery" when considering motion for summary judgment).

\footnote{268} Levy v. Stern, No. CIV.A.11955, 1996 WL 118160, at *3 (Del. Ch. Mar. 12, 1996). In Levy, the court entered summary judgment in favor of the board because plaintiff failed to present any genuine issue of intentional misconduct, bad faith or disloyalty. Id. The court further refused plaintiff's request for additional discovery because the request was too late. Id. Accordingly, the court granted the board's motion for summary judgment. Id.

In Sea-Land, the Chancery Court granted the board's motion for summary judgment seeking to dismiss claims of care and loyalty violations. Sea-Land, 642 A.2d at 807-08. The court found the shareholders' testimony as to loyalty violations to be "self-serving and conclusory... speculative and lacking[ing]... evidentiary foundation." Id. at 807. In contrast, the undisputed material facts provided evidence that a vast majority of the board was independent and acted in good faith, relying upon financial and legal advisors. Id. at 806.

Alternatively, in Byrne v. Lord, No. CIV.A.14215, 1995 WL 684868 (Del. Ch. Nov. 9, 1995) (mem.), the court entered summary judgment in favor of the shareholders because the directors, who were not independent, failed to meet the standards of the entire fairness test and a trial was necessary to resolve the directors' liability. Id. at *1. Finally, summary judgment dismissing nondisclosure claims is appropriate "if uncontroverted facts are so obvious that reasonable minds could not differ on the question of materiality." Emerald, 1995 WL 600881, at *6 (citing Gould v. American Hawaiian S.S. Co., 535 F.2d 761, 771 (3d Cir. 1976)).

\footnote{269} See generally Baylis v. Wilmington Med. Ctr., Inc., 477 A.2d 1051 (Del. 1984) (noting denial of summary judgment motion is interlocutory and must generally await final judgment before any appeal).

\footnote{270} Williams v. Geier, 671 A.2d 1368 (Del. 1996). In Williams, the Delaware Supreme Court noted that it may draw "inferences in making factual determinations and in evaluating the legal significance of the evidence." Id. at 1375. See Arnold v. Society for Sav. Bancorp, 650 A.2d 1270, 1276 (Del. 1994) (noting Dela-
court analyzes the entire record, including the trial court’s opinion, pleadings, depositions and other relevant evidence contained in the record, to determine whether summary judgment was appropriate.²⁷¹

VIII. CONCLUSION

Part I of this Article has described some very basic principles which apply in the normal case in which a shareholder challenges a board’s business decision. Part II of this Article will address these basic principles in transactions outside of the typical business decision.

As we noted in the Introduction, our goal is to provide a primer on the basic rules of the game. We have tried to give our readers a simple road map to understand how the fiduciary duties of directors and the business judgment rule interact. We must caution those relatively unfamiliar with Delaware law that while understanding the rules of the game is essential to effective representation of the players, the simplicity of Part I of this Article does not fully reflect the sophistication and complexity of most cases in the Delaware courts. As we indicated, the Delaware courts have been particularly adept at maintaining a high degree of flexibility in developing the Delaware law to diverse and complex situations, while at the same time consistently applying the basic rules.

This Article also compartmentalizes the various principles to make them easier to understand. Thus, a reader unfamiliar with Delaware practice could infer that the shifting burdens and standard of review are always easily discernable. In practice, there are very few bright lines. No bells ring or lights shine when the business judgment rule is rebutted or the board proves entire fairness. Rather, each party presents its best case on the assumption that the court will impose the burden of proof and the least desirable standard of review upon that party. Typically, the winner of the game is not known until the Chancery Court, and often the Delaware Supreme Court, ultimately determines the appropriate standard of review and burden of proof and resolves the legal and factual issues involved. The parties, however, will use the basic rules of the game to persuade the courts to apply the most favorable standard of review and shift the burden of proof to their adversary.

The nuances which this Article did not discuss are varied and are frequently outcome determinative. Like all games, however, the nuances cannot be appreciated or used effectively until the basics have been mastered.