b. Other factors

[20] My analysis of the factors articulated in *Weinberger* also supports a finding of unfair dealing. On balance, the structure, initiation or timing of the Merger does not weigh much in this entire fairness analysis. The Merger was structured as an all cash transaction for all shares and, thus, was not economically coercive in that respect. At the same time, it was linked to the debt restructuring and presented as the only viable alternative to bankruptcy. These facts are suggestive of unfairness. The timing of the Merger seems dictated by the economic circumstances of the Company, and there is no suggestion that it was timed to disadvantage the Company's shareholders. Similarly, the evidence supports the conclusion that the concept of the Merger was first raised by the Special Committee, not by Haan. Even if this were not the case, I would not regard it as evidence of unfairness on Haan's part.

[21] Other of the *Weinberger* procedural factors, for reasons already discussed at length, strongly indicate a lack of fairness in the process followed. These include the misinformation given to the Special Committee and the resulting absence of meaningful negotiations over the terms of the Merger. I have already discussed my conclusion that the Special Committee was materially misled by Haan's improper activities and lack of disclosure. I need only add that, as a consequence of Haan's faithless conduct, the stockholders were also deprived of critical information regarding Haan's contacts with Bell Atlantic. A central, if not primary, reason offered by the proxy recommending shareholder acceptance of the $0.30 per share price was that ITI and its financial advisors "were unable [in May-June 1992] to obtain substitute accounts receivable or equity financing . . . other than a proposal from Haan to provide . . . a services agreement with ONCOR." The omission of any information about Haan's contact with Bell Atlantic on or after May 18, 1992 and about his failure to disclose those contacts to the Board of Directors renders this (and other) parts of the Merger proxy statement materially misleading. *See Arnold v. Society for Savings Bancorp, Inc.*, Del. Supr., 650 A.2d 1250, 1277 (1996) (stating that a fact is material and must be disclosed if a reasonable stockholder would consider the fact important in deciding how to vote).

The plaintiffs also attack the method of obtaining shareholder approval on several grounds. First, the initial shareholder meeting of March 29, 1993 was adjourned and rescheduled when the requisite vote could not be obtained. The decision to adjourn was made by the board on the morning of the meeting. Although the minutes of the meeting reflect that Haan proposed the adjournment, he testified at first that he opposed the idea. Regardless, the proxy statement stated clearly that the meeting might be

adjourned if the requisite vote were not obtained. I find no unfairness in doing so.

[22] Finally, plaintiffs argue by analogy to the decision of the Supreme Court in *Cinerama v. Technicolor, Inc.* that the fact that the Merger received only a bare majority of the stockholder vote is evidence of its unfairness. Del. Supr., 663 A.2d 1156 (1995). The analogy is inapt. The Supreme Court in *Cinerama* held that an overwhelming vote in favor of a transaction is evidence of fair dealing. *Id.* at 1176. There is no logical force to the suggestion that the obverse is also true. In any case, it is hard to see how compliance with a statutory mandate could ever be part of a showing of unfairness.[8]

2. Fair price

[23] The Supreme Court has made clear that the entire fairness analysis, though structurally bifurcated, is conceptually singular. All aspects of a transaction are considered in determining whether the challenged transaction is entirely fair. *Kahn v. Tremont*, Del. Supr., 694 A.2d 422, 432 (1997).

Defendants urge the Court to conclude that $0.30 per share was more than adequate compensation to ITI's shareholders at a time when their shares were arguably worthless. Because the debt restructuring may have come undone had the shareholders voted down the Merger, the defendants argue that ITI's "fair value" at the time of the Merger cannot reflect the benefits of that restructuring. Thus, in essence, they argue that "fair value" of the shares should be determined as if the agreements of Northern Telecom, WilTel and the Haan entities to reduce ITI's debt load had not been reached and put into effect in November 1992.

I agree that without the debt restructuring, ITI's shares had little or no value. Kane & Co., who rendered a fairness opinion as to the Merger consideration, and Mr. Much, the defendant's expert witness, both valued ITI without taking account of the debt restructuring. Both Kane and Much concluded that ITI's shares had negligible value, due critically to its high pre-restructuring debt load.

I do not agree, however, that the debt restructuring can be ignored in assessing the fairness of the Merger price. In *Tremont*, the Supreme Court reviewed Chancellor Allen's carefully deliberated fair price analysis, giving "considerable deference [to] his selection among the various methodologies

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[8]Finally, plaintiffs also contend that the proxy statement included blatant threats that the company would file for bankruptcy if the merger did not get approved. Under *Williams v. Geier*, such threats would be evidence of wrongful coercion of the vote. Del. Supr., 671 A.2d 1368, 1382-83 (1996). I find that the statements regarding bankruptcy were presented neutrally and not in a threatening way. *Id.* at 1383.

offered by competing experts." 694 A.2d at 432. The Supreme Court then stated that "here, the process is so intertwined with price that under *Weinberger*'s unitary standard a finding that the price negotiated by the Special Committee might have been fair does not save the result." *Id.*

Here, as in *Tremont*, the unfairness of the process also infects the fairness of the price. Had ITI received alternative financing, the evidence supports the conclusion that it would have been able to restructure its debt. Had it succeeded in doing so, there is no reason to believe that the directors would have considered $0.30 per share (or $5 million in total) a fair price. Thus, because Haan's alleged ability to unwind the debt restructuring is related to his breaches of the duty of loyalty, I conclude that I should value ITI without regard to Haan's claimed ability to unravel the debt restructuring. I note that were this an appraisal action, I might reach a different result on this issue, as I would not be concerned by the relationship between the conditional nature of the debt restructuring and Haan's breach of fiduciary duty. *See, e.g., Application of Vision Hardware Group., Inc.*, Del. Ch., 669 A.2d 671 (1995), *aff'd*, Del. Supr., 676 A.2d 909 (1996).

3. Conclusion as to entire fairness

[24] Taking all factors into account, I conclude that Haan and the other defendants have failed to carry their burden of proving that the Merger was entirely fair to the shareholders. Haan's failure to disclose material facts and his diversion of Bell Atlantic away from ITI infected all subsequent events, thus rendering ineffectual the procedures employed by the other directors to ensure an independent and fair process and result.

E. The Plaintiffs' Remedy

Plaintiffs seek a combination of equitable remedies. First, plaintiffs demand rescissory damages to recoup the fair value of the shares taken from them in the Merger. Second, they ask for disgorgement of some or all of the $8 million that Haan obtained as consideration for inducing ITI to enter into the WilTel agreement, any such amount to be treated as a non-operating asset of ITI for purposes of determining rescissory damages. Finally, the plaintiffs allege that Haan made about $60 million from ITI in the five years following the Merger. At trial, Haan testified that he could not say that he would have made any of that money if not for the Merger. On this basis, plaintiffs ask this Court to disgorge some or all of the $60 million. I address each of these contentions separately.

[25] Before turning to these matters, however, some general observations are in order about the process of assessing damages in cases of this nature.

First, significant discretion is given to the Court in fashioning an appropriate remedy. In determining damages, the Court's "powers are complete to fashion any form of equitable and monetary relief as may be appropriate . . . ." *Weinberger*, 457 A.2d at 714.

[26-27] Second, unlike the more exact process followed in an appraisal action, the "law does not require certainty in the award of damages where a wrong has been proven and injury established. Responsible estimates that lack mathematical certainty are permissible so long as the Court has a basis to make a responsible estimate of damages." *Red Sail Easter Limited Partners, L.P. v. Radio City Music Hall Prods., Inc.*, Del. Ch., C.A. No. 12036, mem. op. at 12, Allen, C.. (Sept. 29, 1992); *see also Thorpe v. CERBCO, Inc.*, Del. Ch., C.A. No. 11713, Allen, C. (Oct. 29, 1993) mem. op. at 24 ("so long as the court has a basis for a responsible estimate of damages, and plaintiff has suffered some harm, mathematical certainty is not required").

[28] Third, where, as is true here, issues of loyalty are involved, potentially harsher rules come into play. "Delaware law dictates that the scope of recovery for a breach of the duty of loyalty is not to be determined narrowly . . . . The strict imposition of penalties under Delaware law are designed to discourage disloyalty." *Thorpe v. CERBCO, Inc.*, Del. Supr., 676 A.2d 436, 445 (1996) (relying on *Guth v. Loft, Inc.*, Del. Supr., 5 A.2d 503, 510 (1939)).

1. The value of the shares taken in the Merger

Because of the nature of the wrongs committed here, it is not a sufficient remedy to award plaintiffs their pure out-of-pocket damages, at least as measured (as defendants insist I must) by the fair market value of ITI at the time of the Merger without giving effect to the debt restructuring. So valued, plaintiffs' shares are worthless or nearly so. Instead, what plaintiffs are entitled to receive is, at a minimum, what their shares would have been worth at the time of the Merger if Haan had not breached his fiduciary duties. Of course, this value is inherently unknowable because there is no way to learn what financing arrangements ITI might have made in the absence of Haan's disloyal conduct. In the circumstances, I conclude that the only good way to approximate that value is to value ITI as of the time of the Merger with the Services Agreement and the debt restructuring agreement in place but without giving effect to any contingency Haan attached to them. This is what I will do.

I recognize that before Haan acted disloyally there was uncertainty whether or not ITI could secure financing and restructure its debt and, also, that the measure of damages I mean to allow removes these uncertainties and

might overcompensate plaintiffs for that reason. Nevertheless, I conclude that the potentially harsh nature of this remedy is both appropriate, given the nature of Haan's misconduct, and necessary to avoid short-changing plaintiffs.[9]

Plaintiffs presented expert testimony of Dr. Donald J. Puglisi valuing ITI by the comparable companies method of analysis. Before accounting for the value of non-operating assets, plaintiffs' expert valued ITI at either $2.74 per share or $5.54 per share, depending on whether or not it is assumed that Haan exercised his warrant to purchase over 26 million ITI common shares at $.25 per share. They argue that I should ignore the evidence that Haan would exercise his warrant and award damages based on the higher value. Plaintiffs rely on other evidence valuing the non-operating assets at approximately $6.6 million, consisting of a $1.25 million value for the Company's net operating loss carry forward ("NOL") and $5.33 million for the value of the claim against Haan to recover the $8 million WilTel payment. Because it is not disputed, I accept $1.25 million as the value of the NOL. I address the value of the claim *infra*.

[29] The defendants expert used the discounted cash flow method of analysis and concluded that the ITI shares had no (or nominal) value at the time of the Merger. Because there were no projections beyond one-year forecasts prepared in connection with the annual budget process, defendants' expert prepared his own set of projections, strictly for the purposes of this litigation. To do so, he extrapolated management's one-year forecast for a period of five years, assuming a 10% decrease in revenues (and a concomitant reduction in costs) in each year. While this process may appear reasonable in light of ITI's actual experience in the years following the Merger, it is not supported by the contemporaneous expectations of management. For that reason, I find this methodology too unreliable to use in my damage calculation. *Harris v. Rapid-American Corp.*, Del. Ch., C.A. No. 6462, mem. op. at 14, Chandler, V.C. (Oct. 2, 1990); *In re Radiology Associates, Inc., Litig.*, Del. Ch., 611 A.2d 485, 490-91 (1991).

[30] Defendants also attack Dr. Puglisi's expert testimony and report on several fronts. First, they complain that the comparable companies he used in his analysis are insufficiently comparable. They then challenge his

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[9] I regard this way of calculating plaintiffs' damages as a species of rescissory damages. Rescission is not an available remedy because no mechanism is available to restore the plaintiffs or ITI to the position they would have been in had Haan not acted disloyally. Thus, "the equitable remedy of rescission is impractical." *Lynch v. Vickers Energy Corp.*, Del. Supr., 429 A.2d 497, 501 (1981), *overruled in part on other grounds, Weinberger v. UOP, Inc.*, Del. Supr., 457 A.2d 701 (1983). Moreover, because Haan's misconduct in the May - June 1992 timeframe injured ITI and devalued its shares, it is insufficient, as a remedy, to award only out-of-pocket damages measured by the actual value of ITI's shares at the time of the Merger. *Weinberger*, 457 A.2d at 714.

application of a 30% premium to account for the minority discount inherent in the comparable companies analysis. Next, they claim that he erred in failing to adjust his valuations downward to account for ITI's $11 million working capital deficit.[10] Finally, they argue that I should account for the dilutive value of the stock warrant issued to Haan in 1991 but never approved by the ITI stockholders, more than doubling the number of outstanding shares for valuation purposes. I will discuss these contentions in turn.

> The comparable companies. Kane also used the comparable companies method of analysis in preparing his fairness opinion for the ITI board of directors and included, as comparable companies, essentially the same ones used by Dr. Puglisi. In the circumstances, I cannot accept defendants' objection to Dr. Puglisi's method of analysis or his choice of comparable companies. I do recognize that the group of comparables includes companies of substantially different size and scope than ITI but conclude that these differences are properly reflected in adjustments made to the multiples derived for comparative purposes.
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> The control premium. Defendants do not dispute that the value derived by comparable companies method of analysis reflects an imbedded minority discount. Instead, they argue that no one would have paid a control premium to acquire ITI due to "its reliance on the Services Agreement and its distressed financial condition." Because both the Services Agreement and, to some extent, ITI's distressed financial condition stem from Haan's breach of fiduciary duty, I reject the suggestion that no control premium should be added to determine value. Indeed, even if I recognized that control had already passed to Haan, plaintiffs are entitled to be paid the fair value of their shares without a minority discount. *See Cavalier Oil Corp. v. Hartnett*, Del. Supr., 564 A.2d 1137, 1144 (1989).
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> The working capital deficit. I agree with defendants that Dr. Puglisi's valuation should be adjusted to reflect ITI's $11

[10]For reasons I have already stated, I reject defendants' further argument to include the amount of debt eliminated in the debt restructuring. I also reject their complaint that Dr. Puglisi's analysis is defective because of a "mismatch of earnings periods." While this might present a greater problem in the context of an appraisal action, it is not apparent to me that this "mismatch" materially affects the damages calculation.

million working capital deficit. This approach is consistent with, if not required by, authority of this court holding it proper to *increase* valuations to reflect excess working capital. *See Radiology Associates*, 611 A.2d at 495. Defendants' expert, Mr. Much, determined that there was an $11 million working capital deficit and subtracted that amount in arriving at fair value. Plaintiffs do not dispute this work. Instead they argue only that "Mr. Much did not critique Dr. Puglisi's report" and "Dr. Puglisi's testimony is unrebutted." These arguments do not meet the merits of the objection.

The stock warrant. The final issue I need to address before arriving at a damage figure is whether or not to treat Haan's warrant as though it were exercised. I conclude that I should not because Haan's right to exercise this warrant was expressly made subject to a vote of the ITI stockholders that was never obtained.

If I were to value ITI on the basis of Dr. Puglisi's analysis, without any adjustments to his work beyond those already described, I would derive a damage calculation of approximately $5.09 per share.[11] In my opinion, however, I must make a further adjustment to account for the differences in growth expectation between ITI and the group of comparables.

Dr. Puglisi testified that there is an expectation of growth built into the comparables he used. For example, in the case AT&T long term expected growth rates were "[s]omewhere about the growth of the economy as a whole." He also testified that if the prospects for growth at ITI were lower than for the comparables or for the aggregate of the sample, it would be appropriate to make an adjustment for such differences. Because he "saw nothing in the information that was presented to [him] in terms of management-prepared forecasts that would indicate that an adjustment was in order," he made no such adjustment in his work.

On the basis of the trial record, I am satisfied that growth prospects for ITI at the time of the Merger were significantly lower than for the

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[11]For those readers interested in the math, I calculate this figure by multiplying Dr. Puglisi's multiplier (8.5x) times his range of ITI's "true annual earnings capacity" — $14 million to $17.5 million — and then subtracting from both of those amounts the value of ITI's interest bearing debt ($ 36.9 million). This produces a range of $83 to $112.8 million and a mid-point of approximately $98 million. That mid-point amount is then increased by the 30% control premium to approximately $127 million and reduced by the $11 million working capital deficit. Finally, I add $1.25 million, the value of ITI's NOL. The resulting value of ITI's total invested capital, $117.25 million, is then divided by 23.015 million, being the number of shares outstanding assuming the exercise of all options and warrants other than Haan's, to produce a per share fair value of $5.09.

companies included in Dr. Puglisi's sample. Making a "realistic assessment" of the adjustment necessary to account for this signal difference between ITI and the group of comparable requires, in my judgment, a 50 percent downward adjustment to Puglisi's average multiple (8.3x). Using 4.15x as the multiple produces a fair value per share of $2.34, including the value of the NOL, but excluding the value of the claim against Haan relating to the $8 million WilTel fee. I will next address the value of that claim.

2. The $8 million claim against Haan

As discussed above, Haan got $8 million from WilTel in payment for ITI's agreement to enter into the network services agreement with WilTel. Plaintiffs claim that this amount was obtained in violation of Haan's duty of loyalty and suggest that disgorgement to ITI of $5.33 million[12] of that amount would be the proper remedy, under the Supreme Court's ruling in *Thorpe v. CERBCO, Inc.*, Del. Supr., 676 A.2d 436, 445 (1996).

My analysis of this matter requires that I answer three questions: (1) what is the legal effect of the Report of the special review committee declining to proceed against Haan on account of this fee? (2) what is the legal effect of Haan's contractual right to terminate his agreement to forebear if any litigation based on the WilTel transactions resulted in a final judgment or settlement totaling more than $250,000?, and (3) if the claim survives the Report and the "forbearance condition," how should it be valued and what are plaintiffs' damages?

a. The Report

There is little question that ITI had a strong claim against Haan for breach of his duty of loyalty in connection with the $8 million WilTel payment. Simply stated, WilTel paid Haan an $8 million fee to secure ITI's participation in the new network servicing agreement. Haan made this deal with WilTel after he entered into the MOA with ITI. At the time he secured ITI's participation in that agreement, Haan was ITI's Chairman and CEO. Haan did not disclose his interest in the transaction when he presented it to the ITI directors for their approval and they did not otherwise learn of it before voting. Without some further, substantial explanation, the law would seem to require Haan to disgorge the fee to ITI. *See Thorpe v. CERBCO, Inc.*, Del. Supr., 676 A.2d 436, 445 (1996) ("once disloyalty has been

[12]Plaintiffs reduce the $8 million payment to $5.33 million to account for the likely costs, including attorney's fees, ITI would have incurred in recovering a judgment against Haan for the $8 million.

established" the law "require[s] that a fiduciary not profit personally from his conduct.")

The Report acknowledges that the terms of his agreement with WilTel placed Haan in a position of conflict and that he aggravated his conflict by "using his own personal counsel to help him negotiate the [WilTel/ITI] deal and by limiting the participation of ITI management personnel."[13] The Report also concludes, in effect, that Haan had a duty to disclose his arrangement with WilTel to his fellow directors on several occasions and failed to do so. Haan did disclose the terms of his fee arrangement in his bankruptcy court testimony but that testimony could not be heard by the ITI representatives present and was never reported to the ITI board of directors. Nevertheless, the Report concludes that "ITI was not harmed by WilTel's willingness to pay Haan $13 million for the assets [i.e., $5 million for the assets and the $8 million fee] and other undertakings he provided under the Haan-WilTel Agreement." The Report reaches this conclusion by examining the terms of the WilTel/ITI agreement, which it determines to be fair.

The Report's conciliatory treatment of Haan (accepted by the special review committee and the board of directors) may be largely explained by its timing. The Report is dated June 15, 1992, and was presented to the board of directors at the same meeting (held on June 19, 1992) at which Haan presented his proposal for the Services Agreement. It would seem inescapable that the Report's recommendation that ITI not proceed against Haan was influenced by the fact that, by mid-June 1992, Haan appeared to be the only person ready to provide the financing ITI needed to avoid a ruinous bankruptcy filing. No doubt Haan and his counsel also strongly maintained that he had earned the fee as his compensation for finding and arranging the multi-legged transaction among ITI, WilTel, Haan-controlled entities and the Telesphere bankruptcy estate.

[31] In any event, the Report's legal conclusion misses the point. Under Delaware law, the fact that the deal may have benefited ITI is not dispositive of whether Haan's disloyal acts entitled ITI to recover the fee from him. The Supreme Court's ruling in *Thorpe* restates the fundamental principal that a disloyal fiduciary is not entitled to profit from his breach. 676 A.2d at 445 (citing *Guth v. Loft, Inc.*, Del. Supr., 5 A.2d 503, 510 (1939)).

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[13]The Report even indicates that the ITI board believed that Haan's lawyers, who assisted in negotiating with WilTel, were working on behalf of the Company when in fact, they were representing Haan in his personal capacity.

b. The "forbearance consideration"

Because the Board's actions in June did not lay to rest the $8 million claim, Haan later conditioned his agreement to forebear from exercising certain creditors rights until the Merger vote on the Company's agreement not to bring any action arising out of the WilTel transactions if that claim resulted in a final judgment or settlement exceeding $250,000. He argues that the WilTel claim cannot now be valued at more than $250,000 because the Company has, in effect, released any claim in excess of that amount. I conclude that I must ignore the particular terms of this agreement in determining the amount of damages to award. My reason for doing so is that the forebearance agreement is itself tainted by what I have found to be Haan's breach of the duty of loyalty in his dealings with Bell Atlantic. The specific terms of that agreement are a further consequence of the directors' inability to secure an adequate source of receivables financing apart from the Services Agreement.

c. Valuing the claim

Before turning to this issue, I must address a procedural point raised by defendants. In an early opinion in the appraisal aspect of these consolidated actions, then Vice Chancellor (now Justice) Berger ruled that the claim relating to the $8 million WilTel fee was properly plead because it was a potential element of share value. She also ruled that the underlying claims would not themselves be tried in the appraisal action but, rather, "the value of the claims, if any, will be established through expert testimony in much the same manner that evidence typically is presented as to the value of other corporate assets." *Bomarko v. International Telecharge, Inc.*, Del. Ch., C.A. No. 13052, mem. op. at 6, Berger, V.C. (May 16, 1994). Defendants argue that the plaintiffs' failure to present expert testimony at trial concerning the value of the derivative claim should prevent the Court from assigning any value to it.

I disagree with defendants' argument. Justice Berger's ruling came before the Report was made part of the record and before the fiduciary duty action was even filed. At trial, the Report was admitted into evidence and, I am satisfied, supplies sufficient information, without the aid of expert testimony, upon which to base a reasonable estimate of the value of the claim. Moreover, my assessment of the value of that claim is not made in the context of the appraisal action but, rather, as part of my analysis of the proper measure of damages for breach of fiduciary duty. In the context of that undertaking, I am certain that Justice Berger's early opinion does not preclude my consideration of the Report.

So, what was the claim worth? I value the claim by multiplying (a) my assessment of the probability of success on the merits by (b) the likely amount of a favorable recovery, and subtracting from that result (c) the reasonable costs ITI would have incurred in prosecuting the claim.[14] I conclude that there was a .8 probability of success on this claim. I discount the outcome only to weigh the inevitable uncertainty of litigation and the chance that the forebearance agreement might be upheld. The likely recovery was $8 million. This produces a gross potential recovery of $6.4 million. It seems to me unlikely that the Company would have to pay more than 15% of that amount in fees and expenses to secure the services of competent counsel in a case of this unusually strong merit. Thus, I arrive at a value of $5.44 million for the claim. Plaintiffs will be awarded 9.48% of this amount, or $515,712 in damages for the value of this claim. This comes to $0.24 for each of plaintiffs' 2,181,682 shares.

3. The claim for disgorgement of profits

Finally, plaintiffs ask for disgorgement of the $60 million that they claim Haan made from ITI in the five years after the Merger. They rest their claim on the sound public policy that it is better to give a windfall to a beneficiary that to let a faithless fiduciary benefit from his wrongdoing. *Thorpe*, 676 A.2d at 445 (citing *Guth*, 5 A.2d at 510).

This claim fails. There is simply no evidence here that Haan realized a "windfall" from the Merger that is not remedied (at least insofar as these plaintiffs are concerned)[15] by my award of damages. Putting it differently, there is no evidence in this record that plaintiffs shares were more valuable on any date after the Merger. Thus, in awarding them damages equal to the value of their shares at the time of the Merger, I have given them all they are entitled to receive.

The situation might have been different if, for example, the market multiples for 0+ corporations increased substantially within a short period

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[14]I recognize that, had Haan acted in conformity with his fiduciary obligations, he might have been able legitimately to negotiate a reasonable compromise of this claim in return for some other economic concessions on his part, e.g. in connection with the debt restructuring. Nevertheless, I am unable, without rank speculation, to determine what the results of such a negotiation might have produced. Unlike some other cases, there are no guideposts in the record to show me the way. *See, e.g., HMG/Courtland Properties, Inc. v. Gray*, Del. Ch., C.A. No. 15789, mem. op. at 65-69, Strine, V.C. (July 12, 1999) (crafting a remedy that approximates the result that would have obtained in the absence of a breach of duty) *and Boyer v. Wilmington Materials, Inc.*, Del. Ch., C.A. No. 12549, mem. op. at 53-56, Lamb, V.C. (January 20, 1999) (assessing damages on breach of duty of loyalty claim where evidentiary basis existed to approximate likely course of negotiation).

[15]It bears noting that this is not a class action and these plaintiffs owned less than 10% of the ITI common stock, on a fully diluted basis. Plaintiffs do not address the issues raised by the individual nature of this action and the "class action-like" relief they seek.

after the Merger. In that case, I would have calculated the fair value of the plaintiffs' shares at that time rather than at the time of the Merger. *See Weinberger v. UOP, Inc.*, Del. Ch., C.A. No. 5642, mem. op. at 6, Brown, C. (Jan. 30, 1985), *aff'd*, Del. Supr., 497 A.2d 792 (1985). Thus, the economic windfall of increased values would go to the beneficiary instead of the faithless fiduciary. On the record before me, however, there is no indication that Haan's receipt of monies after the Merger was on account of factors other than the Merger and the debt restructuring. Because my valuation of ITI already takes into account the benefits of the debt restructuring and, as to these plaintiffs, deprives Haan of the value of the Merger, any order requiring disgorgement would constitute a double recovery for the plaintiffs.

F. Prejudgment Interest

[32-33] Delaware law is settled that "[a] successful plaintiff is entitled to interest on money damages as a matter of right from the date liability accrues." *Summa Corp. v. Trans World Airlines, Inc.*, Del. Supr., 540 A.2d 403, 409 (1988). In fixing the rate of interest, I have "broad discretion, subject to principles of fairness." *Id.* The only record evidence relating to the question of interest is Dr. Puglisi's report and testimony in which he presented a range of three rates: the legal rate (8.0%), ITI's cost of borrowing (8.74%), and ITI's cost of equity (11.12%). Plaintiffs ask that I allow calculate interest based only on the highest of these rates.

I decline to do so. Instead, as defendants suggest, I will allow prejudgment interest at a rate equal to the average of the legal rate and ITI's cost of borrowing, or 8.37 %, calculated from the effective date of the Merger. Because I am required to do so by precedent, I direct that the calculation be done without compounding.

IV. CONCLUSION

For all the foregoing reasons, I award plaintiffs the sum of $2.58 per share for each of the 2,181,682 common shares of ITI held by them as of the effective date of the Merger, plus 8.37% simple interest from that date until the date judgment is entered. Counsel for plaintiffs is directed to submit an order, on notice, within 10 days.

IN RE GAYLORD CONTAINER CORP. SHAREHOLDERS LITIGATION

No. 14,616

Court of Chancery of the State of Delaware, New Castle

August 10, 1999

Plaintiffs, stockholders in the corporation, sought class certification stating their claims allege special injury; therefore, their claim states individual, as well as derivative, claims. Plaintiffs' complaint alleged that the defendant's wrongful acts deprived the stockholders right to maximize the value of their shares in the corporation, impaired their franchise rights and restricted their voting power.

The court of chancery, per Vice-Chancellor Strine, denied defendant's objection to class certification and held that plaintiffs' complaint did state individual claims because plaintiffs proved they suffered a special injury directly or indirectly of the corporation.

1. Corporations ⟹ 189(.5), 189(2), 211, 512

In determining whether a complaint pleads derivative or individual claims, or both, the court must determine whether the complaint pleads a special injury to the proposed class.

2. Corporations ⟹ 189(.5), 189(1), 189(2), 499

For a shareholder to have standing to bring individual action, he must be injured directly or independently of corporation.

3. Corporations ⟹ 189(.5), 189(2), 499

Shareholder alleges special injury and maintains individual action, if shareholder complains of injury distinct from that suffered by other shareholders or wrong involving one of his contractual rights as shareholder.

4. Corporations ⟹ 189(.5), 189(2), 499

These categories are not exclusive, and the court must look ultimately to whether the plaintiff has alleged special injury, in whatever form.

5. Corporations ⚿ 189(.5), 202, 310(1), 499

The line between derivative and individual actions can become particularly vague in the area of suits challenging defensive takeover tactics.

6. Corporations ⚿ 189(1), 202, 499

Whether a board action gives rise to a derivative claim, an individual claim, or both does not turn on the nature of the board action itself; instead, the distinction turns on whether the action was taken in response to the immediately threatened or ongoing conduct of a third party or whether the board action was designed to thwart potential conduct by a third party.

7. Corporations ⚿ 198(1), 310(1)

The adoption shareholder rights plan was not subject to an individual challenge unless shareholders were actively engaged in a proxy fight which the rights plan would thwart.

8. Corporations ⚿ 189(1), 310(1)

Under *Moran*, if a rights plan (or other defensive measure) has a merely prospective, even if real, deterrent effect, on the likelihood of an acquisition offer, its adoption by the board cannot be challenged in an individual action.

9. Corporations ⚿ 189(1), 310(1)

Under *Moran*, if a rights plan (or other defensive measure) is adopted in response to an actual acquisition proposal, the bidder and shareholders aligned with the bidder may challenge the rights plan (or other defensive measure) as affecting their individual interests as stockholders.

10. Corporations ⚿ 142, 143, 310(1)

Whether the rights plan (or other defensive measure) is adopted with merely a prospective deterrent effect or in response to an actual acquisition proposal, the effects on the stockholders are similar and the nature of the board action is identical — the only difference is that in the latter case a live competition for control is influenced, and in the former case the potential for a competition for control has been reduced.

11. Corporations ⚷ 180, 182, 307, 310(1)

There is no contractual right on the part of stockholders to receive purchase offers, the only legal justification for a board to interfere is if it is appropriately exercising its fiduciary duties.

12. Corporations ⚷ 189(2), 310(1), 499

If it is alleged that the directors wrongfully reduced the voting power of stockholders through inequitable action, that suffices to state a direct claim.

13. Corporations ⚷ 202, 310(1)

A consideration of which shareholders should recover damages in a case where the directors, as well as public stockholders, hold stock and the plaintiffs demonstrate that defenses caused monetary harm to stockholders also suggest an individual characterization of a *Unocal* claim.

14. Corporations ⚷ 202, 204, 211(2)

A wrong is derivative in nature when it injures shareholders indirectly and dependently through direct injury to the corporation.

15. Corporations ⚷ 189(.5), 189(2), 211(2), 499

When an injury is to the economic property, rights of all the stockholders rather than to their voting rights does not make the injury suffered any less special and non-corporate.

16. Corporations ⚷ 189(7), 211

As long as the plaintiff states a claim implicating the heightened scrutiny required by *Unocal*, demand has been excused under the *Arson v. Lewis* demand excusal test.

17. Corporations ⚷ 189(.5), 189(2)

Where plaintiffs challenge the substantive unfairness of a merger protected by defensive measures, their claims are said to be direct.

18. Corporations ⟹ 240, 310(1)

A potential acquiror may bring an individual action to challenge defensive actions impeding its bid.

19. Corporations ⟹ 189(.5), 189(2)

In a case where the plaintiffs attack a combination of the board actions as operating in tandem to injure stockholders, the focus properly rests on the cumulative impact of the actions on the minority in determining if the claims are individual or derivative.

20. Corporations ⟹ 189(.5), 189(2), 307, 310(1)

An entrenchment claim is individual when the shareholder alleges that the entrenching activity directly impairs some right they possess as a shareholder.

21. Corporations ⟹ 307, 310(1), 189(1), 189(2)

Where the entrenching actions of a corporate board have the purpose and effect of reducing the voting power of stockholders, the affected stockholders may bring an individual action.

22. Corporations ⟹ 189(2), 202

The distinction between a derivative and individual claim does not turn on the strength of the asserted claims, but the nature of them.

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STRINE, *Vice-Chancellor*

Nearly four years into this purported class action, this court confronts the question of whether a class should be certified.[1] The answer to that question turns on whether the plaintiffs' *Unocal* claims allege special injury, justifying a characterization of them as stating individual, as well as derivative, claims. In this opinion, I conclude that the complaint does state individual claims and therefore that class certification is appropriate.

I.

The facts necessary to resolve this motion are drawn from the complaint.

Defendant Gaylord Container Corporation ("Gaylord") manufactures and distributes prosaic items such as corrugated containers and grocery bags, without which America's consumerist economy would function quite cumbersomely. Before 1995, Gaylord's certificate of incorporation provided for two classes of common stock: Class A and Class B. When the two classes voted together, each Class A share was entitled to one vote and each Class B share was entitled to ten votes.

As of the beginning of 1995, Gaylord's founder, Chairman, and Chief Executive Officer, defendant Marvin A. Pomerantz, owned over 85% of the Class B stock, giving him 62% of the company's total voting power. Other Gaylord directors and officers held another 12% of the company's total voting power. As a result, Gaylord management wielded firm control over the company. Collectively, I will refer to Pomerantz and the other management holders as the "Management Holders" and their combined stockholdings as the "Management Block."

In the late 1980's, Gaylord, like many businesses, began to suffer from the adverse effects of a recession. By 1991, Gaylord was unable to meet its

---

[1]Sadly, this motion has been litigated at a quite torpid pace. I note that Court of Chancery Rule 23(c) requires that the court shall determine whether an action shall be maintained as a class action "[a]s soon as practicable after the commencement of an action brought as a class action." In this case, the class certification motion was filed December 22, 1997 and lay dormant until I raised the issue at a scheduling conference. Needless to say, the resolution of this motion is later than practicable. Regrettably, this case is just one of many purported class actions in which the class certification issue has not been presented in compliance with Rule 23(c), a problem of which the members of this court are aware.

debt obligations. As a result, it embarked on a pre-packaged financial restructuring pursuant to Chapter 11 of the federal Bankruptcy Code. The restructuring was consummated in September 1992.

As part of the restructuring, Gaylord was required to issue significant equity in the form of warrants and common stock to its creditors. Compl. ¶ 15. Most important, Gaylord was required to agree to a potential restructuring of its Class A and Class B common stock. The potential restructuring provided that if Gaylord's Class A stock did not reach and maintain a prescribed trading price then the outstanding Class B stock would automatically become Class A stock on July 31, 1995. The effect of such an occurrence would be to reduce the Management Holders' total voting strength from 74% to 20%.

As a result, Gaylord stockholder votes would no longer be controlled by the Management Holders.

By 1995, Gaylord's performance had improved substantially. Yet, its stock price had not reached the level sufficient to ensure that the Class B stock would not be eliminated. In late spring and early summer 1995, the Gaylord board of directors (the "Board") realized that the Management Holders would soon lose voting control of the company. According to the complaint, the Board therefore developed a strategy designed to maintain the Management Holders' continued control of the company.

The strategy began with the Board's adoption of a shareholder rights plan (the "Rights Plan," a.k.a., "poison pill") on June 15, 1995. Suffice it to say, the Rights Plan made it economically impractical for any possible acquirer to obtain control of Gaylord without the Board's approval.

The strategy was furthered by the Board's July 7, 1995 decision to call a stockholder meeting for July 21, 1995. The date of the meeting was significant, because it enabled the Management Holders -- who were due to lose voting control on July 31, 1995 -- to control the outcome of the vote.

The meeting was called for the purpose of voting on proposed charter and bylaw amendments (the "Amendments") providing that:

> All stockholder action be taken at a meeting of the stockholders *and not by written consent*;
>
> Stockholder meetings be called only by the Chairman or the Board;
>
> A two-thirds vote is required to amend the bylaws and the provisions of the charter amended by the Amendments (the "Super-majority Amendment"); and

> Section 203 of the Delaware General Corporation Law, 8 Del. C. § 203, shall govern the company, thus preventing the merger of the company with a stockholder owning less than 85% of the company's stock absent Board approval.

Compl. ¶ 27.

The complaint alleges that the Rights Plan and the Amendments were adopted for the purpose of entrenching Pomerantz and his fellow Management Holders in their offices. Taken together, the Rights Plan and the Amendments constitute a formidable barrier to any potential acquirer not favored by the Management Holders. As a result of the Rights Plan and the Amendments, such an acquirer faces the following barriers:

> The Rights Plan, which is redeemable only by Board action;
>
> The need to acquire 85% of the company's stock not held by the Management Holders or to obtain Board approval for any merger as a result of the Amendment making 8 Del. C. § 203 applicable to the company;
>
> An inability to utilize a consent solicitation to replace the Board and thereby reduce the problems created by the Rights Plan and § 203;
>
> An inability to conduct a proxy fight except at the annual meeting or a time agreed to by the Board; and
>
> An inability to repeal any of the Amendments except by obtaining an overwhelming majority of the shares not held by the Management Holders.

II.

On December 19, 1996, this court, per Vice Chancellor Balick, denied the defendants' motion to dismiss the complaint for failure to state a claim and, as to the derivative claims, for failure to make a demand. *In re Gaylord Container Corp. Shareholders Litig.*, Del. Ch., Consol. C.A. No. 14616, mem. op., Balick, V.C. (Dec. 19, 1996).

As to the defendants' Rule 12(b)(6) motion, Vice Chancellor Balick held that the complaint stated a claim that the Rights Plan and the Amendments, taken in combination, constituted an unreasonable set of

defensive measures adopted for an improper purpose. In this regard, he noted that:

> While the rights plan is in effect, it seems economically unlikely that any party would acquire more than 15% of Gaylord['s] stock, let alone a majority. Considering normal voting behavior, it would be practically impossible for stockholders to reach the supermajority required to remove the charter and bylaw amendments while the board continued to have at least the 20% voting power that it held when the dual-class structure expired. While the [A]mendments are in effect, stockholders who oppose the board's position on an offer could only wait until the next regular meeting to pursue a proxy contest or, if the chairman or board refuses to call a special meeting, file an action claiming breach of fiduciary duty. Of course, timing is likely to be crucial to anyone interested in acquiring control of a company.

In re Gaylord Container Corp., mem. op. at 7.

As such, Vice Chancellor Balick held that the defendants bear the burden under *Unocal Corp. v. Mesa Petroleum Co.*, Del. Supr., 493 A.2d 946 (1985), to demonstrate the reasonableness of these measures. In such circumstances, the "proper course" was "to deny the motion to dismiss, permit the plaintiffs to pursue discovery, and give the defendants an opportunity to satisfy the enhanced scrutiny standard. The court will then have a better basis to determine whether the board took proper precautions to protect stockholders from coercive takeover tactics or, as the plaintiffs claim, acted primarily to keep control." *In re Gaylord Container Corp.*, mem. op. at 8-9.

With regard to the defendants' Rule 23.1 motion, Vice Chancellor Balick held that demand was excused since "the board's adoption of the shareholder rights plan is subject to enhanced scrutiny and the circumstances alleged in the complaint create an inference of improper purpose." *Id.* at 9 (citing *Moran v. Household Int'l, Inc.*, Del. Ch., 490 A.2d 1059, 1071, *aff'd*, Del. Supr., 500 A.2d 1346 (1985); *Wells Fargo & Co. v. First Interstate Bancorp*, Del. Ch., C.A. No. 14696, mem. op. at 18, Allen, C. (Jan. 18, 1996)).

III.

In the complaint, the plaintiffs seek certification on behalf of a class (the "Proposed Class") of all non-defendant Gaylord stockholders who "are

being specially injured and deprived of the opportunity to maximize the value of their Gaylord shares by the wrongful acts of the [defendants] . . . and whose franchise rights and voting control have been impaired by the [defendants'] unlawful actions."[2] Compl. ¶ 43. The plaintiffs seek rescission of the Rights Plan and the Amendments, as well as monetary damages on behalf of the Proposed Class. Although it is the plaintiffs' burden to demonstrate that the Proposed Class should be certified, the reality is that the defendants concede that most of the necessary prerequisites to class certification exist. Therefore, this opinion will only address the primary reason the defendants believe justifies denial of class certification. This reason is that the complaint allegedly states only derivative and not class claims, and therefore class certification would essentially be futile.[3]

A.

The defendants' contention that the complaint fails to state a class claim was confusingly advanced as a "motion to strike." They now concede that this nomenclature was improper and that their argument must be treated as a motion for judgment on the pleadings.[4]

As a result, I will address the defendants' contention that the complaint does not state a class claim on that basis. If I agree with them, I will grant judgment on the pleadings dismissing Count One of the complaint and I will deny class certification. If I disagree with them, I will enter an order certifying the Proposed Class.

B.

[1] My decision to address the defendants' argument forces me to make one of the least precise decisions which regularly confronts members of this court -- determining whether a complaint pleads derivative or individual

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[2]I note, lest the reader think that I am unaware, that this case is rather unusual in that it involves a challenge to four year old defensive measures that, based on the record before me, appear to have had no influence upon any actual potential suitor.

[3]After oral argument, I resolved two other issues raised by the defendants as barriers to class certification.

[4]The plaintiffs initially would have had me reject this argument on procedural grounds. At oral argument, they retracted their objection. Even if they had not, I would have considered the argument. Although the plaintiffs had some legitimate cause for objection to the defendants' rather awkward approach to raising this argument, it makes little sense to duck the issue at this time. Unlike the plaintiffs, I do not read the scheduling order in this case as precluding the filing of a motion for judgment on the pleadings. Even if it did, I would be inclined to amend the order to enable consideration of this argument, which was raised by the defendants, *see* Defs.' Br. in Support of Mot. to Dismiss at 37-40; Defs.' Reply Br. in Support of Mot. to Dismiss at 10-12; but not addressed by my predecessor on the prior motion to dismiss.

claims, or both. To make this decision, I must determine whether the complaint pleads a "special injury" to the Proposed Class. *Lipton v. News Int'l, Plc*, Del. Supr., 514 A.2d 1075, 1078 (1986).

[2-4] Special injury has been defined as an injury that is suffered by the plaintiff either "directly" or "independently" of the corporation. *Kramer v. Western Pac. Indus., Inc.*, Del. Supr., 546 A.2d 348, 351 (1988). Typically, a plaintiff has been found to have alleged a "special injury and may maintain an individual action" if he: i) "complains of an injury distinct from that suffered by other shareholders;" or ii) "a wrong involving one of his contractual rights as a shareholder." *Lipton*, 514 A.2d at 1078. However, according to the Supreme Court, these categories are not exclusive and the court "must look ultimately to whether the plaintiff has alleged 'special' injury, in whatever form." *Id.*

[5] The application of this test -- especially with respect to complaints challenging board actions taken for defensive reasons or in the context of change of control transactions -- has yielded less than predictable results. Some of these results seem to flow from whether the plaintiff cited the correct magic words, rather than from any real distinction between the relief sought or the injury suffered. *Compare Kramer*, 546 A.2d 348 (attack on stock options and parachutes issued in connection with a merger was derivative because the plaintiff did not attack fairness of the merger price, even though the plaintiff alleged that the options and parachutes reduced the merger consideration received by the stockholder class) with *Parnes v. Bally Entertainment Corp.*, Del. Supr., 722 A.2d 1243 (1999) (attack on payments and asset transfers to CEO of corporation in connection with a stock-for-stock merger stated individual claim where the Supreme Court read the complaint as alleging that the merger price was unfair). As our Supreme Court has said, "the line between derivative and individual actions can become particularly vague in the area of suits challenging defensive takeover tactics." *Kramer*,[5] 546 A.2d at 352 n.3.

[6] At times, the answer to the question of whether a particular board action gives rises to a derivative claim, an individual claim, or both does not turn on the nature of the board action itself. Instead, the distinction turns on whether that action was taken in response to the immediately threatened or

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[5]A non-exclusive list of other recent cases noting the uncertain nature of the derivative-individual distinction includes: *Parnes*, 722 A.2d at 1245; *Grimes v. Donald*, Del. Supr., 673 A.2d 1207, 1213 (1996); *Carmody v. Toll Bros., Inc.*, Del. Ch., 723 A.2d 1180, 1188-1189 (1998); *Wells Fargo & Co. v. First Interstate Bancorp*, Del. Ch., C.A. No. 14696, 1996 WL 32169, at *7, Allen, C. (Jan. 18, 1996); *see also* 1 R. Franklin Balotti & Jesse A. Finkelstein, The Delaware Law of Corporations & Business Organizations § 13.7 at 13-18 (1999) ("Balotti & Finkelstein") ("The line between derivative and individual actions has become particularly nebulous in the area of suits challenging defensive takeover tactics.").

ongoing conduct of a third-party or whether the board's action was designed to thwart potential conduct by a third-party.

[7] In *Moran v. Household Int'l, Inc.*, Del. Ch., 490 A.2d 1059, 1070, *aff'd*, Del. Supr., 500 A.2d 1346 (1985), this court held that the adoption shareholder rights plan was not subject to an individual challenge unless shareholders were actively engaged in a proxy fight which the rights plan would thwart. Its holding was based on the following reasoning:

> Plaintiffs' complaints, fairly read, reflect causes of action which are derivative in nature, not individual. Moran's first claim alleges that a majority of Household's directors manipulated the corporate machinery to entrench themselves in office by restricting the shareholders' right to make use of the proxy machinery to gain control of Household. Of course, a board of directors may not use the corporate machinery for the purpose of obstructing the legitimate efforts of dissident stockholders to undertake a proxy contest against management. *Schnell v. Chris-Craft Industries, Inc.*, Del. Supr., 285 A.2d 437 (1971). *However, where, as here, no shareholder is presently engaged in a proxy battle, and the alleged manipulation of corporate machinery does not directly prohibit proxy contests, such an action must be brought derivatively on behalf of the corporation. . . . Thus, although the Rights Plan's impact on proxy contests may ultimately alter the balance of power between shareholders and the board of directors, this allegation does not involve a contractual right of the shareholders.*
>
> *Because the plaintiffs are not engaged in a proxy battle, they suffer no injury distinct from that suffered by other shareholders as a result of this alleged restraint on the ability to gain control of Household through a proxy contest.* Furthermore, although D-K-M is Household's largest shareholder, holding approximately 5% of its stock, it does not suffer any unique injury merely by virtue of its holdings. *There is no allegation that D-K-M desires to employ its block position as a means of gaining control of Household. I conclude, therefore, that this claim must be brought derivatively.*
>
> The plaintiffs' second cause of action alleges a manipulation of corporate machinery which acts to deprive shareholders of

> their right to receive and consider takeover proposals. *Although the Plan may indeed have the effect of limiting a shareholder's ability to consider takeover proposals, shareholders do not possess a contractual right to receive takeover bids. The shareholders' ability to gain premiums through takeover activity is subject to the good faith business judgment of the board of directors in structuring defensive tactics. Absent an allegation that the Rights Plan directly restricts transferability, there is no deprivation of a distinct contractual right of the shareholders.* Because plaintiffs do not allege any distinct injury from the alleged restriction on their ability to receive takeover bids, this claim may only be brought derivatively on behalf of Household.
>
> The third cause of action alleges that the issuance of the rights is invalid under Delaware law. This claim clearly is derivative since it calls into question the authority of the Board to alter the capital structure of the corporation, not any contractual right of the shareholders or any distinct injury to the plaintiff.

490 A.2d at 1070-1071 (emphasis added).

In view of the doctrinal inconsistencies that exist in this area (as well as the benefit of insight gained by the substantial experience since *Moran* was decided) there are several reasons why a reassessment of *Moran*[6] and its progeny in this particular respect, may be called for. Put another way, there might be some practical and doctrinal utility to reconsidering whether properly pled *Unocal* claims should continue to be regarded as presumptively derivative, rather than individual, in nature. By a *Unocal* claim, I mean a claim sufficiently alleging that a board of directors has taken actions designed to defend against an unwanted overture from a possible acquirer to the corporation's stockholders so as to invoke the heightened scrutiny required by the *Unocal* decision.

[8-9] As an initial matter, the *Moran* test seems to turn on a distinction addressed more to the ripeness than to the nature of a *Unocal* claim -- whether a rights plan has an imminent defensive effect or a prospective one.

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[6]By questioning the continued utility of this aspect of *Moran*, I do not mean to question other aspects of that decision, which have well stood the test of time. Nor do I minimize the difficulty of the derivative-individual distinction the court was forced to make in that case, especially given the other substantial and novel questions the court was simultaneously required to address. The derivative-individual distinction made in *Moran* just seems to me to create the potential for the resolution of cases on rather enigmatic grounds, rather than on their real merits, an outcome inconsistent with the overall thrust of decisions like *Moran* and *Unocal*.

If a rights plan (or other defensive measure) has merely a prospective, even if real, deterrent effect, on the likelihood of an acquisition offer, its adoption by the board cannot be challenged in an individual action. If, however, a rights plan (or other defensive measure) is adopted in response to an actual acquisition proposal, the bidder[7] and shareholders aligned with the bidder may challenge the rights plan (or other defensive measure) as affecting their individual interests as stockholders.[8]

[10] Note that in either case, the effects on the stockholders are similar and the nature of the board action is identical. The only difference is that in the latter case a live competition for control is influenced, and in the former case the potential for a competition for control has been reduced.

It is not apparent to me why any claim in the latter situation belongs to the stockholders individually as well as to the corporation, and why in the former case the corporation alone is injured. In both circumstances the board of directors has taken action to interpose itself between willing buyers and willing sellers of stock.[9] The mere fact that the one circumstance involves an actual buyer with an announced intention to purchase does not seem to me to change the basic nature of the stockholder interests at stake.

Nor is it clear to me why a board's action to interpose itself between stockholders who are ordinarily free to sell their shares, and purchasers who

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[7]Under the case law, the bidder's standing in such circumstances has remained putatively tethered, if only by a bare thread, to its status as a stockholder.

[8]*See, e.g.*, *Tate & Lyle PLC v. Staley Continental, Inc.*, Del. Ch., C.A. No. 9813, 1988 WL 46064, at *8, Hartnett, V.C. (May 9, 1988) (where bidder-plaintiff attacked defensive measures, its claims were individual because it brought its claim as a potential acquirer in an effort to assist its tender offer); *GM Sub Corp. v. Liggett Group, Inc.*, Del. Ch., C.A. No. 6155, 1980 WL 6430, at *2, Brown, V.C. (Apr. 25, 1980) (bidder-plaintiffs claims that the target corporation's board sold an asset to impede plaintiffs tender offer was an individual claim because its suit was brought "in an effort to provide assurance that nothing will happen to cause it to deprive its fellow shareholders of an opportunity to sell their shares at a profit"); *Packer v. Yampol*, Del. Ch., C.A. No. 8432, 1986 WL 4748, at *13, Jacobs, V.C. (Apr. 18, 1986) (where defendants allegedly were obstructing an active proxy fight by plaintiffs, plaintiffs' action to remove the obstructions was individual); 1 Balotti & Finkelstein, § 13.7 at 13-18 ("Action taken to prevent a specific stockholder from conducting a proxy contest or a tender offer may constitute 'particular injury' to that stockholder, and thus the claim may be asserted individually."); 3 Ernest L. Folk, III et al., Folk on the Delaware General Corporation Law § 327.2.1.4 at GCL-XIII-46 (1999) ("Folk, Ward & Welch") ("Claims challenging corporate efforts to thwart a change of control may be brought individually if the plaintiff has indicated a desire to use its holdings to gain control of the corporation."); *see also City Capital Assocs. v. Interco, Inc.*, Del. Ch., 551 A.2d 787, 800 (1988) (where plaintiff was asserting its "interests as a buyer, not a seller of stock" the court granted the injunction because it would "make little sense for the court, having determined that the board now has a duty to shareholders to redeem the [poison pill], to fail to protect shareholders by not enforcing that duty specifically"); *cf. Revlon, Inc. v. MacAndrews & Forbes Holdings*, Del. Supr., 506 A.2d 173, 184-185 (1986) (emphasis added) (affirming ruling that plaintiff would suffer irreparable injury without injunction against defensive measure since the plaintiffs "opportunity to bid for *Revlon* [would be] lost").

[9]I note in this regard that the proxy contests at issue in corporate control cases are usually linked to acquisition offers.

are ordinarily free to buy those shares -- if improper -- works an injury on the corporation as an entity. In circumstances where directors act to protect against inadequate acquisition offers, they are acting to protect stockholders from selling at an inadequate price. If they act improperly and prevent stockholders from receiving a favorable offer, it is difficult to conceive how the corporation *qua* corporation is harmed. It is not at all difficult -- in fact, it is quite obvious -- how the stockholders *qua* stockholders are injured. *See* 1 Balotti & Finkelstein, § 13.7 at 13-17 (indicating that *Moran* reached the result it did "notwithstanding that it is arguable that the injury alleged [therein] fell exclusively on the stockholders and was not shared by the corporation.").

[11] While I have no doubt that there is no *contractual* right on the part of stockholders to receive purchase offers, *Moran*, 490 A.2d at 1070, the only possible legal justification for the board to interfere is if the board is appropriately exercising its fiduciary duties.[10] In a capitalist nation like ours, I would think it inarguable that an owner of stock has the right to sell her property, free and clear of unreasonable restrictions imposed by the directors of the corporation she partly owns. Why should our law not recognize such an unquestionable right as individual?

Although defensive measures may well be proper and beneficial to stockholders, that does not change the reality that they often involve a shift of power to insiders at the expense of the public stockholders. Such a shift in corporate power dynamics, if it works an injury, would seem (but for *Moran's* statement to the contrary) to injure those who lose power in the shift, not the corporate entity or the management-affiliated stockholders. In such circumstances, logic would seem to dictate characterization of a plaintiff's *Unocal* claim as individual.

[12] Moreover, cases after *Moran* recognize that breaches of fiduciary duties by boards may cause "special injury" to stockholders, without violating any specific contractual right to, e.g., a certain degree of voting power. Rather, if it is alleged that the directors reduced the voting power of stockholders through inequitable action, that suffices to state a direct claim,

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[10]It is also worth remembering that the power of even a well-intentioned board to take corporate action solely to prevent otherwise willing stockholders from receiving sales offers is quite different from the power to decide whether the corporation should manufacture buggies or electric cars. The former power arguably stretches the theoretical limits of fiduciary power by having the (at least quasi-) agents (i.e., the directors) influence or, in some instances, dictate whether the principals (i.e., the stockholders) can sell the enterprise. *Cf. Interco*, 551 A.2d at 799-800 ("To acknowledge that directors may employ the recent innovation of 'poison pills' to deprive shareholders of the ability effectively to choose to accept a noncoercive offer, after the board has had a reasonable opportunity to explore or create alternatives, or attempt to negotiate on the shareholders' behalf, would, it seems to me, be so inconsistent with widely shared notions of appropriate corporate governance as to threaten to diminish the legitimacy and authority of our corporation law.").

see In re Tri-Star Pictures, Inc. Litig., Del. Supr., 634 A.2d 319, 330-331 (1993), *even if such a reduction could have been effected by a properly motivated and behaved board. See also Lipton*, 514 A.2d at 1084-1085 (where sale of 19% of the corporation's stock to a friendly party gave the friendly party and the corporation's management veto power over a change in corporate management and other important corporate transactions, the corresponding reduction in other stockholders' voting power was sufficient to constitute special injury); *Avacus Partners, L.P. v. Brian*, Del. Ch., C.A. No. 11001, mem. op. at 14, Allen, C. (Oct. 24, 1990) (where board issues stock so as to dilute the voting power of stockholders and amends bylaws to require an 80% vote to remove directors, stockholders suffer special injury); *cf. Carmody v. Toll Bros., Inc.*, Del. Ch., 723 A.2d 1180, 1189 (1998) (where shareholder rights plan prohibited the stockholders from electing a new board in the future with the authority to redeem the rights under the plan, the stockholders pled special injury).

Thus, the *contractual* nature of the voting right -- which itself is usually limited to the simple right to cast a vote on certain corporate matters -- has had little to do with the actual cases finding an individual injury because the voting power of stockholders was diminished, coerced, or rendered misinformed by fiduciary breaches. Instead, a recognition that a wrongful impairment by fiduciaries of the stockholders' voting power or freedom works a personal injury to the stockholders; not to the corporate entity, seems to better explain the results reached. Recognizing a stockholder's individual right to receive sales offers without improper interference from a corporate board is logically consistent with cases like *Lipton*, *Tri-Star*, *Avacus*, and *Toll Brothers*.

If the derivative-individual distinction in *Moran* rests on the fact that defensive measures such as rights plans affect all stockholders equally, that distinction must deal with the reality that in most situations the directors and managers of the corporation hold shares. The inside holders' interests *qua* shareholders might not be affected all that differently by defensive measures, but their total economic interest in the corporation is often affected quite differently by defensive measures than are the interests of public stockholders having only an ownership stake. Hence, the justification for the *Unocal* standard of review. In addition, the inside holders have deprived only the non-inside stockholders of the right to freely receive purchase offers, since the insiders -- in their capacity as directors -- can decide to tear down the defenses when they themselves wish to accept such an offer.

[13] A consideration of which stockholders should recover damages in a case where the directors, as well as public stockholders, hold stock and the plaintiffs demonstrate that defenses caused monetary harm to the stockholders also suggests an individual characterization of a *Unocal* claim.

Grimes v. Donald, Del. Supr., 673 A.2d 1207, 1213 (1996) (indicating that the relief which would flow to plaintiff is relevant to the derivative-individual claim distinction). In a case where wrongfully erected defenses are proved to have damaged the stockholders by causing the stockholders to lose a sales opportunity or to sell at too low a price, should the directors be entitled to recover damages for the economic injury they inflicted on themselves as stockholders? If the answer is no because of the fact that they created the harm, this factor would support awarding relief to the class of innocent stockholders, not to the corporation.[11]

[14] An individual characterization is also plausible even in a scenario where there are no management holders and all stockholders equally suffer an injury because of the wrongful use of a defensive barrier. For example, where a Rights Plan or other defensive measure causes quantifiable economic injury equally to *all* stockholders of a corporation owned wholly by public stockholders because *all* the stockholders lost a valuable opportunity to sell, a derivative characterization is quite strained. After all, the injury suffered results from the directors' action impeding the stockholders from divesting themselves of their personal property, not from actions of the directors directly impairing the value of the enterprise itself to the indirect detriment of all stockholders. "A wrong is derivative in nature when it injures the shareholders indirectly and dependently through direct injury to the corporation." *Avacus*, mem. op. at 12 (*citing Kramer*, 546 A.2d at 353). The economic harm caused to the stockholders by a board's improper use of a rights plan to prevent stockholders from receiving a valuable sales offer will not be reflected on the corporation's balance sheet or, I would venture, in a going concern valuation of the corporation.

[15] Therefore, why should damages be awarded to the enterprise to remedy the economic harm caused because its owners were not permitted to sell their personal property? *Cf. Parnes*, 722 A.2d at 1246 (where plaintiff alleged that other bidders who might have paid a higher price than the eventual acquirer were unwilling to make improper payments to an insider and that the price of the merger that was ultimately consummated was unfair as a result of such payments, the plaintiffs stated an individual claim). The mere fact that such an injury is to the economic property rights of all the stockholders rather than to their voting rights does not make the injury suffered any less "special" and non-corporate.[12] *See Avacus*, mem. op. at 13

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[11]If the relief sought by the plaintiffs is solely or primarily injunctive in nature, this factor (the nature of the relief sought) would seem to be neutral, if not supportive of individual, rather than exclusively derivative, classification so long as the individual claim is asserted on a class basis. *See Grimes*, 673 A.2d at 1213; *but see Wells Fargo*, 1996 WL 32169, at *7 (suggesting the opposite inference).

[12]I acknowledge that defensive measures may cause corporate injury as well. For example,

("The fact that all shareholders have been affected equally does not make this claim of improper interference with the right to vote a corporate claim."). As learned commentators have noted:

> [*Moran's*] holding that a direct action was not available because all existing shareholders were treated the same appears limited to those instances in which no existing shareholder has undertaken a control or proxy contest. Even as so limited, however, [*Moran's*] focus on the similarity of treatment misses the central point that fundamental shareholder rights (e.g., voting and alienability) can be infringed by a variety of board actions that treat existing shareholders alike.

2 Principles of Corporate Governance: Analysis & Recommendations, § 7.01 n.3 at 30 (1994).

Nor would an individual characterization of *Unocal* claims give rise to a flood of new claims or a usurpation of the right of corporate boards to consider whether to bring claims properly belonging to their corporations. This is so for a few reasons.

[16] The derivative-individual claim distinction is already of no practical importance at the pre-transaction stage of corporate litigation -- the stage at which *Unocal* claims are often most hotly contested. So long as the plaintiff states a claim implicating the heightened scrutiny required by *Unocal*, demand has been excused under the *Aronson v. Lewis*, Del. Supr., 473 A.2d 805 (1984), demand excusal test. *Moran*, 490 A.2d at 1071; *Toll Bros.*, 723 A.2d at 1189; *Wells Fargo & Co. v. First Interstate Bancorp*, Del. Ch., C.A. No. 14696, 1996 WL 32169, at *8, Allen, C. (Jan. 18, 1996); *In re Chrysler Corp. Shareholders Litig.*, Del. Ch., C.A. No. 11873, mem. op. at 10, Jacobs, V.C. (July 27, 1992).

[17] Similarly, where plaintiffs challenge the substantive unfairness of a merger protected by defensive measures, their claims are said to be direct. *See, e.g., Parnes*, 722 A.2d at 1245. Therefore, characterizing a well-pleaded *Unocal* claim as individual rather than derivative does little, if

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an excessive termination fee in a merger agreement could, if it actually has to be paid by the corporation, cause corporate injury. If, however, the excessive fee works as a defensive measure and wrongfully prevents stockholders from receiving a more valuable offer, the resulting injury would seem to be personal to the stockholders and not involve harm to the corporate entity itself. Even in the former case, if the fee is paid and the plaintiff alleges that the fee contributed to making the consideration received in an alternative transaction unfair, the plaintiff may, per *Parnes*, challenge it in an individual action. Moreover, where a termination fee is preclusive of a stockholder-bidder or coercive of stockholder-purchasers as voters, our case law would already dictate an individual, as well as derivative, characterization of an attack on the fee.

anything, to encourage additional end-runs around board control of corporate claims.

[18] Moreover, settled case law indicates that a potential acquirer may bring an individual action to challenge defensive actions impeding its bid, and plaintiffs sympathetic to such acquirers seem to have been swept along in the acquirers' wake. *See, e.g., Tate & Lyle PLC v. Staley Continental, Inc.*, Del. Ch., C.A. No. 9813, 1988 WL 46064, at *8, Hartnett, V.C. (May 9, 1988); *GM Sub Corp. v. Liggett Group, Inc.*, Del. Ch., C.A. No. 6155, 1980 WL 6430, at *2, Brown, V.C. (Apr. 25, 1980); *see also* 1 Balotti & Finkelstein, § 13.7 at 13-18; 3 Folk, Ward & Welch, § 327.2.1.3 at GCL-XIII-46. In this regard, it is worth noting that *Moran's* statement that *stockholders* have no distinct right (i.e., separate from the board's control) to *sell* their shares has led to the anomalous[13] recognition of an individual right to challenge board actions restricting a *stockholder-bidder* from a company. That is, Delaware law now seems to recognize a stockholder's individual right to make, but not to receive, a takeover offer without improper interference from the target corporation's board.[14]

At the post-transaction stage where plaintiffs challenge pre-transaction defensive actions, the derivative-individual claim divide regains significance because of the continuous ownership requirement of 8 Del. C. § 327 and Court of Chancery Rule 23.1. In a merger extinguishing plaintiffs' status as stockholders, the question of whether the plaintiffs' claims are individual or derivative becomes outcome determinative. If the claims are individual, the plaintiffs' claims survive the merger. If not, the plaintiffs' claims are extinguished. Thus cases like *Kramer* and *Parnes*. *See also In re First Interstate Bancorp Consol. Shareholder Litig.*, Del. Ch., 729 A.2d 851, 861-862 (1998) (where plaintiffs alleged that certain pre-merger acts by the

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[13]I say anomalous because directors arguably owe no fiduciary duties to stockholders as bidders. While I believe there is a strong policy rationale for according bidders standing to challenge as lacking legal justification board actions that impede a bidder's free market rights unless the board is acting in accord with its duties to the stockholders, *see* n.14 *infra*, the directors' obligations as fiduciaries would seem to flow primarily, if not exclusively, to the stockholders in their capacities as holders or prospective sellers.

[14]There are very sound practical, value-enhancing reasons for the case law according bidders standing, even though the practice of according *bidders standing as stockholders* leads to a certain amount of undeniable doctrinal incoherence. *See generally* J. Travis Laster, The Line Item Veto and *Unocal*: Can a Bidder *Qua* Bidder Pursue *Unocal* Claims Against a Target Corporation's Board of Directors?, 53 Business Lawyer 767 (1998). There are also very sound doctrinal reasons for recognizing that defensive measures primarily affect stockholders as prospective sellers and bidders (regardless of stockholder status) as prospective buyers, and enabling each to bring individual actions to protect their legitimate interests in being able to deal with each other without improper (i.e., not fiduciarily compliant) interference by corporate boards. Such a reality-based approach seems to have little downside and is a more straightforward manner in which to address cases implicating *Unocal*.

defendant directors reduced the merger consideration but did not render the merger price unfair, the claims were derivative and were extinguished by the merger). Even so, the need to apply the derivative-individual claim distinction in such cases is not obvious.

Undoubtedly, there is a need to prevent windfalls to plaintiffs who have accepted the benefits of a corporate transaction extinguishing their ownership of stock and who continue thereafter to challenge the transaction. The question is whether the test for distinguishing between individual and derivative claims really is the best way to do that. Other possibilities would seem more direct.

For example, those stockholders who freely vote to accept the benefits of a transaction should be barred from recovery on that basis alone.[15] Such a result is consistent with the teaching of prior cases. *See, e.g.*, *Bershad v. Curtiss-Wright Corp.*, Del Supr., 535 A.2d 840,848 (1987) ("when an informed minority shareholder either votes in favor of the merger or . . . accepts the benefits of the transaction, he or she cannot thereafter attack its fairness").

Where the plaintiffs lose stockholder status against their will, they could still be required to prove that the transaction eventually consummated, taken in its entirety and not as to component parts or as to the steps (including defensive measures) leading to it, was unfair.[16] This might be a more direct, and less erratic, method to achieve the desirable and necessary end of denying unfair windfalls. The confluence of *Parnes* and *Kramer* will in reality indirectly create such a "bitter with the sweet" method, but in the non-merits context of an evaluation of whether the plaintiffs complaint challenges the overall fairness of the deal and therefore states an individual claim. An appropriate application of ordinary business judgment rule and entire fairness principles should be adequate to eliminate such windfalls, which in the post-squeeze out transaction context do not involve stockholders who purchased their shares to buy into litigable claims.

And in a circumstance such as exists in this case, the practical importance of the distinction between the direct and derivative nature of the plaintiffs' *Unocal* claims seems trivial, if not non-existent. Because Vice Chancellor Balick ruled that the complaint stated a claim triggering heightened scrutiny under *Unocal*, he also held, per *Moran*, that demand was excused under *Aronson*. Therefore, this case will proceed to a summary judgment motion or trial regardless of my ruling on this motion. That is, my ruling on this motion will not influence whether or how I address the merits

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[15]Or who buy stock and challenge the earlier adoption of properly disclosed defensive measures.

[16]If the business judgment rule presumption is rebutted then the defendants would simply have to show that their actions, taken as a totality, were fair.

of the plaintiffs' claims. It will essentially only determine whether I certify a class.[17]

I highlight all these issues simply because I believe that there may be value to rethinking the derivative-individual claim distinction in the area of defensive measures. One of the great virtues of *Unocal* is that it strips away doctrinal barriers to a substantive examination of whether directors, in circumstances fraught with the potential for conflicts of interest between themselves and the stockholders, have fulfilled their fiduciary duties. The hair-splitting and illusive analysis required to determine whether a *Unocal* claim is individual or derivative seems somewhat at odds with *Unocal's* merits-based approach to the resolution of corporate control cases. Given the limited consequences that flow from such analyses because of the automatic demand excusal and the multiple exceptions to derivative characterization that accompany claims invoking *Unocal*, it is unsurprising that courts have at times simply decided it was not worthwhile to classify such claims before trial. *See, e.g.*, *Wells Fargo*, 1996 WL 32169, at *8. The effort required seems out of proportion to any substantive benefit thereby achieved.[18] For today's purposes, however, I must apply the law as it stands.

C.

[19] In view of *Moran*, if the plaintiffs only challenged the Board's adoption of the Rights Plan, then the complaint would not have stated an individual claim. But the complaint, as interpreted by Vice Chancellor Balick, challenges the Rights Plan and the Amendments as an interrelated set of defensive measures motivated solely by the desire of the defendant directors to entrench themselves in their corporate offices. In a case where the plaintiffs attack a combination of board actions as operating in tandem to injure the stockholders, "the focus properly rests on the cumulative impact of [the actions] on the minority" in determining if the claims are individual or derivative." *Tri-Star*, 634 A.2d at 331 (emphasis omitted).

[20-21] "Although entrenchment claims may be either individual or derivative, '[a]n entrenchment claim . . . [is] . . . individual . . . when the shareholder alleges that the entrenching activity directly impairs some right

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[17]It may also influence the possible remedy, but not in any manner that cuts against an individual characterization of the claims. There are other equitable methods (other than a derivative characterization) to tailor relief that does not provide anyone with a windfall. The issue of who, if anyone, is responsible for attorneys' fees to successful class counsel also seems manageable.

[18]At oral argument, for example, the parties could provide me with little, if any reason, why the characterization to be made is at all substantively consequential in this case. The defendants cited to the fact that if the Proposed Class is certified, that Gaylord stockholders will be notified that they have a class claim, giving rise to some bad publicity for the company.

she possesses as a shareholder.'" *Toll Bros.*, 723 A.2d at 1188-1189 (quoting *Avacus*, mem. op. at 13). Where the entrenching actions of a corporate board have the purpose and effect of reducing the voting power of stockholders, the affected stockholders may bring an individual action. *See, e.g.*, *Tri-Star*, 634 A.2d at 330; *Lipton*, 514 A.2d at 1084-1085; *Toll Bros.*, 723 A.2d at 1189; *Avacus*, mem. op. at 14.

In this case, the Amendments markedly diminish the voting power of the Gaylord stockholders. Absent the Amendments, Gaylord stockholders could remove the Gaylord Board by written consent at any time. After the Amendments, Gaylord stockholders may only elect directors at the annual meeting or at a special meeting called by the Board or its Chairman, Pomerantz. *See Avacus*, mem. op. at 14 ("The changed by-laws can harm only the shareholders directly because this change in the governance structure of the corporation is a matter that directly involves the shareholders' right to elect and remove directors."). Absent the Supermajority Amendment, Gaylord stockholders would have had the authority to amend the corporate bylaws and undo the Amendments by majority vote. After the Supermajority Amendment, the Gaylord stockholders have to muster a huge majority to secure the two-thirds vote now necessary to accomplish these acts over the objections of the Management Holders. *Cf. Lipton*, 514 A.2d at 1084-1085 (issuance of stock that gave friendly party and management the voting power to block corporate transactions gave rise to an individual claim).

Moreover, in no non-formalistic sense can the Rights Plan and the Amendments, taken together, be said to affect all stockholders equally. Although a Gaylord share is a Gaylord share, the reality is that the Rights Plan and the Amendments affect the non-Management Holders and the Management Holders differently. The Rights Plan and Amendments operate in tandem to increase the power the Management Holders wield over the corporation, both as stockholders and directors, to the detriment of the non-Management
Holders.

In the wake of the Rights Plan and the Amendments, the Management Holders as Board members have the authority to block a hostile acquirer by refixing to redeem the Rights Plan, waive § 203's application, or call a special meeting for the purpose of holding a special election. Because the Amendments reduce the likelihood that the Management Holders will be removed as Board members, the Amendments also make it more probable that the Management Holders will continue to sit on the Board and wield this authority.

Purely as stockholders, the Management Holders have also increased their blocking power, because of the Supermajority Amendment.

Furthermore, because this Amendment increases the blocking power of the Management Block, the Amendments therefore also arguably increase the economic value of the Management Block, an increase not shared with the non-Management Holders.[19] *Cf. Tri-Star*, 634 A.2d at 330 (where transaction increased value of controlling stockholder's interest at expense of minority, this factor supported a finding of special injury).

Although the increased power of the Management Holders under the Rights Plan and the Amendments is not insurmountable, that those acts increased the power of the Management Holders at the expense of the non-Management Holders cannot be reasonably questioned. When a corporate board undertakes related actions that diminish the ability of non-management stockholders to elect a new slate of directors, entertain sales proposals, and to amend the corporation's charter and bylaws, the resulting injury to the non-management stockholders is independent of and distinct from any injury to the corporation. Indeed, whatever injury results is to the stockholders within the corporate structure that have lost relative power, not to the corporation as an entity. After all, the corporation as an entity has not lost the power to do anything, it is power to cause the corporation to do certain things that has shifted. Nor are all stockholders injured equally in such circumstances, since whatever injury has been suffered has been borne disproportionately, if not exclusively, by the non-management stockholders whose power has been diminished.

[22] In concluding that the complaint states individual as well as derivative claims, I in no manner comment on the merits of the claims pled by the plaintiffs here. The claims are hardly of overwhelming strength.[20] However, the distinction between a derivative and individual claim does not turn on the strength of the asserted claims, but the nature of them. *Lipton*, 514 A.2d at 1079 n.4; *Avacus*, mem. op. at 14.

IV.

For all these reasons, I deny the defendants' objection to class certification. Plaintiffs shall present, after notice as to form, a conforming order.

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[19]That is, the Management Block (or at least Pomerantz's portion) may be able to command a premium over that which would be available to other stockholders in a sales transaction.

[20]By way of example, the proposition that a corporate board may be held liable for proposing that 8 Del. C. § 203 -- a state law -- apply to the corporation seems on its face to be quite extraordinary and implausible.

GOLAINE v. EDWARDS

No. 15,404

Court of Chancery of the State of Delaware, New Castle

December 21, 1999

Plaintiff, a shareholder in a corporation targeted for merger, brought a claim challenging the propriety of a payment made by the target corporation to the affiliate investment bank in connection with the merger. Defendants filed a motion to dismiss alleging that (1) the challenge of the propriety of the payment made to the affiliate investment bank in connection with the merger raises a derivative claim for which plaintiff no longer has standing to bring; (2) the difference between the amount received by the affiliate investment bank and the amount received by other stockholders of the target corporation does not speak to the fairness of the merger, and (3) there is no breach of fiduciary duty, mismanagement, nor waste because the payment was approved by a disinterested and independent board majority of target corporation.

The court of chancery, per Vice-Chancellor Strine, granted the defendants' motion to dismiss for failure to state a claim, pursuant to Delaware Court of Chancery Rule 12(b)(6). The court concluded that plaintiff failed to state a claim that the payment tainted merger negotiations as to render the transaction unfair to target corporation's stockholders, and therefore, an individual claim. Also, plaintiff failed to plead facts rebutting the business judgment rule.

1. Corporations ⟹ 202, 320(4), 320(8)
   Federal Civil Procedure ⟹ 103.1
   Pleading ⟹ 49, 72

In determining whether a complaint is an individual claim or a derivative claim, the court considers the nature of the wrong alleged and the relief that could be granted to the prevailing plaintiff.

2. Corporations ⚷ 512, 513, 513.1
Pleading ⚷ 49, 72

In an inquiry on whether a complaint states an individual rather than derivative claim, the court must look to the body of the complaint and not the complainant's designation or stated intent.

3. Corporations ⚷ 202, 207, 586, 587
Federal Civil Procedure ⚷ 103.1

As a result of the merger, stockholders lost their standing to sue derivatively on behalf of the targeted corporation.

4. Corporations ⚷ 202, 207, 320(8)

Stockholders may sue on their own behalf (and, in appropriate circumstances, as representatives of a class of stockholders) to seek relief for direct injuries that are independent of any injury to the corporation.

5. Corporations ⚷ 202, 207, 320(8)

A stockholder who directly attacks the fairness or validity of a merger alleges an injury to the stockholders, not the corporation, and may pursue such a claim even after the merger at issue has been consummated.

6. Corporations ⚷ 202, 207, 307, 310(1), 320(8), 512, 513, 513.1
Pleading ⚷ 49, 72

In order to state a direct claim with respect to a merger, a stockholder must challenge the validity of the merger itself, usually by charging the directors with breaches of fiduciary duty resulting in unfair dealing and/or unfair price.

7. Corporations ⚷ 202, 320(4), 320(8)
Federal Civil Procedure ⚷ 103.1
Pleading ⚷ 49, 72

In the context of a merger transaction, derivative-individual distinction is essentially outcome-determinative of any breach of fiduciary duty claims that can be asserted in connection with the merger by the target company stockholders.

8. Corporations ⚷ 202, 320(4), 320(8), 512, 513, 513.1
Federal Civil Procedure ⚷ 103.1
Pleading ⚷ 49, 72

A complaint states only a derivative claim for mismanagement where it merely alleges that wrongful transactions associated with a merger reduced the amount paid to the cashed-out stockholders.

9. Corporations ⚷ 202, 307, 310(1), 320(4), 320(8), 512, 513, 513.1
Federal Civil Procedure ⚷ 103.1
Pleading ⚷ 49, 72

In order to state a direct claim with respect to a merger, a stockholder must challenge the validity of the merger itself usually by charging the directors with breaches of fiduciary duty resulting in unfair dealing and/or unfair price.

10. Corporations ⚷ 202, 320(4), 320(8), 512, 513, 513.1
Federal Civil Procedure ⚷ 103.1
Pleading ⚷ 49, 72

If the side transactions were not so costly that they enable the plaintiffs to allege that the consideration offered to the target stockholder was reduced to an unfair level, then a price attack on them must be labeled as derivative and extinguishable by the merger.

11. Corporations ⚷ 202, 320(4), 320(8), 512, 513, 513.1
Federal Civil Procedure ⚷ 103.1
Pleading ⚷ 49, 72

If the side transactions are alleged to have reduced the consideration offered to the target stockholders to a level that is unfair, then an attack is labeled as individual because it goes directly to the fairness of the merger.

12. Corporations ⚷ 202, 307, 310(1), 320(4), 320(8), 512, 513, 513.1
Federal Civil Procedure ⚷ 103.1
Pleading ⚷ 49, 72

A target company stockholder cannot state a claim for breach of fiduciary duty in the merger context unless he adequately pleads that the merger terms were tainted by unfair dealing.

13. Corporations ⚷ 202, 320(4), 320(8), 512, 513, 513.1
Federal Civil Procedure ⚷ 103.1
Pleading ⚷ 49, 72

It cannot be that the mere fact that an insider (or the affiliate of an insider) received a payment in connection with the merger in itself provides a sufficient basis for a target stockholder plaintiff to state an individual claim based on the simple syllogism that: (1) the payment was part of the total consideration the acquirer was willing to pay, (2) the target board had a duty to ensure that the payment's worth was spread equally to all the stockholders, and (3) the target board's failure to do so therefore constituted unfair dealing tainting the merger.

14. Corporations ⚷ 512, 513, 513.1

The target stockholder plaintiff must, at the very least, allege facts showing that the side payment improperly diverted proceeds that would have, if the defendant directors had acted properly, ended up in the consideration paid to the target stockholders.

15. Corporations ⚷ 307, 310(1), 512, 513, 513.1
Pleading ⚷ 49, 72

In order to plead a breach of fiduciary duty, the complaint must set forth facts tending to rebut the business judgment rule's presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.

16. Corporations ⟹ 182.4(2), 307, 310(1)
Waste ⟹ 404(1)

Where a decision was made by a disinterested and independent board majority, it can only be challenged on the grounds that it constituted corporate waste.

Joseph A. Rosenthal, Esquire, of Rosenthal, Monhait, Gross & Goddess, Wilmington, Delaware; Scott W. Fisher, Esquire, and Adam Steinfeld, Esquire, of Garwin, Ranzaft, Gerstein & Fisher, New York, New York, of counsel; Robert I. Harwood, Esquire, and Jeffrey M. Haber, Esquire, of Wechsler Harwood Halebian & Feffer, New York, New York, of counsel; and Nadeem Naruqi, Esquire, of Faruqi & Faruqi, New York, New York, of counsel, for plaintiff.

Kenneth J. Nachbar, Esquire, of Morris, Nichols, Arsht & Tunnell, Wilmington, Delaware; and John D. Donovan, Jr. Esquire, John P. Bueker, Esquire, and Michele T. Perillo, Esquire, of Ropes & Gray, Boston, Massachusetts, of counsel, for defendant Gillette Company.

Jesse A. Finkelstein, Esquire, of Richards, Layton, & Finger, Wilmington, Delaware; and Michael J. Chepiga, Esquire, of Simpson Thacher & Bartlett, New York, New York, of counsel, for defendants Duracell and KKR affiliates.

STRINE, *Vice-Chancellor*

In this action, plaintiff Rosalyn Golaine challenges the propriety of a $20 million payment to Kohlberg Kravis Roberts & Co., L.P. ("KKR") made in connection with a merger between The Gillette Company and Duracell International, Inc. Before the merger, KKR's affiliate KKR Associates, L.P. owned 34% of Duracell's outstanding common stock. It is alleged that two KKR principals who served on the Duracell board of directors—defendants Henry R. Kravis and Scott M. Stuart—conducted the merger negotiations with Gillette.

In the merger, each of Duracell's 121,369,663 shares—including those held by KKR Associates—was converted into .904 Gillette shares, resulting in an implied cost to Gillette of nearly $8.3 billion. But KKR received an additional $20 million in investment banking fees from Duracell in connection with the merger in exchange for its role in negotiating the transaction.

The defendants have filed a motion to dismiss claiming that Golaine's challenge to the $20 million payment raises solely a derivative claim and not an individual claim. Specifically, the defendants assert that the complaint fails to state facts to support an inference that the merger terms were tainted in any way by the $20 million fee. In fact, the defendants contend that the complaint fails to allege that the issue of the fee even arose before the merger price negotiations between KKR and Gillette were concluded. Furthermore, the defendants assert that the difference in consideration between what was received by KKR and what was received by the other Duracell stockholders is too insubstantial to buttress a direct attack on the fairness of the merger. Because Golaine lost her status as a Duracell stockholder as a result of the merger, she has therefore lost her standing to raise a derivative claim challenging the $20 million payment.

For virtually the same reasons, the defendants assert that the Golaine's complaint fails to state a claim for breach of fiduciary duty or waste at all, particularly because a disinterested and independent Duracell board majority approved the KKR fees.

In this opinion, I conclude that the complaint fails to state a claim that the $20 million fee to KKR tainted the merger negotiation process or the merger terms so as to render that transaction unfair to Duracell's non-KKR stockholders. Therefore, the complaint fails to state an individual claim. Furthermore, Golaine has failed to plead facts rebutting the business judgment rule's presumptive applicability to the Duracell board's decision to award KKR the fees or facts adequate to support a waste claim. Thus I grant the defendants' Rule 12(b)(6) motion.

I.[1]

A.

Defendant Duracell, a Delaware corporation, is the leading American producer of alkaline batteries. After the merger, Duracell continued to exist as a separate, wholly-owned subsidiary of Gillette until July 1997, when it was merged into Gillette.

Defendant Gillette is also a Delaware corporation that is a world-class competitor in several consumer product areas, including grooming products, toothbrushes and oral care appliances, and writing instruments.

Defendant KKR is an investment bank. Defendant KKR Associates, L.P is an affiliate of KKR and the general partner of two partnerships that collectively owned 34% of Duracell's stock before the merger.

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[1]All facts have been drawn from the complaint.

KKR or its affiliates designated four of the eleven members of the Duracell board before the merger. Defendants Kravis, Stuart, Paul E. Raether, and George R. Roberts were the four KKR designees on the Duracell board. According to the complaint, defendants Kravis and Stuart were not only directors of Duracell, but were also "general partner[s] of KKR Associates and . . . affiliate[s] of KKR."[2]

Defendant Charles R. Perrin was Duracell's Chairman of the Board and Chief Executive Officer, and formerly its President and Chief Operating Officer. The remaining defendants were members of the Duracell board before the merger: Earnest J. Edwards; C. Robert Kidder; Charles E. Kiernan; and G. Wade Lewis.

B.

Gillette formed a project team in August of 1995 to identify potential acquisitions. By mid-November of that same year, Duracell had been identified as a leading target. Thereafter, Gillette's Chairman of the Board, Alfred M. Zeien, approached Kravis — rather than Duracell's Chief Executive Officer, Perrin — to discuss the basis on which Gillette might acquire Duracell. According to plaintiffs, Zeien went to Kravis because he knew that given KKR Associates' 34% block, KKR could block any transaction it did not favor.

Zeien met with Kravis and his KKR Associates partner, Stuart, on January 19 and February 6 of 1996. According to the complaint, Kravis and Stuart negotiated with Zeien wearing their KKR hats, and were not retained by and did not purport to speak for Duracell. These initial discussions were not fruitful, as "Messrs. Zeien, Kravis and Stuart determined that there were substantial differences in their views as to the appropriate values to be placed on the stock of Gillette and Duracell."[3] As of this time, senior members of Duracell management were unaware that the discussions were even taking place.

Gillette's ardor for Duracell was such that its board decided in June of 1996 to pursue renewed talks with Kravis. Thereafter, on July 10, 1996, Zeien, Kravis, and Stuart met again to discuss a possible deal.

Two days later, Kravis and Stuart advised Duracell's senior management for the first time of the discussions they had been having with Gillette. After that notice was provided, Kravis continued to be the point person with Duracell and in that capacity worked with Stuart during July and August to negotiate the terms of a transaction.

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[2]Compl. ¶¶ 12, 13.
[3]Compl. ¶ 14.

Kravis and Zeien agreed on the fundamental price terms of the merger on August 29, 1996. Under those terms, Duracell stockholders were to receive .904 of a share of Gillette common stock for each of their Duracell shares.

At some point in the process, it was proposed that KKR receive a $20 million fee in connection with the merger for its role in negotiating the deal. The investment bank that was formally retained by Duracell in connection with the merger, Morgan Stanley & Co., was to receive $10 million. The complaint is, frankly, quite vague on this topic. One cannot tell from the complaint whether Zeien and Kravis discussed the $20 million fee for KKR before negotiating and agreeing on the Exchange Ratio, or who proposed the concept of the fee. The complaint does not even touch on this subject.

What is clearly alleged is that the Duracell board met on September 12, 1996 and approved the merger, the $20 million payment to KKR, and the $10 million Morgan Stanley fee. It is also clearly alleged that the Gillette board considered the merger and the $30 million in investment banking fees the same day. The Gillette board approved the merger unanimously. The investment banking fees evoked greater controversy.

Although the $30 million payment was technically to be made by Duracell, as a matter of economic reality the fee was to be paid almost entirely by Gillette. Put another way, the $30 million in investment banking fees was a part of Gillette's acquisition costs. During its meeting, the Gillette board members apparently discussed whether they could reduce the fees. When they concluded that was not possible, eleven members of Gillette's twelve-member board voted to approve the fees. Gillette director Warren Buffett objected to the payments to KKR and Morgan Stanley and abstained from the vote approving them.

Piecing the rather elliptical complaint together, its basic logic is as follows:

- KKR undertook negotiations with Gillette for its own benefit and did not even inform the Duracell board of the discussions until a half year after they started.

- "[A]s directors of Duracell, Messrs. Kravis and Stuart had . . . fiduciary responsibility to maximize value for Duracell shareholders in the type of transaction in which Gillette was interested; and, as directors, . . . Kravis and Stuart were amply compensated by Duracell for carrying

out their responsibilities to the Company and its shareholders.[4]

- KKR was never formally retained by the Duracell board as an investment bank and was acting, through Kravis and Stuart, primarily for its own account. Yet KKR was granted a $20 million fee, a fee twice that approved by the Duracell board for its formally retained investment banker, Morgan Stanley.

- The Duracell directors' duty of loyalty "preclude[d] them from favoring one shareholder or group of shareholders over other shareholders in the allocation and distribution of the total merger consideration payable by Gillette. . . ."[5]

- The plaintiff alleges that the $20 million payment to KKR "constitutes an improper preferential allocation of the total merger proceeds payable by Gillette."[6]

- As a result, "plaintiff and the class [were] denied their proportionate share of the total merger consideration payable by Gillette, .904 shares for each Duracell share, plus $20 million cash."[7]

- Thus plaintiff seeks an award granting all "class members their proportionate interest in the improper preferential payment to KKR."[8]

II.

[1-2] In determining whether a complaint states an individual rather than derivative claim, the court must consider the "'nature of the wrong alleged' and the relief, if any, which could result if plaintiff were to prevail."[9] In that

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[4]Compl. ¶ 13.
[5]Compl. ¶ 19.
[6]Compl. ¶¶ 22(b).
[7]Compl. ¶ 21.
[8]Compl. ¶ 22(c).
[9]*Kramer v. Western Pacific Industries, Inc.*, Del. Supr., 546 A.2d 348, 352 (1988) (quoting *Elster v. American Airlines, Inc.*, Del. Ch., 100 A.2d 219, 221-23 (1953)).

inquiry, the court must look to "'the body of the complaint, not to the plaintiffs designation or stated intention.'"[10]

[3] As a result of the merger, plaintiff Golaine and all the other Duracell stockholders lost their status as Duracell stockholders and therefore their standing to sue derivatively on behalf of Duracell.[11] Thus the question of whether Golaine's claim is individual or derivative in nature takes on heightened importance in this post-merger context.

In considering how to approach the individual-derivative distinction in this scenario, it is helpful to note that cases like this one are rather common. It is fairly standard to confront transactions wherein the stockholders of one corporation (the "target") receive consideration for agreeing to give up their shares in a merger with another corporation (the "acquirer"). In connection with the merger, management insiders, advisors, and the largest stockholders of the target may receive some benefits not shared with all the target stockholders, such as golden parachutes, advisory and consulting fees, new employment contracts, or additional merger consideration ("side transactions").

Unfortunately, Delaware law has struggled to develop a predictable method by which to distinguish the nature of claims in this context. As our Supreme Court has acknowledged, "it is often difficult to determine whether a stockholder is challenging the merger itself, or alleged wrongs associated with the merger, such as the award of golden parachute employment contracts."[12] This acknowledgment is simply one of many expressions of frustration by our courts with the individual-derivative claim distinction in merger settings.[13]

[4-6] But looking at the half full part of the doctrinal glass, our Supreme Court recently gave very helpful guidance in this area when it held:

> Stockholders may sue on their own behalf (and, in appropriate circumstances, as representatives of a class of stockholders) to seek relief for direct injuries that are independent of any injury to the corporation. A stockholder who directly attacks the fairness or validity of a merger alleges an injury to the stockholders, not the corporation, and may pursue such a claim

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[10] *Id. (quoting Lipton v. News International, PLC*, Del. Supr., 514 A.2d 1075, 1078 (1986)).

[11] *Lewis v. Anderson*, Del. Supr., 477 A.2d 1040, 1049 (1984); *Parnes v. Bully Entertainment Corp.*, Del. Supr., 722 A.2d 1243, 1244-45 (1999); 8 Del. C. § 327.

[12] *Parnes*, 722 A.2d at 1245.

[13] *See, e.g., Turner v. Bernstein*, Del. Ch., C.A. No. 16190, mem. op. at 28, Jacobs, V.C. (Feb 9, 1999) ("a thin grey line often marks the difference between derivative and individual claims that arise in the merger context"); *In re Gaylord Container Corp. Shareholders Litig.*, Del. Ch., Cons. C.A. No. 14616, mem. op. at 10 n.5, 1999 Del. Ch. LEXIS 175, at *13 n.5, Strine, V.C. (Aug. 10, 1999)(citing several cases to this effect).

> even after the merger at issue has been consummated. . . . In order to state a direct claim with respect to a merger, a stockholder must challenge the validity of the merger itself, usually by charging the directors with breaches of fiduciary duty resulting in unfair dealing and/or unfair price.[14]

[7] In the context of a merger transaction, the derivative-individual distinction is essentially outcome-determinative of any breach of fiduciary duty claims that can be asserted in connection with the merger by the target company stockholders. If the claims are held to be individual, then the target company plaintiff may press on. If the claims are found derivative, she may not. At best, any derivative claim may be asserted by the target corporation itself.[15] More likely, as is overwhelmingly probable in this case, the new acquirer gave up such a right in the merger agreement itself.[16]

Put another way, the individual-derivative distinction comes as close as possible to being a determination of the merits of a claim. By denominating a claim as derivative in this context, the court comes very near to immunizing the defendants from any culpability for the conduct complained of. While the courts may indulge the notion that the claims still "survive" as waste, mismanagement, or unfairness claims for dimunition of the value of the target, they usually die as a matter of fact. If there were any improper gains by insiders of the target corporation, the insiders will usually be able to retain them unless they defrauded the acquirer into entering into the merger. In this case, for example, there is no realistic chance that Gillette could successfully sue KKR for return of the $20 million, because Gillette specifically approved the payment.[17]

Thus cloaked within the application of the individual-derivative distinction to post-merger claims is the actual reality of the situation. If the harm alleged is seen as a derivative one, it is nearly certain to be non-compensable. But if the harm alleged is seen as individual, it may be compensable. Viewed somewhat differently, if plaintiffs fail to allege facts that convince the court that the side transactions rendered the underlying

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[14]*Parnes*, 722 A.2d at 1245.

[15]*Lewis v. Anderson*, 477 A.2d at 1050.

[16]*See also Bershad v. Hartz*, Del. Ch., C.A. No. 6960, mem. op. at 6, 1987 Del. Ch. LEXIS 380 at *7, Berger, V.C. (Jan. 29, 1987) (acquiror specifically agreed to honor golden parachutes issued in anticipation of merger). Depending on the circumstances, the new acquirer may be barred from causing the target corporation itself to do so under basic contract law or, much less commonly, the doctrine articulated by *Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R. Co.*, 417 U.S. 703 (1974). The *Bangor Punta* was adopted by this court in *Courtland Manor, Inc. v. Leeds*, Del. Ch., 347 A.2d 144 (1975). *But see Lewis v. Anderson*, 477 A.2d at 1050 (emphasizing the limits of the *Bangor Punta* doctrine in the merger context).

[17]It may well have been part of the merger agreement itself.

transaction unfair to the target's stockholders and instead simply allege that the acquirer's cost of acquisition was made higher, the plaintiffs fail to state an individual claim.

Parnes makes this clear. In that case, the Delaware Supreme Court found that the complaint directly attacked the fairness of both the process and the price in a merger between the Bally and Hilton Hotels corporations. The Bally Chairman and CEO "allegedly informed all potential acquirers that his consent would be required for any business combination with Bally and that, to obtain his consent, the acquirer would be required to pay [him] substantial sums of money and transfer to him valuable Bally assets."[18] Several would-be acquirers who might have paid a higher price than Hilton walked away. Hilton, however, agreed to the CEO's demands and agreed to a large array of payments and asset transfers worth over $70 million. Based on these allegations, the Supreme Court concluded that the plaintiff had adequately alleged that the merger price was unfair and resulted from unfair dealing.[19]

[8-9] In *Parnes*, the Supreme Court distinguished the situation before it from the one the Court had addressed in its earlier decision in *Kramer v. Western Pacific Industries*.[20] The *Parnes* Court's discussion of *Kramer* bears repeating here:

> In *Kramer v. Western Pacific Industries*, this Court discussed the differences between a derivative claim for mismanagement related to a merger and a direct claim for unfairness in the merger terms. The *Kramer* complaint was filed shortly before the merger of Western Pacific Industries, Incorporated with Danaher Corporation. It alleged that two of Western's twelve directors breached their fiduciary duties by "diverting to themselves eleven million dollars of the Danaher sales proceeds through their receipt of stock options and golden parachutes and [by] incurring eighteen million dollars of excessive or unnecessary fees and expenses in connection with the sale of Western Pacific." The complaint did not question the fairness of the price offered in the merger or the manner in which the merger agreement was negotiated. Nonetheless, Kramer argued that his claims of corporate waste, in the form of excessive payments to Western's management directors and

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[18] *Parnes*, 722 A.2d at 1245.
[19] *Id.* at 1246.
[20] 546 A.2d 348.

> others, were "tantamount to direct attacks upon the fairness of the merger terms."
>
> *The* Kramer *Court held that the complaint stated only a derivative claim for mismanagement. Although the complaint did allege that wrongful transactions associated with the merger (such as the award of golden parachutes) reduced the amount paid to Western's stockholders, it did not allege that the merger price was unfair or that the merger was obtained through unfair dealing. The* Kramer *Court explained that a claim alleging corporate mismanagement, and a resulting drop in the value of the company's stock, is a classic derivative claim*; the alleged wrong harms the corporation directly and all of its stockholders indirectly. The fact that such a claim is asserted in the context of a merger does not change its fundamental nature. *In order to state a direct claim with respect to a merger, a stockholder must challenge the validity of the merger itself usually by charging the directors with breaches of fiduciary duty resulting in unfair dealing and/ or unfair price.*[21]

The distinction *Parnes* articulates seems to me to be a judgment that goes as much to the merits of the claim as it does to its nature. If the side transactions are part of an acquirer's total acquisition costs, it seems unlikely that the acquirer cares all that much about how its total costs were allocated. If the target board wishes to increase payments to insiders in order to allocate more of the total acquisition cost to them rather than the public stockholders, the acquirer will mostly likely be indifferent, unless the allocation is proposed so crassly or is so disparate as to raise the specter of meritorious stockholder suits attacking the merger.

[10-11] The analysis of whether such side transactions tainted the fairness of the transaction to the target stockholders becomes in large measure a judgment about whether it was appropriate or not for those side transactions to occur. For example, consider what *Parnes* says about price. As I read that case, it says that if the side transactions were not so costly that they enable the plaintiffs to allege that the consideration offered to the target stockholders was reduced to an unfair level, then a price attack on them must be labeled as derivative and extinguishable by the merger. If the side transactions are alleged to have reduced the consideration offered to the

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[21] *Parnes*, 722 A.2d at 1245 (*quoting Kramer*, 546 A.2d at 350, 351) (emphasis added).

target stockholders to a level that is unfair, then an attack is labeled as individual because it goes directly to the fairness of the merger.

As to process, *Parnes* is somewhat less precise. It is not quite clear whether the door is open for a plaintiff to state an individual claim by alleging that the negotiation of side transactions tainted the merger negotiations by unfairly diverting merger consideration that would have otherwise gone to the target stockholders into the pockets of target company fiduciaries.

For example, make the unlikely assumption that a CEO was told that the acquirer would pay another $10 million for the target company shares and that he reacted by agreeing in general terms but asking that $2 million of that sum be diverted to enhancing golden parachutes for him and his fellow managers. Further assume that the total consideration ultimately offered to the target stockholders was fair but would have been $2 million higher had the CEO not traded for himself and his fellow officers. It is probable that *Parnes* contemplates that the $2 million payment could be attacked individually as unfair dealing that tainted the final merger terms.[22] But it is also possible to read *Parnes* as indicating that a plaintiff must allege that the process violations were so severe as to reduce the merger consideration to an unfair level before the claim will cross the threshold from derivative to individual.[23]

In my view, the price and process test articulated by *Parnes* deepens the merit-based nature of the derivative-individual distinction. Posit as we have a scenario where all the side transactions were entered into in anticipation of the merger and would not have occurred but for the merger. In that scenario, it seems quite strained to characterize any attack on the transactions as stating a claim for waste of the assets of the target corporation because the side transactions are, in reality, part and parcel of the consideration (inclusive of transaction costs) paid by the acquiror.[24] Cutting

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[22]*Parnes*, 722 A.2d at 1245 (indicating that a plaintiff "may challenge the validity of the merger itself, usually by charging the directors with breaches of fiduciary duty resulting in unfair dealing") (*citing Kramer*, 546 A.2d at 354). *Chaffin v. GNI Group, Inc.*, Del. Ch., C.A. No. 16211-NC, mem. op. at 19-20, 1999 Del. Ch., LEXIS, at *24-25, Jacobs, V.C. (Sept. 3, 1999) can be read as supporting this interpretation. Although in that case the price was alleged to be unfairly low, the primary thrust of the court's holding that the claims were individual seemed to turn on allegations that insiders diverted substantial benefits to themselves through unfair dealing and thereby improperly reduced the merger consideration.

[23]*Parnes*, 722 A.2d at 1245.

[24]That is, it is quite difficult to say that such side transactions have no business purpose and that there was no consideration given for them. If insiders have demanded them in exchange for their support of the merger and the costs are being borne in reality by the acquirer, the notion that the payments are waste turns on a normative judgment as to whether it was proper for the insiders to demand the payments in exchange for their support of the deal. If it was improper for them to do so, it seems likely that costs of acquisition that could have been obtained by properly behaving

through doctrine and looking at the economic realities, is not the real question underlying the teaching of *Parnes* whether the complaint states a claim that the side transactions caused legally compensable harm to the target's stockholders by improperly diverting consideration from them to their fiduciaries? If the side transactions did not cause such harm, is it not likely that no legally compensable harm was caused to anyone and that the side transactions were simply a proper part of the total acquisition costs of the acquirer?

[12] Viewed in this practical manner, the derivative-individual distinction as articulated in *Parnes* is revealed as primarily a way of judging whether a plaintiff has stated a claim on the merits. In this sense, the distinction seems to be a quite sensible basis for determining which, if any claims, ought to survive a merger. That is, *Parnes* can be straightforwardly read as stating the following basic proposition: a target company stockholder cannot state a claim for breach of fiduciary duty in the merger context unless he adequately pleads that the merger terms were tainted by unfair dealing.[25] If the plaintiff cannot meet that pleading standard, then he has simply not stated a claim under Rule 12(b)(6). This merits focus of *Parnes* is, in my view, a more candid approach that places primary emphasis on whether compensable injury to the target stockholders is alleged rather than on whether the target stockholder's complaint has articulated only a waste or mismanagement claim for which there is likely no proper plaintiff on earth.[26]

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fiduciaries for the stockholders ended up in the fiduciaries' own pockets. The same seems to be the case if the target board decides to pay its advisors overly healthy fees and demands that the acquirer foot the bill for those fees, rather than raise the merger consideration to a higher, attainable level. In either case, any legally compensable harm would seem to be to the target stockholders rather than to the acquirer who did a deal with its eyes wide open.

[25] *Cf. Bershad v. Hartz*, mem. op. at 8, 1987 Del. Ch. LEXIS 380 at *9 ("It is true that a claim for fiduciary duty can, in the merger context, give rise to a class claim. For it to do so, however, the alleged breach must go directly to the fairness of the merger, and plaintiff must be directly attacking the merger."); *Lewis v. Anderson*, 477 A.2d at 1046 n.10 ("The two recognized exceptions to the [continuous ownership] rule are: (1) where the merger itself is the subject of a claim of fraud; and (2) where the merger is in reality a reorganization which does not affect plaintiffs ownership of the business enterprise.").

[26] *Cf. Gaylord*, mem. op at 26, 1999 Del. Ch. LEXIS 175, at *35 ("Where the plaintiffs lose stockholder status against their will, they could still be required to prove that the transaction eventually consummated, taken in its entirety and not as to component parts or as to the steps (including defensive measures) leading to it, was unfair. This might be a more direct, and less erratic, method to achieve the desirable and necessary end of denying unfair windfalls. The confluence of *Parnes* and *Kramer* will in reality indirectly create such a 'bitter with the sweet' method, but in the non-merits context of an evaluation of whether the plaintiffs complaint challenges the overall fairness of the deal and therefore states an individual claim. An appropriate application of ordinary business judgment rule and entire fairness principles should be adequate to eliminate such windfalls, which in the post-squeeze out transaction context do not involve stockholders who purchased their shares to buy into litigable claims.") (footnote omitted).