With these thoughts in mind, I will analyze the complaint to determine whether it states an individual claim, and, thereafter, whether the claim as it is pled even states a claim upon which relief can be granted. I turn to these tasks now.

III.

Distilled to its essence, the complaint alleges that KKR received additional merger consideration of $20 million that should have been shared with Duracell's other stockholders. If the $20 million had been shared in this fashion, Duracell shareholders would have received .906179, rather than .904, of a Gillette share, for each of their Duracell shares. Put in monetary terms, the non-KKR stockholders of Duracell would have received approximately $13.2 million dollars more in the merger, or 16 cents a share in addition to the $68.365 dollars a share the Exchange Ratio implied. This equals 2/10 of 1% of the total merger consideration received by the non-KKR stockholders of Duracell.

At the outset, therefore, let me express my doubt that the $20 million fee wagged the $8.3 billion merger dog. The $20 million seems quite immaterial in the scheme of things. The allegations of the complaint do little to persuade me otherwise.

Although the complaint indicates that KKR was trading only for itself in the early negotiations with Gillette and did not discuss these negotiations with Duracell's board or management, the complaint fails to allege any harm flowing from those actions. Indeed, the complaint indicates that those negotiations were terminated because Gillette and KKR were too far apart on the deal's economics for continued discussions to be useful.

The complaint alleges that during the summer of 1996 KKR was again approached by Gillette. It appears that Gillette was closer to the mark this time, because KKR promptly informed the Duracell management about Gillette's overture. The complaint does not indicate one way or the other whether KKR was empowered by the Duracell board to negotiate with Gillette on behalf of Duracell itself.[27] The complaint also does not indicate whether Duracell retained Morgan Stanley at that time or whether the company retained KKR to provide advisory services. The complaint is simply devoid of information on these scores.

Indeed, the complaint fails to allege any defect in the bargaining conducted by Kravis and Stuart on Duracell's behalf. The negotiations resulted in an Exchange Ratio on August 29, 1999 that provided KKR's

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[27]*But see* Pls. Br. at 10 "([A]s plaintiff alleges, both Kravis and Stuart were solely responsible for negotiating the merger with Gillette").

affiliate KKR Associates and the other Duracell stockholders with the identical consideration. The complaint does not allege that advisory or investment banking fees were a subject of the negotiations during this period.[28] The complaint fails to mention whether the Duracell board met at all during the course of these negotiations to discuss how they were going.

The complaint is also silent about what happened between August 29, 1999 and September 12, 1999, the day on which the Duracell and Gillette boards approved the merger agreement and the Morgan Stanley/KKR fees. As to that day itself, the complaint indicates that one of Gillette's eleven directors, Warren Buffett, objected to the fees as excessive and did not want to pay them because Gillette itself would bear the freight for them.

But the complaint provides precious little information about the Duracell board's deliberations that day regarding the fees to KKR or the board's rationale for approving those fees. The complaint does assert that Morgan Stanley's fees were paid "pursuant to a valid and enforceable retainer agreement," while KKR was paid a fee even though it "at all times was acting for its own account" and that "Messrs. Kravis and Stuart were [otherwise] amply compensated by Duracell for carrying out their responsibilities to the Company and its shareholders."[29] Facts supporting the allegation that KKR was "at all times acting for its own account" are not pled. Nor does the complaint set forth facts indicating that Kravis and Stuart received director fees from Duracell that would constitute consideration equivalent to what Kravis and Stuart would receive to negotiate a merger on behalf of a paying client. Although outside directors' pay has increased over the years, I doubt that it approaches what a client must pay experienced and skillful investment bankers to negotiate the price terms of a significant merger transaction.

These allegations do not, in my view, meet the *Parnes* test. The mere fact that Gillette considered the fees as part of its total acquisition costs does not distinguish this case from *Kramer* or from any other case in which side transactions in connection with a merger are in reality a part of the total acquisition costs of the acquirer. Absent are well-pleaded factual allegations that support the proposition that KKR's negotiation of a $20 million fee from Duracell tainted the merger's final terms in a way that injured Duracell's other stockholders.[30] There is simply no link between the

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[28]Golaine's brief states that the complaint does not say that the fees were not discussed during this period. Pls. Br. at 10 n.5. This unusual argument misconceives Rule 12(b)(6), which enables Golaine to survive a dismissal motion on the basis of well-pleaded facts contained in the complaint itself, not on factual possibilities not precluded by what is in fact pled in the complaint.

[29]Compl. ¶¶ 18, 13.

[30]*Turner*, mem. op. at 29, 1999 Del. Ch. LEXIS 18, at *39 (Under *Parnes* and *Kramer*, "challenges to alleged wrongs that are *associated* with the merger but do not involve a challenge to

conclusory allegation that KKR was trading solely for itself and KKR Associates during the summer negotiations *and* the term of the merger agreement most important to the Duracell stockholders — the Exchange Ratio.

Put differently, there is nothing in the complaint that supports the notion that KKR took anything off the table that would have otherwise gone to all the Duracell stockholders; indeed, by its silence on the matter, the complaint suggests that the Exchange Ratio was fixed before the KKR fee was set.[31] In fact, it is not at all clear from the complaint whether the KKR fee was even negotiated *with Gillette* before it was fixed by Duracell at $20 million.

[13] In a merger negotiation, there are countless issues to be figured out. 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.

This syllogism is nearly identical to the principal argument advanced by the plaintiff in *Kramer*:

> [Kramer's] principal contention for sustaining an individual, as distinguished from a derivative, claim is that the effect of the defendants' act of waste was to reduce the common shareholders' net distributive share of an otherwise adequate tender offer price paid by Danaher for taking Western Pacific private.[32]

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the validity of the merger itself, are derivative claims.") (emphasis in original) (citation omitted).

[31]*See, e.g.*, *In re First Interstate Bancorp Consolidated Shareholders Litig.*, Del. Ch., 729 A.2d 851, 861-64 (1998) (rejecting conclusory allegations that side transactions affected the terms of a merger agreement and granting motion to dismiss for failure to state an individual claim).

[32]*Kramer*, 546 A.2d at 350 n.2.

The Court emphatically rejected this argument, which was premised in part on the payment of eighteen million dollars of allegedly excessive or unnecessary merger fees and expenses.[33]

[14] Under *Parnes* and *Kramer*, 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.[34] The complaint here is devoid of any such allegations.

Under the facts pled in the complaint, the only party that seems to have been adversely affected by the deal in real terms is Gillette. Under our case law, the claim is therefore at best a derivative one alleging that Duracell became $20 million less valuable upon the payment to KKR, a claim that no one likely has standing to raise.

IV.

[15] For similar reasons, the complaint also fails to state a claim upon which relief can be granted. 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."[35]

Here, KKR, through its affiliate KKR Associates, controlled only four members of the Duracell board of directors. Golaine has failed to plead facts suggesting that the other seven members of the Duracell board had an interest in the $20 million payment to KKR. Nor has Golaine pled facts suggesting that these Duracell board members acted under the control or

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[33]*See Kramer*, 546 A.2d at 351 (rejecting a similar syllogism). In fairness, it must be noted that the fees in *Kramer* were associated with an earlier merger agreement that was a key step on the way to the final merger agreement, which was signed a mere three weeks later. *Kramer*, 546 A.2d at 352 n.4. In any event, the key issue is that in neither that case nor this one did the plaintiff claim that the "excessive fees" rendered the merger unfair.

[34]*See In re First Interstate Bancorp*, 729 A.2d at 865 ("Delaware law is well-settled that claims arising from transactions involving corporate assets that allegedly operate to reduce the consideration received by stockholders in a merger are, in the absence of [special] circumstances... derivative in nature."); *Turner*, mem. op. at 30, 1999 Del. Ch. LEXIS 18, at *41 (rejecting, per *Parnes*, the argument that in a merger context whenever "a significant stockholder enters into a related transaction with the corporation for no or inadequate consideration that involves that stockholder receiving value that is not shared with the remaining shareholders, the resulting 'cash value dilution' may be challenged in an individual claim"); *Bershad v. Hartz*, mem. op. at 8-9, 1987 Del. Ch. LEXIS 380, at *6-7 (where plaintiff did not attack merger terms as unfair, court rejected as derivative a claim that golden parachutes issued in advance of merger reduced the value of the merger consideration that the stockholders received).

[35]*Aronson v. Lewis*, Del. Supr., 473 A.2d 805, 812 (1984).

improper influence of KKR. Finally, Golaine has not alleged that the Duracell board majority was mis- or uninformed when it decided to pay KKR these fees.

All Golaine has alleged is that the Duracell board had a duty to treat the $20 million it paid to KKR as potential merger consideration available to enhance the Exchange Ratio. There are no facts pled that suggest that this was in fact the case. And though Golaine contends in a cursory way that KKR's negotiations with Gillette during the summer of 1996 were not conducted on behalf of all of Duracell's stockholders, that contention is not supported by pled facts.

From the complaint itself, one can draw the inference that KKR, through Kravis and Stuart, conducted the crucial negotiations with Gillette that led to a merger whose Exchange Ratio the plaintiff has not challenged as unfair.[36] That is, KKR obtained favorable merger terms for not only its affiliate KKR Associates, but for all the other Duracell stockholders. As previously noted, nothing in the complaint supports a conclusion that the decision of the Duracell board to pay KKR $20 million in fees for negotiating the transaction tainted the negotiations over the Exchange Ratio in any way.

[16] At best, the complaint raises an inference that a perhaps overly generous Duracell board majority too richly rewarded KKR for a job well done. Because this decision was made by a disinterested and independent board majority,[37] it can only be challenged on the grounds that it constituted corporate waste. In view of KKR's successful negotiation of an $8.3 billion dollar transaction in exchange for a fee equaling 2/10 of 1% of that amount, the complaint fails to plead facts demonstrating that no person of ordinary business judgment could have considered the $20 million fee a fair exchange for Duracell.[38] And even if the complaint states a waste claim, such a claim is clearly derivative in nature and Golaine has no standing to raise it.[39]

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[36]*See also* Pk. Br. at 10 (Kravis and Stuart were "solely responsible for negotiating the merger with Gillette").

[37]And perhaps by a disinterested majority of Duracell stockholders.

[38]*See, e.g., Lewis v. Vogelstein*, Del. Ch., C.A. No. 14954, 699 A.2d 327, 336 (1997) ("a waste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade"); *Saxe v. Brady*, Del. Ch., 184 A.2d 602, 610 (1962) (where waste of corporate assets is alleged, notwithstanding independent stockholder ratification, the court's examination "is limited solely to discovering whether what the corporation has received is so inadequate in value that no person of ordinary, sound business judgment would deem it worth what the corporation has paid"); *see also Gottlieb v. Heyden Chemical Corp.*, Del. Supr., 91 A.2d 57, 58 (1952) (same).

[39]Golaine has also sued Gillette for aiding and abetting. My disposition of Golaine's claims against the Duracell directors is sufficient to dispose of that claim. Moreover, the complaint fails to allege facts from which one can infer that Gillette knowingly participated in any breach of duty by the Duracell directors. *In re Santa Fe Pacific Shareholder Litig.*, Del. Supr., 669 A.2d 59, 72

V.

For the foregoing reasons, the defendants' motion to dismiss is GRANTED. IT IS SO ORDERED.

GREENWALD v. BATTERSON

No. 16,475

Court of Chancery of the State of Delaware, New Castle

July 26, 1999

Plaintiff, an alleged stockholder, filed this action derivatively. This action arose out of the decision of the board of directors to approve a financing transaction intended to infuse the company with needed capital. The plaintiff contended that the board chose a financing transaction for entrenchment purposes and in violation of its fiduciary duties to the corporation and its stockholders. The plaintiff also contended that the financial transaction resulted in the substantial dilution of the corporation's stock and a sharp decline in its market value. Pending are the defendant's motions to dismiss pursuant to Chancery Court Rules 23.1 and 12(b)(6).

The court of chancery, per Vice-Chancellor Lamb, granted the defendant's motion made pursuant to Rule 23.1, finding that it is unnecessary to reach the Rule 12(b)(6) motion and thereby denying it without prejudice.

(1995); *see also Nebenzahl v. Miller*, Del. Ch., C.A. No. 13206, mem. op at 17-18, 1996 Del. Ch. LEXIS 113, at *20, Steele, V.C. (August 26, 1996) (aiding and abetting liability requires that fiduciary breach its duties in an "inherently wrongful manner" and that the fiduciary knowingly participate in such breach); *Carlton Invs. v. TLC Beatrice Int'l Holdings, Inc.*, Del. Ch., C.A. No. 13950, mem. op at 38, 1995 Del. Ch. LEXIS 140, at *49 n.11, Allen, C. (Nov. 21, 1995) (aiding and abetting claim must be supported by proof of an understanding between the parties "with respect to their complicity in any scheme to defraud or in any breach of fiduciary duties").

1. Corporations ⚷ 320(7), 512, 513, 513.1

In considering a motion to dismiss under Rule 12(b)(6) for failure to state a claim, the court is required to assume the truthfulness of all well-pleaded allegations in the complaint. DEL. CH. CT. R. 12(b)(6).

2. Pretrial Procedure ⚷ 679

The plaintiff must be extended the benefit of all reasonable inferences that can be drawn from a complaint when there is a Rule 12(b)(6) motion to dismiss for failure to state a claim. DEL. CH. CT. R. 12(b)(6).

3. Pretrial Procedure ⚷ 679

When a Rule 12(b)(6) motion to dismiss for failure to state a claim is brought, neither inferences nor conclusions of fact unsupported by allegations of specific facts upon which the inferences or conclusions rest are accepted as true. DEL. CH. CT. R. 12(b)(6).

4. Corporations ⚷ 206(5), 320(5)

In considering a motion to dismiss under Rule 23.1, for failure to make pre-suit demand or show why demand is futile, the court is limited to the allegations of the complaint. DEL. CH. CT. R. 23.1.

5. Pretrial Procedure ⚷ 679

In weighing the adequacy of the complaint under Rule 23.1, only well-pleaded allegations of fact may be accepted as true; conclusory allegations of fact or law not supported by allegations of specific fact may not be taken as true. DEL. CH. CT. R. 23.1.

6. Pretrial Procedure ⚷ 679

In considering a motion to dismiss under Rule 23.1, a trial court need not blindly accept as true all allegations nor must it draw all inferences from them in plaintiff's favor unless they are reasonable inferences. DEL. CH. CT. R. 23.1.

7. Pretrial Procedure ⟹ 679

The pleading requirements of Rule 23.1 are an exception to the general notice pleading standard, and a derivative plaintiff's pleading burden under this rule is more onerous than that required to withstand a Rule 12(b)(6) motion to dismiss. DEL. CH. CT. R. 12(b)(6), 23.1.

8. Pretrial Procedure ⟹ 679

Rule 23.1 requires that in a derivative action brought by shareholders on behalf of a corporation, the complaint shall allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort. DEL. CH. CT. R. 23.1.

9. Corporations ⟹ 206(2), 519(1)

Demand under Rule 23.1 is an objective burden which must be met in order for the shareholder to have capacity to sue on behalf of the corporation. DEL. CH. CT. R. 23.1.

10. Corporations ⟹ 206(2), 499

The right to bring a derivative action does not come into existence until the plaintiff shareholder has made a demand on the corporation to institute such an action or until the shareholder has demonstrated that demand would be futile.

11. Corporations ⟹ 206(4), 211(5), 519(1)

A plaintiff who has not made a pre-suit demand bears the burden of alleging with particularity why demand should be excused as futile.

12. Corporations ⟹ 206(4), 307, 310(1), 320(7), 519(1)

Plaintiff's burden is met where the stockholder-plaintiff pleads facts sufficient to demonstrate that: (1) a majority of the board of directors is interested in or lacks independence as to the challenged transaction, or (2) there exists reasonable doubt that the challenged transaction was a valid exercise of business judgment (the *Aronson* test).

13. Corporations ⚿ 307, 310(1), 320(7), 512, 513, 513.1

A plaintiff-shareholder may successfully plead pre-suit demand futility by alleging that the sole or primary purpose of the challenged board action was to perpetuate the directors in control of the corporation.

14. Corporations ⚿ 211(5), 307, 310(1), 320(5), 320(7), 512, 513, 513.1

The mere allegation that directors have taken action to entrench themselves, without an allegation that the directors believed themselves vulnerable to removal from office, will not excuse demand.

15. Corporations ⚿ 211(5), 320(5), 320(7), 512, 513, 513.1

A successful claim of demand futility requires an allegation that an actual threat to the directors' positions on the board existed.

16. Pretrial Procedure ⚿ 679

Evidence of post-transaction contact does not lend support to any inference of an entrenchment motive.

17. Corporations ⚿ 206(4)

A claim that certain terms of a proposal may themselves be seen as posing a threat to the control of the board of directors fails where the terms proposed were merely proposals and not threats, and it was within the control of the directors to accept the terms proposed, to negotiate different terms, or to reject the proposals altogether.

18. Pretrial Procedure ⚿ 679

Where the complaint does not suggest either that the board contemplated a related party veto at the time they approved the financing agreement, or that the board had a history of such transactions, the court cannot infer that the related party veto condition in a proposal was at all consequential to the directors in choosing between the two proposals.

19. Corporations ⟹ 307, 310(1), 512, 513, 513.1
Pretrial Procedure ⟹ 679

The court will not infer from the allegedly disastrous consequences of a financing agreement that the decision to approve that agreement was driven by an entrenchment movement where the complaint contains no factual allegations from which the court could reasonable infer that the individual board members knew of, or should have foreseen these consequences.

20. Corporations ⟹ 182, 206(4), 307, 310
Pretrial Procedure ⟹ 679

For the court to infer that the dilution resulting from the issuance of large numbers of shares of common stock and the related decline in the market value of that stock support an inference that the directors approved the financing agreement solely or primarily to entrench themselves in office, facts must be plead showing that the individual directors knew, or should have foreseen, such a consequence of the financing agreement.

21. Corporations ⟹ 320(7), 512, 513, 513.1
Pretrial Procedure ⟹ 679
Pleading ⟹ 16

A plaintiff is entitled to only the reasonable inferences that can be drawn from the allegations of the complaint.

22. Corporations ⟹ 206(4)

Demand will be excused as futile where the plaintiff shows that there exists reasonable doubt that the challenged transaction was a valid exercise of business judgment.

23. Corporations ⟹ 307, 310(1), 519(1)

The business judgment rule is a presumption that directors making a business decision, not involving self-interest, act on an informed basis, in good faith, and in honest belief that their actions are in the corporation's best interest, and therefore a court will not substitute its judgment for that of the board if the latter's decision can be attributed to any rational business purpose.

24. Corporations ⟹ 206(4), 211.5, 310(1), 519(1)

In light of the business judgment presumption, the court will not assume that the transaction was a wrong to the corporation requiring corrective measures by the board, but the plaintiff is required instead to plead particularized facts creating a reasonable doubt as to the soundness of the challenged transaction sufficient to rebut the presumption that the business judgment rule attaches to the transaction.

25. Corporations ⟹ 206(4), 519(1)

Plaintiff faces a substantial burden, as the second prong of the *Aronson* test is directed to extreme cases in which, despite the appearance of independence and disinterest, a decision is so extreme or curious as to itself raise a legitimate ground to justify further inquiry and judicial review.

26. Corporations ⟹ 206(4), 307, 310(1), 512, 513, 513.1

To plead a claim of entrenchment, a plaintiff must allege facts sufficient to demonstrate that the sole or primary purpose of the challenged board of action was to perpetuate the directors in control of the corporation.

27. Corporations ⟹ 206(4), 307, 310(1), 519(1)

Neither an after the fact evaluation of a financing agreement nor the allegation that a financing agreement had adverse effects on the company's stock act to rebut the presumption of the business judgment rule.

28. Corporations ⟹ 206(4), 307, 310(1)

It is the essence of the business judgment rule that a court will not apply 20/20 hindsight to second guess a board's decision, except in rare cases where a transaction may be so egregious on its face that board approval cannot meet the test of business judgment.

Pamela S. Tikellis, Esquire, James C. Strum, Esquire, and Robert J. Kriner, Jr., Esquire, of Chimicles & Tikellis LLP, Wilmington, Delaware; and David A.P Brower, Esquire, of Wolf, Haldenstein, Adler, Freeman & Herz, LLP, New York, New York, of counsel, for plaintiff.

R. Franklin Balotti, Esquire, Anne C. Foster, Esquire, and Thad J. Bracegirdle, Esquire, of Richards, Layton & Finger, Wilmington, Delaware;

and David L. Weinstein, Esquire, of Wildman, Harrod, Allen & Dixon, Chicago, Illinois, of counsel, for individual defendants.

Richard L. Horwitz, Esquire, and Matthew E. Fischer, Esquire, of Potter, Anderson & Corroon LLP, Wilmington, Delaware, for nominal defendant.

LAMB, *Chancellor*

I. INTRODUCTION

This action arises out of the decision of the board of directors of Illinois Superconductor Corporation ("ISCO") to approve a financing transaction intended to infuse the company with needed capital. Plaintiff Jonathan Greenwald, an alleged stockholder of the company, filed this action derivatively on behalf of ISCO, contending that the board, for entrenchment purposes and in violation of its fiduciary duties to the corporation and its stockholders, chose a financing transaction which resulted in the substantial dilution of ISCO's stock and a sharp decline in its market value. Pending are defendants' motions to dismiss pursuant to Chancery Court Rules 23.1 and 12(b)(6). For the following reasons, I will grant the motion made pursuant to Rule 23.1. Because I find it unnecessary to reach the Rule 12(b)(6) motion, it is denied without prejudice.

A. Factual History[1]

1. The Defendants

Nominal defendant ISCO is a Delaware corporation with its principal offices in Mount Prospect, Illinois. ISCO is primarily engaged in the development and sale of filters used in cellular telephone base stations. ISCO is a publicly traded company whose stock is traded on NASDAQ. The individual defendants are eight current or former members of ISCO's board of directors: Leonard A. Batterson ("Batterson"), Michael J. Friduss ("Friduss"), Peter S. Fuss ("Fuss"), Edward W. Laves ("Laves"), Steven Lazarus ("Lazarus"), Tom L. Powers ("Powers"), Ora E. Smith ("Smith") and Paul G. Yovovich ("Yovovich").

Batterson, Friduss and Yovovich are former outside directors of the ISCO board, Batterson serving from February 1990 until his resignation in

[1]The facts recited, *infra*, are those as presented by the complaint. For the purposes of this decision only, the well-pleaded facts of the complaint and any reasonable inferences to be drawn therefrom to support plaintiff's claims will be taken as true. *In re Tri-Star Pictures, Inc., Litig.*, Del. Supr., 634 A.2d 319, 326 (1993).

July 1997, Friduss serving from October 1996 until his resignation in July 1997, and Yovovich serving from October 1993 until his resignation in June 1997. All were directors at the time the board approved the financing challenged in the complaint. Friduss and Yovovich each own approximately 1000 shares of ISCO common stock.

Fuss, Powers and Lazarus have been outside directors of ISCO since June 1995, October 1996, and January 1992, respectively. Lazurus served as Chairman of the Board from August 1993 until July 1997. Powers owns 2,400 shares of ISCO common stock.

Smith has been a director of ISCO since October 1990, and served as President and Chief Executive Officer ("CEO") from October 1990 until July 1997. Since July 1997, Smith has served as Chairman of the Board. On July 1, 1997, Smith and ISCO entered into an Amended and Restated Employment Agreement, pursuant to which Smith is paid no less than $203,960 annually and which allows additional bonuses at the board's discretion. Smith also owns 69,000 shares of ISCO common stock.

Laves has been President, CEO and a director of ISCO since July 8, 1997. Laves was not a member of the board at the time the challenged financing was approved, but was a director at the time the board approved the draw down of additional tranches of funding from the financing.

2. The Search for Financing

ISCO was founded in 1989 by ARCH Development Corporation, an affiliate of the University of Chicago, to commercialize certain superconducting technologies. ISCO has recognized little revenue from sales and, since its inception in 1989, has accumulated operating losses in excess in $30 million. ISCO has traditionally funded its operations primarily through public and private equity financings, which have raised in excess of $40 million.

In early 1997, the ISCO board found itself in need of additional capital and began to solicit and review funding options. In May 1997, proposals were received from Wexford Capital ("Wexford") and Southbrook International Investments, Ltd. ("Southbrook"). The Wexford proposal contemplated the investment of $8 million into ISCO through the purchase of bonds with interest payable at the rate of 8% per year in cash, or additional debt, convertible to ISCO common stock at the price of $12 per share. The proposal also required Wexford's consent to any related party transactions and that Wexford be entitled to elect one member to the ISCO board.

The Southbrook proposal contemplated Southbrook's purchase of up to $15 million of specially issued ISCO preferred stock in tranches. The

preferred stock issued under this proposal was to be convertible into ISCO common stock at a conversion price to be determined by a formula based on closing prices of ISCO common stock over defined periods prior to the date of issuance. Unlike the Wexford proposal, the Southbrook proposal did not involve a condition of board representation or the right to veto related party transactions.

After considering these two proposals, the board selected the Southbrook financing proposal and, in early June 1997, reached an agreement with Southbrook on the terms described above ("Financing Agreement" or "Agreement").

3. The Dissident Stockholder and the Alternative Financing Proposal

It is alleged that, at some unspecified time in "early" 1997, the ISCO board began receiving demands for changes in management and the board's composition from Sheldon Drobny ("Drobny"), a holder of more than 7% of ISCO's common stock. In particular, the complaint alleges that, on June 30, 1997, Drobny demanded the resignation of the company's directors (except Smith), President and CEO, and their replacement by persons selected by Drobny; and that, on July 10, 1997, Drobny asked the board to rescind ISCO's shareholder rights plan. The board rejected these demands.

The complaint also alleges that, on August 4, 1997, some months after approval of the financing at issue here, Dr. Semir Sirazi ("Sirazi")[2] submitted a third financing proposal to the board. Under Sirazi's proposal, ISCO would receive in excess of $8 million in exchange for the issuance of 300,000 "units" of ISCO securities, each unit to consist of three shares of ISCO common stock and one warrant to purchase a share of ISCO common stock at a price of $11 per share. This proposal was contingent on the replacement of ISCO's board of directors and management as demanded by Drobny.

4. The Implementation of the Southbrook Financing Agreement

On June 6, 1997, ISCO drew down the first $3 million tranche of financing from Southbrook and issued to Southbrook 600 shares of convertible preferred stock in exchange therefor. As it was required to do under the terms of the Agreement, ISCO thereafter promptly filed a Registration Statement and Prospectus with the Securities and Exchange Commission covering the shares of ISCO common stock to be issued upon

[2]Dr. Sirazi was Drobny's choice for ISCO's replacement President and CEO.

conversion of this preferred stock. The registration statement was amended on September 22, 1997 to cover additional shares.

On October 30, 1997, another tranche of financing was drawn down, consisting of $1.5 million from existing investors Southbrook, Westgate International L.P. and Brown Simpson Strategic Growth Fund L.P. and $3.5 million from new investor Elliott Associates, L.P. Thereafter, the registration statement was again amended to cover additional shares due to be issued upon conversion. As a result of the conversion of the preferred stock issued pursuant to the Financing Agreement, the total number of shares of ISCO common stock issued and outstanding increased from 5,050,987 in May 1997 to 12,556,773 in May 1998.

5. The Decline in Value of ISCO Common Stock

In May 1997, the ISCO common stock was trading at an average of approximately $12 per share. By November 14, 1997, the per share price had dropped to $5 and by March 31, 1998 to $1.50 per share. As of May 13, 1998, the per share price had increased slightly to $2.75.

6. The Filing of the Complaint

The complaint was filed on June 24, 1998, seeking "redress for the injury caused to the Company by breaches of fiduciary duties by certain current and former ISCO directors." (Pl.'s Opp'n Br. at 1.) More specifically, the complaint contends that the ISCO directors acted to entrench themselves, "select[ing] a particular financing source from several different otherwise equally attractive available sources, solely or primarily to avoid a change in the composition of the Board and a loss of control of the Company." *Id.*

Plaintiff alleges, generally, that in choosing this financing source, the board knew or should have known that the consequences of the conversion of the preferred stock to common stock would be harmful to the Company and its shareholders, in terms of both the significant dilution of the stock and the related decrease in its value. The complaint also alleges that the latter, while related to the increase in the amount of common shares of the company, is also a result of, as the complaint alleges, the fact that "on one or more occasions . . . Southbrook or agents acting on its behalf and at its direction sold short shares of ISCO common stock." (Compl. ¶ 30.) No further particulars of these "short sales" are alleged.

Plaintiff also alleges that the board breached its fiduciary duties in "materially misrepresent[ing] the terms under which the ISCO preferred stock could be converted to common stock," thus giving "the false

impression that the Southbrook Deal would drive up the value of the stock when the exact opposite was the case." (Pl.'s Opp'n Br. at 8.) Plaintiff bases this allegation on a June 10, 1997 press release, which states:

> The preferred stock is convertible into Illinois Superconductor Corporation common stock at current market prices, or under certain circumstances at a premium to prevailing market prices. The conversion price will be adjusted upward if the price of the company's common stock attains certain levels.

The complaint does not allege that this press statement does not accurately state the actual terms of the Financing Agreement.

II. DISCUSSION

Defendants' move to dismiss the complaint pursuant to Chancery Court Rule 12(b)(6), for failure to state a claim and Court of Chancery Rule 23.1, for failure to make pre-suit demand or show why demand is futile.

A. Standard

[1-3] In considering a motion to dismiss under Rule 12(b)(6) for failure to state a claim, the Court is required to assume the truthfulness of all well-pleaded allegations in the complaint. *See Grobow v. Perot*, Del. Supr., 539 A.2d 180, 187 n.6 (1988). Further, the plaintiff must be extended "the benefit of all reasonable inferences" that can be drawn from the complaint. *In re USACafes, L.P. Litig.*, Del. Ch., 600 A.2d 43, 47 (1991). However, "neither inferences nor conclusions of fact unsupported by allegations of specific facts upon which the inferences or conclusions rest are accepted as true." *Grobow*, Del. Supr., 539 A.2d at 187 n.6.

[4-7] In considering a motion to dismiss under Rule 23.1, for failure to make pre-suit demand or show why demand is futile, the Court is also limited to the allegations of the complaint. *See Spiegel v. Buntrock*, Del. Supr., 571 A.2d 767, 774 (1990); *Pogostin v. Rice*, Del. Supr., 480 A.2d 619, 622 (1984). In weighing the adequacy of the complaint under Rule 23.1, "only well-pleaded allegations of fact may be accepted as true; conclusory allegations of fact or law not supported by allegations of specific fact may not be taken as true. A trial court need not blindly accept as true all allegations, nor must it draw all inferences from them in plaintiffs' favor unless they are reasonable inferences." *Grobow*, Del. Supr., 539 A.2d at 187 (footnote omitted). The pleading requirements of Rule 23.1 are "an exception to the general notice pleading standard," and a derivative

plaintiff's pleading burden under this rule is "more onerous than that required to withstand a Rule 12(b)(6) motion to dismiss." *Levine v. Smith*, Del. Supr., 591 A.2d 194, 207-210 (1991).

B. Rule 23.1 Analysis

[8-10] Rule 23.1 requires that in a derivative action brought by shareholders on behalf of a corporation, "[t]he complaint shall . . . allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort." Ch. Ct. R. 23.1. Demand under Rule 23.1 "is an objective burden which must be met in order for the shareholder to have capacity to sue on behalf of the corporation. The right to bring a derivative action does not come into existence until the plaintiff shareholder has made a demand on the corporation to institute such an action or until the shareholder has demonstrated that demand would be futile." *Kaplan v. Peat, Marwick, Mitchell & Co.*, Del. Supr., 540 A.2d 726, 730 (1988).

1. The *Aronson* Demand Futility Test

[11-12] Plaintiff acknowledges that he did not make pre-suit demand on the ISCO board. Thus, he bears the burden of alleging with particularity why demand should be excused as futile. *See Aronson v. Lewis*, Del. Supr., 473 A.2d 805, 815 (1984). This burden is met where the stockholder-plaintiff pleads facts sufficient to demonstrate that: (1) a majority of the board of directors is interested in or lacks independence as to the challenged transaction, or (2) there exists reasonable doubt that the challenged transaction was a valid exercise of business judgment ("the Aronson test"). *Id.* at 814.

2. Prong One of Aronson

Plaintiff does not allege that the individual defendants: (1) had a personal financial interest in the Financing Agreement, (2) are not independent or (3) did not proceed with due care in selecting and approving the Agreement. Rather, in arguing that the first prong of the *Aronson* demand futility test is met, plaintiff relies solely on paper-thin allegations of entrenchment. Specifically, plaintiff argues that the directors chose to enter into the Financing Agreement, rather than pursue the Wexford Proposal, because Southbrook did not demand board representation or the power to veto related party transactions. The plaintiff also suggests, with the full

benefit of hindsight, that the terms of the Financing Agreement created such a clear threat of dilution to the value of the ISCO shares, that the directors must have known and intended the resultant dilution and decrease in market value.

[13-15] A plaintiff-shareholder may successfully plead pre-suit demand futility by alleging that "the 'sole or primary purpose' of the challenged board action was to perpetuate the directors in control of the corporation." *Green v. Phillips*, Del. Ch., C.A. No. 14436, Jacobs, V.C., mem. op. at 9 (June 19, 1996). This standard was first set forth in *Pogostin*, where the Supreme Court of Delaware stated:

> Where . . . allegations detail the manipulation of corporate machinery by directors for the sole or primary purpose of perpetuating themselves in office, the test of *Aronson* is met and demand is excused.

Del. Supr., 480 A.2d at 627. However, the mere allegation that directors have taken action to entrench themselves, without an allegation that the directors believed themselves vulnerable to removal from office, will not excuse demand. *See Grobow*, Del. Ch., 526 A.2d 914, 923 (1987), *aff'd*, Del. Supr., 539 A.2d 180 (1988). A successful claim of demand futility requires an allegation that an actual threat to the directors' positions on the board existed. *See Bodkin v. Mercantile Stores Co., Inc.*, Del. Ch., C.A. No. 13770, Chandler, V.C., mem. op. at 8 (Nov. 1, 1996).

[16] Plaintiff attempts to meet this burden by reference to the demands and proposals of Drobny and Sirazi, who both requested that defendants step down and allow new directors to take their places. Initially, I note that the complaint contains no particularized allegations of fact that any actual threat to the directors' positions existed at the time they considered the two competing financing proposals and entered into the Financing Agreement. The first contact between Drobny or Sizari and the board of directors that is alleged with any particularity occurred *after* the board selected the Southbrook transaction and entered into the Agreement. Evidence of such post-transaction contact does not, of course, lend support to any inference of an entrenchment motive. Moreover, I note that Drobny is alleged to have owned only approximately 7% of the ISCO common stock at the time. That level of share ownership did not give him the power to remove the board, and he is not alleged to have been acting in concert with any other ISCO stockholder.

[17-18] Plaintiff also argues that certain terms of the Wexford proposal (*e.g.* the requirement of board representation and the veto over related party transactions) may themselves be seen as posing a threat to the control of the

board of directors. This argument fails for several reasons. Most obviously, the terms proposed by Wexford were merely proposals, not threats. It lay entirely within the control of the directors to accept the terms proposed by Wexford, to negotiate different terms, or to reject the Wexford proposal altogether. Moreover, the proposed terms on which plaintiff relies hardly posed a threat to the directors' control over the corporation. The board consisted of five persons. Adding a sixth would hardly have affected defendants' control. It is also noteworthy that three of the five directors who approved the Financing Agreement left the board the following month, suggesting a lack of entrenchment motivation. Similarly, I cannot infer on the basis of the well-pleaded facts in this complaint that the related party veto condition in the Wexford proposal was at all consequential to the directors in choosing between the Southbrook and Wexford proposals. There is nothing in the complaint to suggest either that the defendants contemplated such a transaction at the time they approved the Financing Agreement, or that the board had a history of such transactions.[3]

[19-21] Finally, I must reject plaintiff's contention that it is reasonable to infer from the allegedly disastrous consequences of the Financing Agreement that the decision to approve that agreement was driven by an entrenchment motivation. The linchpin of this argument is the allegation that "[t]he structure of the Financing Agreement's conversion formula and the absence of any prohibition against short selling by Southbrook provided Southbrook with the opportunity of risk free profit, while at the same time almost guaranteeing a massive drop in the Company's stock price." (Compl. ¶ 21.) Although it is possible that Southbrook and its associates profited through unspecified short selling activity and that this activity caused a decline in the market value of ISCO, the complaint contains no factual allegations from which I can reasonably infer that the individual defendants knew of, or should have foreseen, such a consequence of the Financing Agreement. Thus, I am unable and unwilling to infer from the well-pleaded facts of the complaint that the dilution resulting from the issuance of large numbers of shares of ISCO common stock and the related decline in the market value of that stock support an inference that the directors approved the Financing Agreement solely or primarily to entrench themselves in

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[3]Plaintiff also argues that the defendants' *de minimus* level of ownership of ISCO common stock, meant that "they had nothing to lose from a personal financial standpoint by agreeing to the Southbrook deal that would inevitably devastate the value of the Company's common stock," and left them free to choose the option that allowed them to entrench themselves in office. (Pl.'s Opp'n Br. at 15.) This argument ignores the fact that 2 of the directors owned 1,000 shares of stock each, a third owned 2,400 shares and Smith, who was President and CEO, owned 69,000 shares. Moreover, there is no legal merit to the novel argument that relatively smaller share ownership permits a stronger inference of entrenchment motivation.

office. It is well settled that a plaintiff is entitled to only the reasonable inferences that can be drawn from the allegations of the complaint. *See Grobow*, Del. Supr., 539 A.2d at 187. However, it is both unreasonable and illogical to draw the inference suggested, based merely on plaintiff's unsupported, conclusory allegations, and I will not do so.

For these reasons, I do not find plaintiff's allegations sufficient to meet the first prong of the *Aronson* test for demand futility.

3. Prong Two of *Aronson*

[22-23] Demand will also be excused as futile where the plaintiff shows that there exists reasonable doubt that the challenged transaction was a valid exercise of business judgment. *See Aronson*, Del. Supr., 473 A.2d 814-15. The business judgment rule is "a presumption that directors making a business decision, not involving self-interest, act on an informed basis, in good faith and in the honest belief that their actions are in the corporation's best interest." *Grobow*, Del. Supr., 539 A.2d at 187. Therefore, "a court will not substitute its judgment for that of the board if the latter's decision can be 'attributed to any rational business purpose.'" *Unocal Corp. v. Mesa Petroleum Co.*, Del. Supr., 493 A.2d 946, 954 (1985) (quoting *Sinclair Oil Corp. v. Levien*, Del. Supr., 280 A.2d 717, 720 (1971)).

[24-25] In light of the business judgment presumption, the Court will not "assume that the transaction was a wrong to the corporation requiring corrective measures by the board." *Pogostin*, Del. Supr., 480 A.2d at 624. Instead, plaintiff is required to "plead particularized facts creating a reasonable doubt as to the 'soundness' of the challenged transaction sufficient to rebut the presumption that the business judgment rule attaches to the transaction." *Levine*, Del. Supr., 591 A.2d at 206. Plaintiff faces a substantial burden, as the second prong of the *Aronson* test is "directed to extreme cases in which despite the appearance of independence and disinterest a decision is so extreme or curious as to itself raise a legitimate ground to justify further inquiry and judicial review." *Kahn v. Tremont Corp.*, Del. Ch., C.A. No. 12339, Allen, C., mem. op. at 16 (Apr. 21, 1994, rev. Apr. 22, 1994).

[26] Plaintiff contends that his substantive allegations of entrenchment are evidence of defendants' breach of their fiduciary duties to the company and its stockholders, and are sufficient to rebut the business judgment rule, thus excusing demand under *Aronson*.[4] *See Packer v. Yampol*, Del. Ch., C.A.

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[4]Plaintiff does not challenge the board's procedural due care, noting that "On the contrary, plaintiff alleges that the board knew precisely what the various financing alternatives entailed . . ." (Pl.'s Opp'n Br. at 19.)

No. 8432, Jacobs, V.C., mem. op. at 37-45 (Apr. 18, 1986). This contention must be rejected, as plaintiff has failed to meet the pleading requirements for a claim of entrenchment. *See Green*, Del. Ch., C.A. No. 14436, mem. op. at 9 (To plead a claim of entrenchment, a plaintiff "must allege facts sufficient to demonstrate that the 'sole or primary purpose' of the challenged board action was to perpetuate the directors in control of the corporation."). [27-28] Further, while the complaint makes the conclusory allegation that the terms of the Financing Agreement were "guaranteed" to create a drop in the price of ISCO common stock, neither an after the fact evaluation of the Agreement nor the allegation that the Financing Agreement had adverse effects on the company's stock act to rebut the presumption of the business judgment rule. *See In re The Walt Disney Co. Derivative Litig.*, Del. Ch., Cons. C.A. No. 15452, mem. op. at 32 (Oct. 7, 1998) ("It is the essence of the business judgment rule that a court will not apply 20/20 hindsight to second guess a board's decision, except 'in rare cases [where] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment.'") (quoting *Aronson*, Del. Supr., 473 A.2d at 815).

As plaintiff has failed to meet either prong of the *Aronson* test, the complaint must be dismissed for failure to make pre-suit demand in accordance with Rule 23.1.

C. Rule 12(b)(6)

Defendant also moves to dismiss the complaint on the basis of Rule 12(b)(6), arguing that plaintiff's entrenchment and disclosure claims fail to state a claim upon which relief can be granted. Because the complaint must be dismissed for failure to satisfy the demand requirements of Rule 23.1, I find it unnecessary to address these issues at this juncture.

III. CONCLUSION

For the reasons stated herein, the complaint will be dismissed for failure to comply with the demand requirements of Rule 23.1. Defendants' motion to dismiss pursuant to Rule 12(b)(6) will be denied without prejudice. Counsel for the defendants are to prepare and submit an appropriate order within 10 days of the date hereof, on notice to the plaintiff's counsel.

HARBOR FINANCE PARTNERS v. HUIZENGA

No. 14,933

Court of Chancery of the State of Delaware, New Castle

November 17, 1999

Plaintiff, a minority shareholder, sought to attack the validity of a merger contending that it was a self-interested transaction effected for the benefit of plaintiff directors who owned a substantial block of shares, that the terms of the transaction were unfair to plaintiff and its public stockholders, and that stockholder approval of the transaction was procured through a materially misleading proxy statement.

Defendants sought to dismiss the complaint because the plaintiff failed to make a demand on the plaintiff board and as such the derivative unfairness claim in the complaint should be dismissed pursuant to Chancery Court Rule 23.1; the complaint failed to state a claim that the merger was unfair to plaintiff or its stockholders; and the complaint failed to state a claim that the proxy statement was materially misleading.

The court of chancery, per Vice-Chancellor Strine, granted defendant's motion to dismiss because the complaint failed to state a claim that the disclosures in connection with the merger were misleading or incomplete. As a result, the business judgment standard of review was envoked and the merger could only be attacked as wasteful. But, because the complaint at best alleged that the merger was unfair and did not plead facts demonstrating that no reasonable person of ordinary business judgment could believe the transaction advisable for plaintiff, the waste doctrine did not aid the plaintiff.

1. Corporations ⟹ 310(1), 320(1), 320(2), 320(6), 320(9)

A pleading, alleging a stockholder in a company proposing a merger is a shareholder in the target company, has significant business relationships with the target company's largest shareholder and is that shareholder's brother-in-law demonstrates the stockholder's inability to objectively consider a demand that the company proposing the merger's board sue the merger's proponents.

2. Corporations ☞ 310(2), 320(1), 320(6)
Waste ☞ 404(1), 404(5), 404(12), 404(13)

Where the affirmative shareholder vote on a merger was informed and uncoerced and disinterested shares constituted the overwhelming proportion of the company proposing the merger's electorate, the business judgment standard of review is envoked and the merger may only be attacked as wasteful.

3. Action ☞ 2
Corporations ☞ 320(1), 320(6)
Waste ☞ 404(1), 404(5), 404(12), 404(13)

A waste claim must be supported by facts demonstrating that no person of ordinary sound business judgment could consider the merger fair to the company proposing it.

4. Action ☞ 2
Corporations ☞ 320(1), 320(4), 320(6)
Waste ☞ 404(1), 404(5), 404(12), 404(13)

A nonunanimous, although overwhelming free and fair, vote of disinterested shareholders does not extinguish a claim of waste.

5. Corporations ☞ 320(1), 320(6), 320(7), 320(9)
Pleading ☞ 16
Waste ☞ 404(1), 404(5), 404(12), 404(13)

Where the complaint at best alleges that the merger was unfair and does not plead facts demonstrating that no reasonable person of ordinary business judgment could believe the transaction advisable for the company proposing the merger, waste does not apply.

6. Corporations ☞ 320(1), 320(2), 320(5), 320(6), 320(9)
Motions ☞ 33
Pleading ☞ 18

Chancery Court Rule 23.1 requires a plaintiff prosecuting a derivative action to allege with particularity the reasons for not making a demand on the board of directors. DEL. CH. CT. R. 23.1.

7. Corporations ⟹ 320(1), 320(6), 320(9)
Motions ⟹ 33
Pleading ⟹ 16

In considering a motion to dismiss under Rule 23.1, the court must accept the well-pleaded allegations of the amended complaint as true. DEL. CH. CT. R. 23.1.

8. Pleading ⟹ 36(1), 36(2)

Conclusory allegations will not be accepted as true.

9. Corporations ⟹ 310(1), 320(1), 320(4), 320(6), 320(9)

To determine whether demand is excused, the court evaluates whether under the particularized facts alleged in the complaint a reasonable doubt is created that either a majority of the directors are disinterested and independent or that the challenged transaction was otherwise the product of a valid exercise of business judgment.

10. Action ⟹ 3
Corporations ⟹ 320(1), 320(6)

Where a party owns 100,000 shares of a target company's stock for which he receives $825,000 in shares of a company proposing a merger with the target company, section 144 is satisfied. DEL. CODE ANN. tit. 8, § 144 (1999).

11. Corporations ⟹ 307, 320(1), 320(6)

The materiality standard articulated in the supreme court's opinions in *Cinerama, Inc. v. Technicolor, Inc.* and *Cede & Co. v. Technicolor, Inc.* (Cede II) is inapplicable when a director's interest implicates section 144. DEL. CODE ANN. tit. 8, § 144 (1999).

12. Corporations ⟹ 307, 320(1), 320(6)
Pleading ⟹ 18

The particularized pleading requirement of Rule 23.1 places special burdens on derivative plaintiffs. DEL. CH. CT. R. 23.1.

13. Corporations ⟹ 310(1), 307, 320(1), 320(6), 320(9)
Pleading ⟹ 18

The court is disinclined to find that a derivative plaintiff has the obligation at the pleading stage to demonstrate that a director's material holdings on the other side of the table from the corporation are not outweighed by his stockholdings in the corporation itself; there is a difference between the burden a plaintiff bears to plead reasonable doubt as to director disinterest under Rule 23.1 and its ultimate burden to demonstrate director interest later in the litigation through admissible evidence. DEL. CH. CT. R. 23.1.

14. Corporations ⟹ 307, 320(1), 320(6)

The holdings of a director of the company proposing the merger in the target company are not dispositive.

15. Corporations ⟹ 310(1), 320(1), 320(2), 320(6)

Other factors justifying demand excusal as to a director of the company proposing the merger were: his over thirty-year business relationship with the chairman of the company proposing the merger, who was the director with the largest share in the target company, who could face the forced return of stock worth nearly $235 million and further damages; and the fact that the director in question and the chairman were brothers-in-law.

16. Corporations ⟹ 310(1), 320(1), 320(6)

Close familial relationships between directors can create a reasonable doubt as to impartiality.

17. Corporations ⟹ 320(1), 320(6), 320(9)
Pleading ⟹ 16

The plaintiff bears no burden to plead facts demonstrating that directors who are closely related have no history of discord or enmity that renders the natural inference of mutual loyalty and affection unreasonable.

18. Corporations ⟹ 310(1), 320(1), 320(6), 320(9)
Pleading ⟹ 7

Placing a relative on a board, investing together, and working together to start a new company sufficiently proves that directors who are closely related have no history of enmity or discord rendering the natural inference of mutual loyalty and affection unreasonable.

19. Corporations ⟹ 310(1), 320(1), 320(2), 320(6), 320(9)
Pleading ⟹ 16

Because plaintiff has pled facts that cause the court to harbor a reasonable doubt about a director's ability to consider a demand impartially and the defendant's admit three other directors cannot impartially evaluate the demand, demand is excused.

20. Motions ⟹ 33

On a 12(b)(6) motion, where the plaintiff relies upon the proxy statement in support of its disclosure claim and that document is necessarily integral to that claim, it is proper for the court to consider that document in evaluating whether the complaint states a disclosure claim.

21. Corporations ⟹ 307, 317(.5), 317(3), 320(1), 320(6), 320(14)
Waste ⟹ 404(1), 404(5), 404(12), 404(13)

Where only the claims of breach of the duty of loyalty and failure to disclose are raised, the court concludes that dismissal of the latter for failure to state a claim requires dismissal of the former because the effect of untainted shareholder approval of a merger is to invoke the protection of the business judgment rule and to insulate the merger from all attacks other than on the ground of waste.

22. Corporations ⟹ 320(1), 320(6), 320(9)
Pleading ⟹ 7
Waste ⟹ 404(1), 404(5), 404(12), 404(13)

The court must consider whether the plaintiff's implicit waste claim is adequately pled; so long as a claimant alleges facts in his description of a series of events from which a gift or waste may reasonably be inferred and

makes a specific claim for the relief he hopes to obtain, he need not announce with any greater particularity the precise legal theory he is using.

23. Corporations ☞ 307, 310(1), 320(1), 320(6), 320(9)
Motions ☞ 33
Pleading ☞ 7

In view of the pleading doubt that the court must afford the plaintiff on a 12(b)(6) motion, the court denied the defendant's motion to dismiss on grounds that the plaintiff failed to allege facts that, if accepted as true, support the inference that the merger was unfair to the company proposing it and its stockholders because the plaintiff pled facts that suggest a majority of the company proposing the merger's board could not disinterestedly or independently evaluate the merger; that the company proposing the merger's special Committee did not function with the independence and competence necessary to command deference; and that the company proposing the merger's board may be unable to prove the financial fairness of the merger.

24. Corporations ☞ 307, 310(1), 320(1), 320(6), 320(9)
Pleading ☞ 16

Where the plaintiff pled facts that suggest that a majority of the company proposing the merger's board could not disinterestedly or independently evaluate the merger; that the company proposing the merger's special committee did not function with the independence and competence necessary to command deference; and that the company proposing the merger may be unable to prove the financial fairness of the merger, the burden of proof may ultimately fall on the defendants to establish that the transaction was entirely fair to the company proposing the merger and its stockholders.

25. Corporations ☞ 307, 310, 320(1), 320(6), 320(9)
Waste ☞ 404(1), 404(5), 404(12), 404(13)

The pleading burden on a plaintiff attacking a corporate transaction as wasteful is necessarily higher than that of a plaintiff challenging a transaction as unfair as a result of the directors' conflicted loyalties or lack of due care.

26. Action ⟹ 2
Corporations ⟹ 307, 310(1), 320(1), 320(6), 320(9)
Pleading ⟹ 16

To plead a claim of waste, the plaintiff must allege facts showing that no person of ordinary sound business judgment could view the benefits received in the transaction as a fair exchange for the consideration paid by the corporation; put another way, if, under the facts pled in the complaint, any reasonable person might conclude that the deal made sense, then the judicial inquiry ends.

27. Corporations ⟹ 320(1), 320(6), 320(9)

The reasonable business judgment of a company considering a merger was developing its own network of new automobile dealerships purchasing a company that was simultaneously developing a network of used car megastores and had already invested $50 million in bringing the idea to market, is not rebutted by the use, in lieu of facts, of newspaper article quotes questioning the value of the target company's used car superstores and indicating that the concept of such superstores has yet to be proved profitable.

28. Pleading ⟹ 36(1), 36(2)

Although Delaware has a notice pleading standard, that standard does not totally relieve a plaintiff of the burden to plead facts, not conclusions.

29. Action ⟹ 2
Waste ⟹ 404(1), 404(5), 404(12), 404(13)

The mere assertion that the transaction implicated section 144 and that the directors did not conduct the negotiations through a well-functioning special committee cannot, in and of itself, be sufficient to support a waste claim. DEL. CODE ANN. tit. 8, § 144 (1999).

30. Pleading ⟹ 16
Waste ⟹ 404(1), 404(5), 404(12), 404(13)

The fundamental basis for a waste claim must rest on the pleading of facts that show that the economics of the transaction were so flawed that no disinterested person of right mind and ordinary business judgment could think the transaction beneficial to the corporation; otherwise, the distinction

between a fairness claim extinguishable by a shareholder vote and a waste claim would be illusory.

31. Corporations ☞ 307, 317, 320(1), 320(6)

The fact that a purchase transaction did not yield hoped for returns does not mean that the assets purchased were valueless at the time of the purchase.

32. Corporations ☞ 307, 320(1), 320(6)

The company proposing the merger had a duty to disclose all material information to its shareholders when it sought shareholder approval of the merger.

33. Corporations ☞ 307, 317(3), 320(1), 320(6)

The materiality standard requires directors to disclose all facts which, under all the circumstances, would have assumed actual significance in the deliberations of a reasonable shareholder.

34. Corporations ☞ 307, 317(3), 320(1), 320(6)

Where it would have been clearer for the proxy statement to have indicated the total amount of financing the company proposing the merger was obligated to provide the target company before the merger closed, but the omission was not material in the overall mix of what was disclosed, the allegation does not support a disclosure claim.

Joseph A. Rosenthal, Esquire, of Rosenthal, Monhait, Gross & Goddess, Wilmington, Delaware; and Jeffrey M. Haber, Esquire, of Weschsler Harwood Halebian & Feffer, New York, New York, of counsel, for plaintiffs.

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STRINE, *Vice-Chancellor*

This matter involves a challenge to the acquisition of AutoNation, Incorporated by Republic Industries, Inc. A shareholder plaintiff contends

that this acquisition (the "Merger") was a self-interested transaction effected for the benefit of Republic directors who owned a substantial block of AutoNation shares, that the terms of the transaction were unfair to Republic and its public stockholders, and that stockholder approval of the transaction was procured through a materially misleading proxy statement (the "Proxy Statement").

The defendant directors of Republic seek to dismiss the complaint because: the plaintiff failed to make a demand on the Republic Board and as such the derivative unfairness claim in the complaint should be dismissed pursuant to Chancery Court Rule 23.1; the complaint fails to state a claim that the Merger was unfair to Republic or its stockholders; and the complaint fails to state a claim that the Proxy Statement was materially misleading.

In this opinion, I resolve these issues as follows:

[1] *The Rule 23.1 motion*: Three of the seven Republic directors are concededly disabled from impartially considering a demand and the issue of demand excusal turns on the status of a fourth director, defendant Harris V. Hudson. Because Hudson was a stockholder in AutoNation, has significant business relationships with AutoNation's largest stockholder, defendant H. Wayne Huizenga, and is Huizenga's brother-in-law, plaintiff has pled facts demonstrating Hudson's inability to objectively consider a demand that the Republic board sue the proponents of the Merger. *See* § II(A), *infra*. Demand is therefore excused and the defendants' motion to dismiss under Chancery Court Rule 23.1 is denied.

[2-5] *The Rule 12(b)(6) motion*: The complaint fails to state a claim that the disclosures in connection with the Merger were misleading or incomplete. *See* § II(B)(5), *infra*. The affirmative stockholder vote on the Merger was informed and uncoerced, and disinterested shares constituted the overwhelming proportion of the Republic electorate. As a result, the business judgment rule standard of review is invoked and the Merger may only be attacked as wasteful. As a matter of logic and sound policy, one might think that a fair vote of disinterested stockholders in support of the transaction would dispose of the case altogether because a waste claim must be supported by facts demonstrating that "no person of ordinary sound business judgment" could consider the merger fair to Republic[1] and because many disinterested and presumably rational Republic stockholders voted for the Merger. *See* § II(B)(4), *infra*. But under an unbroken line of authority dating from early in this century, a non-unanimous, although overwhelming, free and fair vote of disinterested stockholders does not extinguish a claim for waste.[2] *See* § 11(B)(4), *infra*. The waste vestige does not aid the

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[1]*See, e.g., Saxe v. Brady*, Del. Ch., 184 A.2d 602, 610 (1962).

[2]*See, e.g., Michelson v. Duncan*, Del. Supr., 407 A.2d 211 (1979).

plaintiff here, however, because the complaint at best alleges that the Merger was unfair, *see* § 11(B)(2), *infra*, and does not plead facts demonstrating that no reasonable person of ordinary business judgment could believe the transaction advisable for Republic. *See* § 11(B)(3), *infra*. Thus I grant the defendants' motion to dismiss under Chancery Court Rule 12(b)(6).

I. Factual Background

The following facts are for the most part drawn exclusively from the amended complaint.[3] Some are also drawn from the Proxy Statement, which was expressly referenced and quoted in the complaint.

A. The Defendants

Nominal defendant Republic operates several business lines, including a solid waste disposal, collection, and recycling business. In 1996, Republic expanded into the automobile rental and retailing business.

The other defendants are all members of the board of directors of Republic (the "Board"). Four of the directors were AutoNation stockholders before the Merger. Three were not.

1. The AutoNation Stockholder Directors

Defendant Wayne Huizenga has been the Chairman and Chief Executive Officer of Republic since August 1995, when he made a major equity investment in the company. He owns 15% of the outstanding common stock of Republic.

Huizenga has had a diverse and successful business career. Huizenga co-founded Waste Management, Inc. in 1971 and served that company in various capacities, including as President and director, until 1984. Huizenga served as Chairman of the Board and CEO of Blockbuster Entertainment Corporation from 1987 until 1994, when that company was sold to Viacom Inc. Huizenga now also owns or controls the Miami Dolphins, the Florida Marlins, the Florida Panthers, and the Pro Player Stadium in Southern Florida. He is Chairman of the Board of Florida Panthers Holding, Inc. ("PUCK") and Extended Stay America, Inc. ("Extended Stay"). In 1996, Huizenga also became the second largest stockholder in Century Business Services, Inc. ("Century").

Before the Merger, Huizenga was AutoNation's largest stockholder. In the Merger he received 6,397,757 Republic shares in exchange for his

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[3]Hereinafter referred to solely as the complaint.

29,375,000 AutoNation shares. On the Merger date of January 16, 1997, the Republic shares Huizenga received were worth over $235 million.

Defendant Harris Hudson is a director of Republic and owned 10.1% of the company's shares before the Merger. From August 1995 until October 1996, Hudson served as Republic's President. His involvement in Republic commenced simultaneously with that of Huizenga. Hudson owned 100,000 shares of AutoNation stock before the Merger and received 21,779 Republic shares in that transaction. On the Merger date, the Republic shares Hudson received were worth $825,000. Hudson is Huizenga's brother-in-law. For eighteen years, Hudson served as a Vice President of Waste Management of Florida, Inc., which was Waste Management's predecessor and later one of its subsidiaries. Hudson also serves as a director of PUCK.

Defendant George A. Johnson has served as a director of Republic since November 1995. In the Merger, Johnson received 544,490 shares of Republic shares for his 2.5 million AutoNation shares. On the Merger date, the Republic shares Johnson received were worth over $20 million. Johnson is Chairman, CEO, and director of Extended Stay. From 1993 until 1995, when Huizenga sold Blockbuster to Viacom, Johnson was a director of Blockbuster and a president of one of Blockbuster's divisions.

Defendant John J. Melk became a director of Republic at the time Huizenga joined the Board. In the Merger, Melk received 179,681 Republic shares for his 825,000 shares of AutoNation stock. On the Merger date, the Republic shares Melk received were worth over $6.6 million. Melk held various management positions at Waste Management while Huizenga controlled that company. Before Huizenga sold Blockbuster, Melk was a member of that company's board. As of December 1996, he was a director of Extended Stay.

2. The Republic Directors Who Did Not Own AutoNation Shares

Defendant Michael G. DeGroote is a director and the largest single stockholder in Republic, owning 15.1% of Republic's shares before the Merger. Before August 1995, DeGroote was Republic's CEO. DeGroote is CEO of Century and its largest stockholder. DeGroote has served as a director of Gulf Canada Resources Ltd. ("Gulf Canada") since May of 1995.

Defendant J.L. Bryan is a director of Republic and President and CEO of Gulf Canada.

Defendant Rick L. Burdick has been a director of Republic since May 1991. Burdick has an equity interest in the law firm of Akin, Gump, Strauss, Hauer & Feld ("Akin Gump"). Akin Gump, through Burdick, performed legal services for Republic in 1996 and 1997 and "received substantial

remuneration therefrom."[4] Burdick has also performed legal work on behalf of DeGroote, and *Institutional Investor* magazine has allegedly referred to him as one of the "key members of Huizenga's entourage" of "a small and loyal group of investors."[5]

3. The Relationships Among Republic's Directors

As the reader has probably gleaned from the numerous companies mentioned above, the Republic directors' business relationships with one another are not confined to their common association with Republic. Rather, the Republic directors have worked together as fellow directors, managerial colleagues, and shareholders in a variety of business enterprises over the years.

The following chart illustrates the companies in which the directors have simultaneously served as managers, directors, contractors, or shareholders. As to Republic itself, I limit inclusion to those instances where the director was a manager or contractor contemporaneously with the Merger.

	Auto Nation	Block-buster	Century	Extended Stay	Gulf Canada	PUCK	Republic (current officer or service provider only)	Waste Manage-ment
Huizenga	✓	✓	✓	✓		✓	✓	✓
Hudson	✓					✓		✓
Johnson	✓	✓		✓				
Melk	✓	✓		✓				✓
DeGroote			✓		✓			
Bryan					✓			
Burdick			✓				✓	

B. The Merger

AutoNation was formed in the second half of 1995. AutoNation's business plan contemplated the development of a chain of used car "megastores" that would operate under the brand name "AutoNation USA."[6]

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[4]Compl. ¶ 15 a.
[5]*Id.* ¶ 15 c.
[6]Compl. ¶ 2.

Several Republic directors helped form AutoNation. Huizenga and members of his family initially held 55% of AutoNation's stock; this was reduced to 37.4% through subsequent transfers. As noted, Directors Johnson, Melk, and Hudson also bought substantial blocks of AutoNation shares.

Before AutoNation opened a single store, it embarked on merger discussions with Republic. In mid-March of 1996, Huizenga told DeGroote that AutoNation had retained Merrill Lynch, Pierce, Fenner & Smith, Incorporated ("Merrill Lynch") and other investment advisors to assist AutoNation in considering an initial public offering. In these discussions, Huizenga said that these advisors had given oral advice that the preliminary valuation of AutoNation for purposes of an IPO was around $1 billion. Yet Merrill Lynch's contemporaneous written valuation of AutoNation allegedly contained base case scenarios valuing AutoNation at no more than $300 million.[7]

On March 29, 1996, Republic held a Board meeting. At that meeting, Huizenga proposed that Republic acquire AutoNation for $250 million worth of Republic shares. The Board agreed to the proposal and Republic issued a press release later that day announcing that it intended to purchase AutoNation on those terms. This amounted to 17,467,248 Republic shares or 0.217796 Republic shares for every AutoNation share (the "Exchange Ratio"), based on the trading price of Republic shares at the close of the market on March 26, 1996.[8]

The Board formed a special committee (the "Special Committee") to consider the acquisition proposal. Bryan, Burdick, and DeGroote were appointed. DeGroote was selected to be the Chairman.

The Special Committee undertook to hire an independent investment advisor to assist it in reviewing the acquisition proposal. Rejecting proposals from other prestigious investment banking firms, the Special Committee retained Merrill Lynch. It did so despite Merrill Lynch's forthright disclosure of its relationship with AutoNation and the fact that Merrill Lynch had already '"built a substantial valuation model of AutoNation's history, operations and financial prospects' on this very issue for 'certain stockholders of AutoNation.'"[9]

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[7]The Proxy Statement indicates that Merrill Lynch's later discounted cash flow analysis produced values for AutoNation's equity of $600 million to $1 billion under a "conservative case" scenario and values of $2 to $2.6 billion under an "aggressive case" scenario. Proxy Statement (hereinafter "P.S.") at 21.

[8]The number of shares and exchange ratio at that time were actually half what is referenced above. Republic's stock split after the May Board approval of the Merger and that accounts for the difference. I use the final Exchange Ratio, which is not economically different, for the sake of clarity and simplicity.

[9]Compl. ¶ 27.

Negotiations between Republic and AutoNation ensued to reach a final merger agreement. These negotiations proceeded without participation by any members of the Special Committee or Merrill Lynch.[10] Richard L. Handley and Gregory K. Fairbanks handled the negotiations for Republic. Handley was Republic's Senior Vice President and General Counsel at the time. Fairbanks was Executive Vice President and Chief Financial Officer of Republic. As such, both Handley and Fairbanks were management subordinates of Republic's CEO, Huizenga, at the time of the negotiations. The negotiations did not produce a change in the Exchange Ratio.[11]

On May 7, 1996, Merrill Lynch delivered a written opinion to the Special Committee indicating that the Exchange Ratio was fair to Republic's stockholders from a financial point of view. The next day the Special Committee approved the Merger and the full Board met thereafter and approved the Merger Agreement. The Merger was contingent on approval by the stockholders of Republic.

In connection with the Merger Agreement, Republic and AutoNation also entered into a loan agreement (the "Loan Agreement"). The Loan Agreement required Republic to provide AutoNation with a line of credit to fund AutoNation's cash flow requirements before consummation of the Merger.

The Board's approval of the Merger Agreement was publicly disclosed the same day. The press release disclosed the Exchange Ratio but did not mention the Loan Agreement.

On December 16, 1996, Republic sent its stockholders the Proxy Statement in connection with the Merger vote. By this time, the implied merger consideration to be provided to AutoNation stockholders had risen to $558 million because of a sharp increase in the value of Republic's stock price.

By December 31, 1996, AutoNation had also drawn down $247.5 million under the Loan Agreement. The Proxy Statement disclosed that

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[10]For fairness' sake, I note that the Proxy Statement describes negotiations that include the direct participation of members of the Special Committee. P.S. at 17. The plaintiff does not allege that this description is false.

[11]According to the Proxy Statement, the negotiations did result in an agreement by several of the largest stockholders of AutoNation, including Huizenga, to hold their Republic shares for at least two years after the Merger. "The Special Committee believed such lock-up agreements to be important as they would preclude the investors in AutoNation, including Mr. Huizenga, from being able to realize any financial gain from the shares of Republic Common Stock received in the Merger until a point in time when the financial performance of AutoNation as a division of Republic would be contributing to the earnings and growth of Republic. Alternatively, if AutoNation were to fail to meet expectations, the shareholders of AutoNation, including Mr. Huizenga, would not be able to profit from the merger transaction before the results of AutoNation were established and presumably reflected in the market price of Republic Common Stock." P.S. at 18.

Republic had advanced $112.9 million to AutoNation as of September 30, 1996 but did not disclose the specific amounts of any subsequent advances.

On January 16, 1997, the Republic shareholders overwhelmingly voted to approve the Merger. Although the complaint does not mention this fact, the Proxy Statement indicates that the Republic directors who owned AutoNation shares controlled no more than 27% of the votes.[12]

According to the plaintiff, the AutoNation concept resulted in a $150 million restructuring charge a year after the Merger. The charge reflected the cost of merging Republic's AutoNation used car business with its new car franchise operations. At the same time, Republic announced that it would no longer report business information regarding its used car business separately from its new car business. For these reasons, the plaintiff contends that "Republic buried its used-car tracks under its new-car business . . . to conceal the ill-conceived nature and poor results of its used-car AutoNation acquisition . . . ."[13]

II. Legal Analysis

The defendants argue that the complaint should be dismissed for two major reasons. First, the defendants contend that Count I of the complaint, which challenges the Merger's fairness to Republic, should be dismissed pursuant to Chancery Court Rule 23.1 because the plaintiff failed to make a demand on the Republic Board. Second, the defendants contend that Counts I and II fail to state a claim upon which relief can be granted.

For the sake of creating a completely reviewable record, I deal with each of these arguments in turn.

A. Defendants' Rule 23.1 Motion: Was Demand On The Republic Board Required?

[6-8] Chancery Court Rule 23.1 requires a plaintiff prosecuting a derivative action to "allege with particularity . . . the reasons . . . for not making" a demand on the board of directors.[14] In considering a motion to dismiss under Rule 23.1, the court must accept the well-pleaded allegations of the amended complaint as true.[15] Conclusory allegations, however, will not be accepted as true.[16]

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[12]P.S. at 41-42.
[13]Compl. ¶ 47.
[14]Ch. Ct. Rule 23.1.
[15]*Grobow v. Perot*, Del. Supr., 539 A.2d 180, 186 (1988).
[16]*Id.* at 187; *see also Rales v. Blasband*, Del. Supr., 634 A.2d 927, 931 (1993).

[9] To determine whether demand is excused, I must apply the familiar test set forth by the Supreme Court in *Aronson v. Lewis*.[17] That test requires an evaluation of whether, under the particularized facts alleged in the complaint, a reasonable doubt is created that either a majority of "the directors are disinterested and independent" or that the "challenged transaction was otherwise the product of a valid exercise of business judgment."[18]

In this case, the plaintiff alleges that demand is excused under the first prong of *Aronson* because a majority of the Board members are directly interested in the Merger and/or beholden to Huizenga. For their part, the defendants concede that defendants Huizenga, Johnson, and Melk held so many AutoNation shares before the Merger as to render them incapable of objectively considering a demand. They argue that the remaining four members of the Republic Board have no disabling characteristics and can independently and impartially determine whether to bring suit to rescind the Merger or recover damages resulting from that transaction. As a result, if the amended complaint gives me reason to doubt the impartiality of any one of the remaining directors, demand is excused.

Plaintiff and defendants do battle mostly over the status of director Hudson. Plaintiff contends that director Hudson's objectivity is in grave doubt because of his familial and business relationships with Huizenga, as well as the fact that Hudson owned AutoNation shares before the Merger.

The defendants contend that Hudson is not so beholden to Huizenga as to make it doubtful that Hudson can impartially consider whether to cause Republic to sue to rescind a merger in which Huizenga received $235 million worth of Republic stock. They note that Delaware courts have often adjudicated business disputes involving fights among family members and that I cannot presume that Hudson has a cordial familial relationship with his brother-in-law. They also argue that irrespective of Hudson's direct interest in the Merger as an owner of AutoNation stock, he can be impartial because he owned a much more substantial block of Republic stock before the Merger that rendered his AutoNation holdings immaterial to him.

[10] For several reasons, I harbor a reasonable doubt about Hudson's ability to impartially consider a demand. First, I would be hesitant to conclude that a director whose interest in a transaction clearly implicates the literal terms of 8 Del. C. § 144 can disinterestedly evaluate whether the corporation should sue to rescind that transaction.[19] Even if there were some *de minimis*

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[17]Del. Supr., 473 A.2d 805 (1984).

[18]*Id.* at 814-15.

[19]*Aronson*, 473 A.2d at 812 & 815 (*citing* 8 Del. C. § 144 (a)(1) and stating that where a majority of directors "appear on both sides of a transaction" . . . "futility of demand has been established by any objective or subjective standard.").

exception to § 144 for insubstantial holdings, such an exception would not seem to apply in Hudson's case.[20] Hudson owned 100,000 shares of AutoNation stock for which he received $825,000 in Republic shares (as of January 16, 1996) in the Merger. This level of investment appears to satisfy § 144.

[11] As a pleading matter, it also seems to meet the materiality standard articulated in the Supreme Court's opinions in *Cinerama, Inc. v. Technicolor, Inc.*[21] and *Cede & Co. v. Technicolor, Inc.* ("*Cede II*")[22] — a standard that is inapplicable when a director's interest implicates § 144.[23] On this motion, it would seem reasonable to infer that a reasonable Republic director would have regarded the fact that Hudson had nearly a million dollars riding on the Merger "'as a significant fact in the evaluation of the proposed transaction.'"[24] And at this pleading stage, it would difficult for me to infer other than that Hudson desired to receive the highest price possible for his AutoNation shares.[25] Likewise, it would be hard to conceive how he could neutrally determine whether Republic should sue him and the other AutoNation stockholder directors to obtain disgorgement of the Republic shares they received in the Merger.

[12] It may well be that economic evidence might ultimately persuade me that it would have been irrational for Hudson to seek unfair economic advantage in the Merger for AutoNation stockholders at the expense of Republic, because any such advantage would cause more than offsetting harm to him, given his 10% ownership interest in AutoNation. I also

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[20]There is analytic force to the argument that § 144 should, like many statutes, be read as incorporating a "materiality" element. Such an element would ensure that a director who, for example, owns one share of stock worth $100 or even $1,000, in another entity with which the corporation of which he is a fiduciary is transacting business is not considered "interested." But where a director's interest which triggers the literal language of § 144 is worth, as Hudson's was, several hundred thousand dollars, any statutory materiality element would be easily satisfied. The incorporation of a materiality element into § 144 as a matter of statutory interpretation should not, however, be confused with the "materiality" test articulated in *Cede II* and *Cinerama* to determine whether directors are "interested" in a transaction to which § 144 does not apply. *Cinerama, Inc. v. Technicolor, Inc.*, Del. Supr. 663 A.2d 1156 (1995); *Cede & Co. v. Technicolor, Inc.*, Del. Supr. 634 A.2d 345 (1994) ("*Cede II*"); *see also HMG/Courtland Properties, Inc. v. Gray*, Del. Ch., C.A. No. 15789, mem. op. at 42-46, 1999 Del. Ch. LEXIS 149, at *54-61, Strine, V.C. (July 12, 1999) (explaining that the *Cede II* and *Cinerama* materiality test applies when § 144 is inapplicable and not when a director is deemed interested by virtue of 8 Del. C. § 144).

[21]663 A.2d at 1168.

[22]634 A.2d at 362-64.

[23]*HMG/Courtland Properties, Inc. v. Gray*, mem. op. at 44-46, 1999 Del. Ch. LEXIS 149, at *59-60.

[24]*Cinerama*, 663 A.2d at 1168 (*quoting Cinerama, Inc. v. Technicolor, Inc.*, Del. Ch., 663 A.2d 1134, 1153 (1994)).

[25]*Chaffin v. GNI Corp.*, Del. Ch., C.A. No. 16211, mem. op. at 13, 1999 Del. Ch. LEXIS 182, at *15, Jacobs, V.C. (Sept. 3, 1999) ("a director who stands to receive a substantial benefit in a transaction he votes to approve, cannot objectively be viewed as disinterested").

recognize that the particularized pleading requirement of Rule 23.1 places special burdens on derivative plaintiffs.

[13] But I would be disinclined to find that a derivative plaintiff has the obligation at the pleading stage to demonstrate that a director's material holdings on the other side of the table from the corporation are not outweighed by his stockholdings in the corporation itself. In *Siegman v. Tri-Star Pictures, Inc.*,[26] Vice Chancellor Jacobs refused to analyze whether the holdings of certain Tri-Star Pictures directors in Coca-Cola were insignificant in view of their allegedly more substantial holdings in Tri-Star. Because the directors' Coca-Cola holdings resulted in their receipt of benefits from the challenged transaction not available to all Tri-Star stockholders, a reasonable doubt was created for demand excusal purposes. In so holding, Vice Chancellor Jacobs distinguished between the burden a plaintiff bears to plead reasonable doubt as to director disinterest under Rule 23.1 and its ultimate burden to demonstrate director interest later in the litigation through admissible evidence.[27]

[14] Siegman's refusal to engage in the weighing analysis advocated by the defendants strikes me as quite sensible.[28] But I need not and do not hinge

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[26]Del. Ch., C.A. No. 9477, mem. op. at 32, 1989 Del. Ch. LEXIS 56, at *37-38, Jacobs, V.C. (May 5, 1989, rev. May 30, 1989).

[27]*Id.* at 32-33.

[28]The type of weighing analysis that defendants commend to me may be relevant in situations where directors address a transaction that has different effects on two classes of the corporation's own stock. In those situations, the directors often own both classes of stock because corporations want to align the directors' interests with those of all the company's stockholders. Our case law has long recognized that necessity requires directorial action in these circumstances and that such ownership interests do not necessarily strip directors of their disinterested status. *Gilbert v. El Paso Co.*, Del. Supr., 575 A.2d 1131, 1147-48 (1990); *Solomon v. Armstrong*, Del. Ch., Cons. C.A. No. 13515, mem. op. at 30-31, 47-48, 1999 Del. Ch. LEXIS 62, at *44, *65, Chandler, C. (Mar. 25, 1999); *Jedwab v. MGM Grand Hotels, Inc.*, Del. Ch., 509 A.2d 584, 595 (1986); *Freedman v. Restaurant Assocs. Indus.*, Del. Ch., C.A. No. 9212, mem. op. at 27-28, 1987 Del. Ch. LEXIS 498, at *28 (Oct. 16, 1987). Such transactions do not implicate 8 Del. C. § 144.

In evaluating whether to accord business judgment rule protection to a decision of the General Motors board in that context, I recently weighed whether the members of the General Motors board owned so much more of one class of GM's stock than the other as to render it improbable that they could evaluate the transaction impartially. *In re General Motors Class H Shareholders Litig.*, Del. Ch., 734 A.2d 611, 617-18 (1999); *see also In re FLS Holdings, Inc. Shareholders Litig.*, Del. Ch., Cons. CA. No. 12623, mem. op. at 8-10, 1993 Del. Ch. LEXIS 57, at *13-15, Allen, C. (Apr. 21, 1993) (conducting a similar weighing analysis). I engaged in the weighing analysis rather than assume that the necessity of decisionmaking in such circumstances renders it proper for the court to blind itself totally to the directors' economic motivations. Such an analysis was beneficial to the stockholders in that case because it recognized that a board's personal economic circumstances might make it impossible for them to act as an impartial broker between classes of the corporation's stockholders in a zero-sum transaction. Use of the weighing analysis in such cases encourages directors to avoid acting unilaterally in situations where their disinterestedness might be reasonably questioned and to employ procedural protections such as class-specific votes or special committees to ensure fairness.

my decision solely on Hudson's AutoNation holdings, because those holdings are only one of several factors justifying demand excusal as to him.
[15] Hudson's relationship with Huizenga is the most important reason I doubt Hudson's ability to consider a demand impartially. Granting demand in this case would be materially adverse to Huizenga's personal interests, because it could result in Republic pressing for him to return stock worth nearly $235 million and to pay damages on top of that amount. Such a decision would have "potentially significant financial consequences," even for a man of Huizenga's wealth.[29]

Hudson's ties to Huizenga are such that it is unreasonable to believe that Hudson could objectively consider the approval of such a suit against Huizenga. Hudson's business relationship with Huizenga extends back over 30 years. He was a management subordinate of Huizenga's at Waste Management during many of those years. He bought into Republic at the same time as Huizenga. He helped Huizenga develop the AutoNation concept and start the company.[30] He serves on the board of PUCK, Huizenga's sports holding company. This long-standing pattern of mutually advantageous business relations makes me doubtful that Hudson could impartially consider a demand that Republic file a lawsuit adverse to Huizenga's interests.
[16-18] That Hudson also happens to be Huizenga's brother-in-law makes me incredulous about Hudson's impartiality. Close familial relationships between directors can create a reasonable doubt as to impartiality.[31] The plaintiff bears no burden to plead facts demonstrating that directors who are closely related have no history of discord or enmity that renders the natural inference of mutual loyalty and affection

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Putting aside the large issue of whether the statute permits such balancing, the extension of that type of weighing analysis to director interests in other corporations that trigger § 144 would have the opposite effect. Such an extension would encourage directors to eschew procedural protections for the public stockholders in the hope that a court will later find that the directors' conflicting interests in other businesses were outweighed by their stockholdings in the company of which they were fiduciaries. Nor would it make sense to engage in such a weighing exercise exclusively in the demand excusal context. That would set up one standard of interestedness for business judgment rule purposes and another for Rule 23.1 purposes. It is difficult to conceive of the utility of such a bifurcated standard. *See Aronson*, 473 A.2d at 812 ("the entire question of demand futility is inextricably bound to issues of business judgment and the standards of that doctrine's applicability").

[29]*Rales*, 634 A.2d at 936.

[30]P.S. at 15.

[31]*Grimes v. Donald*, 673 A.2d 1207, 1216 (1996) (a "material financial or familial interest" can justify demand excusal); *Mizel v. Connelly*, Del. Ch., C.A. No. 16638, mem. op. at 9-11, 1999 Del. Ch. LEXIS 157, at *11-12, Strine, V.C. (July 22, 1999) (grandson could not objectively consider demand adverse to interests of his grandfather); *see also Chaffin v. GNI Group, Inc.*, mem. op. at 14, 1999 Del. Ch. LEXIS 182, at *17-18 (where approval of transaction benefited the son of a director, the father-director was interested for purposes of business judgment rule analysis).

unreasonable.[32] Even were such a burden to exist, the plaintiff has met it here. Why would Huizenga put Hudson on the PUCK board if they were estranged? Why would they have invested in Republic together? Why would they have worked together to start AutoNation?

I acknowledge that a not insubstantial proportion of people have rather cool relationships with their in-laws. That would not seem to be the case with Hudson and Huizenga. Even if it were, many people swallow their actual views of their in-laws for the sake of their spouses (and for the self-interested reason of avoiding marital strife).

[19] Because plaintiff has pled facts that cause me to harbor a reasonable doubt about Hudson's ability to consider a demand impartially and the defendants admit three other directors cannot impartially evaluate the demand, demand is excused.

B. The Defendants' Rule 12(b)(6) Motion

[20] In deciding the defendant's motion to dismiss, I will apply the familiar standard.[33] Because the plaintiff relies upon the Proxy Statement in support of its disclosure claim and that document is necessarily integral to that claim, it is proper for me to consider that document in evaluating whether the complaint states a disclosure claim.[34]

1. The Interrelationship Between The Counts Of The Complaint

The complaint states two counts. Count I alleges that the defendants breached their duty of loyalty by approving the Merger. The Count contends that the defendants approved the Merger to benefit the AutoNation stockholder directors and that the terms of the Merger were unfair to Republic and its public stockholders. Count II alleges that the Proxy Statement failed fairly to disclose all material facts regarding the Merger and, as a result, "Republic's public shareholders were wrongfully induced to approve the . . . Merger . . . ."[35]

[21] In this case, Counts I and II are in an important sense dependent on each other. In § II(B)(5), *infra*, I conclude that Count II fails to state a claim that the Republic stockholders' vote in favor of the Merger was tainted by material misdisclosures. Therefore, Count I must be dismissed as well,[36]

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[32]*Mizel*, mem. op. at 11, 1999 Del. Ch. LEXIS 157, at *13. In this regard, one wonders how a plaintiff could use tools such as 8 Del. C. § 220 or public filings to generate such facts.

[33]*See, e.g., In re Tri-Star Pictures, Inc. Litig.*, Del. Supr., 634 A.2d 319, 326 (1993).

[34]*In re Santa Fe Pacific Corp. Shareholders Litig.*, Del. Supr., 669 A.2d 59, 69-70 (1995).

[35]Compl. ¶ 55.

[36]Although it is defendants' burden to prove that the business judgment rule should attach

because the effect of untainted stockholder approval of the Merger is to invoke the protection of the business judgment rule and to insulate the Merger from all attacks other than on the ground of waste.[37]

[22] Because the parties themselves did not initially address the connection between Counts I and II, they were afforded the opportunity to brief that issue. In its supplemental submissions, the plaintiff conceded that dismissal of Count II would preclude Count I. But even though the complaint does not specifically plead waste, the plaintiff contends that the facts set forth in the complaint adequately support a waste claim. Under the Supreme Court's teaching in *Michelson v. Duncan*, "[s]o long as [a] claimant alleges facts in his description of a series of events from which a gift or waste may reasonably be inferred and makes a specific claim for the relief he hopes to obtain, he need not announce with any greater particularity the precise legal theory he is using."[38] Therefore, I must consider whether the plaintiff's implicit waste claim is adequately pled. If it is not, then the complaint can be dismissed in its entirety because Count II is deficient.[39]

For the sake of thoroughness, I will first address whether the complaint states claims for breach of loyalty and/or waste, independently of any consideration of the stockholder vote on the Merger. I will then explain why Count II does not, in my view, state a disclosure claim.

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as a result of the vote (i.e., that they made adequate, non-coercive, and non-misleading disclosures in connection with the vote), I have reviewed the Proxy Statement and have failed to identify any material omission or misleading disclosure not asserted by the plaintiff. As such, it is proper to accord burden-shifting ratification effect to the vote. *Solomon v. Armstrong*, mem. op. at 59-60, 1999 Del. Ch. LEXIS 62, at *81-82. In and of itself, the fact that a defendant has proven that a Proxy Statement's disclosures are adequate to justify a Rule 12(b)(6) dismissal should ordinarily be sufficient to meet that burden. The substantial difficulty of winning such a motion (the plaintiff is given the benefit of every doubt), the illogic of requiring the court and defendants to identify disclosure deficiencies not complained of by experienced plaintiffs' lawyers, and the interests of judicial economy support that conclusion. *See In re General Motors Class H Stockholders Litig.*, 734 A.2d 611, 616-17 and 621-29 (1999) (according ratification effect to stockholder vote after examining and dismissing multiple challenges to a merger proxy statement).

[37]*Marciano v. Nakash*, Del. Supr., 535 A.2d 400, 405 n.3 (1987) ("approval by fully-informed . . . disinterested stockholders . . . permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction"); *In re General Motors Class H Stockholders Litig.*, 734 A.2d at 616 (citing cases); *Solomon v. Armstrong*, mem. op. at 20-29, 1999 Del. Ch. LEXIS 62, at *28-42 (discussing this burden-shifting effect in detail).

[38]Del. Supr., 407 A.2d at 217.

[39]*In re General Motors Class H Stockholders Litig.*, 611 A.2d at 616; *Solomon v. Armstrong*, mem. op. at 25-26, 1999 Del. Ch. LEXIS 62, at *36.

2. Putting The Stockholder Vote Aside, Does The Complaint State An Unfairness Claim?

[23] The defendants argue that the plaintiff has failed to allege facts that, if accepted as true, support an inference that the Merger was unfair to Republic and its stockholders. In view of the pleading doubt I must afford the plaintiff on a Rule 12(b)(6) motion, I reach a contrary conclusion.

The complaint alleges that, as of the time of the Republic Board's approval of the Merger Agreement, AutoNation was an unproven start-up company with no active operations and huge capital needs. As of that time, the total investment made by AutoNation's stockholders in the company was around $52 million. Yet Republic agreed to give AutoNation's stockholders Republic stock worth five times that amount and ended up pumping another $250 million into AutoNation before the Merger closed.

A majority of the AutoNation Board held material amounts of AutoNation stock and had an interest triggering 8 Del. C. § 144. Although the Merger price and terms were blessed by a putatively independent special committee, the Special Committee included DeGroote and Burdick, whose business relationships with Huizenga allegedly extend beyond Republic itself. Most important, it is alleged that the Special Committee did not participate in negotiations over the Merger, but left that to management insiders subordinate to the company's CEO Huizenga — the leading mover on the other side of the deal.

Not only that, the Special Committee hired an investment bank that had been helping Huizenga determine whether to raise capital for AutoNation through an IPO. The natural inference is that Merrill Lynch did its best in that role, within the wide confines of professional valuation techniques, to justify an impressive value for AutoNation on behalf of its client, Huizenga. Merrill Lynch then turned around and began working for a client, the Special Committee, whose role was to avoid over-paying for AutoNation. Thus Merrill Lynch's professional incentives were the opposite of what they had been just months before.[40] Furthermore, plaintiff alleges that Merrill Lynch's advice to the Special Committee was flawed.

[24] The plaintiff has pled facts that suggest that a majority of the Republic Board could not disinterestedly or independently evaluate the Merger. The plaintiff has also pled facts that suggest that the Republic Special Committee did not function with the independence and competence necessary to

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[40] *Kahn v. Tremont*, Del. Supr., 694 A.2d 422,429 (1997) (the fact that a special committee used advisors who had significant prior dealings with the controlling stockholder with whose ninety percent-owned corporation the committee was supposed to be negotiating "cast serious doubt on the effectiveness of the Special Committee").

command any deference.[41] As such, the burden of proof may ultimately fall on the defendants to establish that the transaction was entirely fair to Republic and its stockholders.

The plaintiff has also pled facts suggesting that the defendants may be unable to prove the financial fairness of the Merger.[42] Their sum total convinces me that Count I states a claim, although some of these "facts" are pled at the very outer margins of adequacy.[43]

3. Putting The Stockholder Vote Aside, Does The Complaint State A Claim Of Waste?

[25-26] The pleading burden on a plaintiff attacking a corporate transaction as wasteful is necessarily higher than that of a plaintiff challenging a transaction as "unfair" as a result of the directors' conflicted loyalties or lack of due care.[44] To plead a claim of waste, the plaintiff must allege facts showing that "'no person of ordinary sound business judgment'" could view the benefits received in the transaction as "'a fair exchange'" for the consideration paid by the corporation.[45] Put another way, if, under the facts pled in the complaint, "any reasonable person might conclude that the deal made sense, then the judicial inquiry ends."[46]

[27] Here, the plaintiff has not pled *facts* that, if true, could support a conclusion that no rational person could regard the Merger as sensible. In

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[41]*Kahn*, 694 A.2d 428 (special committee does not obviate use of entire fairness standard and burden to prove unfairness is only placed on the plaintiff if the special committee is shown to be "independent" and "well functioning").

[42]In this regard, I give no weight to the increase in value of Republic's shares from May 1996 until the Merger consummation. There is no factual allegation that the Exchange Ratio was fixed with the foreknowledge that Republic's share value would thereafter increase. Indeed, it is much more plausible to infer that the increase in Republic's share price reflected the marketplace's favorable reaction to the Merger. The timing of the increases in Republic's stock prices suggest that when Republic made announcements in support of or consistent with a corporate strategy built around the automobile retailing megastore concept, the market reacted with appreciation. On a motion to dismiss, however, I need only note that no inference of unfairness can be drawn from the increase.

[43]*Cf. Solomon v. Pathe Communications Corp.*, Del. Ch., C.A. No. 12563, mem. op. at 12, 1995 Del. Ch. LEXIS 46, at *14, Allen, C. (Apr. 21, 1995) ("Even in a self-interested transaction in order to state a claim a shareholder must allege some facts that tend to show that the transaction was not fair."), *aff'd*, 672 A.2d 35 (1996).

[44]*In re 3Com Corp. Shareholders Litig.*, Del. Ch., C.A. No. 16721, mem. op. at 11, Steele, V.C. (Oct. 25, 1999).

[45]*Michelson v. Duncan*, Del. Supr., 407 A.2d at 224 (*quoting Kaufman v. Schoenberg*, Del. Ch, 91 A.2d 786,791 (1952)); *see also Saxe v. Brady*, Del. Ch., 184 A.2d 602,610 (1962); *Solomon v. Armstrong*, mem. op. at 25-26, 1999 Del. Ch. LEXIS 62, at *36 (*quoting In re The Walt Disney Co. Derivative Litig.*, 731 A.2d at 368-69 (1998)).

[46]*Steiner v. Meyerson*, Del. Ch., C. A No. 13139, mem. op. at 2, 1995 Del. Ch. LEXIS 95, at *3, Allen, C. (Jul. 18, 1995).

determining why that is so, I believe it important to step back and look at the big picture presented by the Merger. By the complaint's own admission, Republic entered the new car retail automobile industry in 1996.[47] Although the complaint does not burden me with what that means, I infer that it means that Republic was developing its own network of new automobile dealerships. At the same time, AutoNation was putting together a network of used car "megastores," and over $50 million had already been invested by its owners in laying the groundwork to bring that concept to market. The proposition that it might make sense for Republic to purchase AutoNation and to develop a network of dealerships that could sell new and used cars seems to me to be one that could well commend itself to a reasonable person of ordinary business judgment.

The complaint does not plead facts to the contrary. In lieu of facts, the plaintiff quotes excerpts from newspaper articles questioning the value AutoNation's proposed network of used car superstores and indicating that the concept of such superstores is one that has yet to be proved profitable. The president of one of AutoNation's competitors, Drivers Mart Worldwide — an executive who himself was "preparing to open used car superstores in the Fall of 1996" and therefore must have thought the concept worthy of exploration — is quoted as having "laughed" when he was asked whether he could fetch $250 million for Drivers Mart.[48] The complaint alleges no facts indicating that Drivers Mart can be validly compared to AutoNation for valuation purposes. The complaint quotes another of AutoNation's competitors who questioned AutoNation's strategy of planning to open a number of superstores at one time.[49] Furthermore, the complaint confidently tells me that "losses in the used-car industry are the norm, rather than the exception."[50]

[28] Although Delaware has a notice pleading standard, that standard does not totally relieve a plaintiff of the burden to plead facts, not conclusions. The complaint does not contain any analysis of AutoNation's actual plans to open the megastores; it simply contains eye-catching snippets of quotes from industry competitors who have obvious motives for downplaying AutoNation's prospects. And its rather amazing statement (in view of the sheer number of such apparently money-losing establishments in this small state alone) that the used-car industry is, on the whole, an unprofitable one is wholly conclusory.

Other than these assertions, the complaint rests largely on: i) the previously discussed facts bearing on the fairness of the negotiations; ii)

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[47]Compl. ¶ 10.
[48]*Id.* at ¶ 22.
[49]*Id.* at ¶ 21.
[50]*Id.* at ¶ 21.

allegations that Merrill Lynch's fairness opinion was flawed; and iii) the fact that over a year after the Merger Republic took a charge against earnings to consolidate its new and used car operations. But even the totality of these pleadings do not give rise to a proper waste claim.

[29-30] The attack on the fairness of the negotiations certainly gives flavor to the plaintiff's claim of waste. But the mere assertion that the transaction implicates 8 Del. C. § 144 and that the directors did not conduct the negotiations through a well-functioning special committee cannot, in and of itself, be sufficient to support a waste claim. Rather, the fundamental basis for a waste claim must rest on the pleading of facts that show that the economics of the transaction were so flawed that no disinterested person of right mind and ordinary business judgment could think the transaction beneficial to the corporation.[51] Otherwise, the distinction between a "fairness" claim extinguishable by a stockholder vote and a "waste" claim would be illusory.[52]

Of course, the complaint's attack on the Merrill Lynch fairness opinion is relevant to whether there is a basis for determining that Republic received so little consideration in the Merger that the Merger might be deemed wasteful. The complaint is detailed in its discussions of the flaws in the Merrill Lynch fairness opinion.[53] But the complaint does not plead facts that show that, if properly conducted, a fairness opinion would have valued AutoNation at such a low level that no rational person would have thought AutoNation worth the Republic stock required to be paid under the Merger Exchange Ratio. Furthermore, the complaint is wholly devoid of any allegations discussing the actual business plans of AutoNation, the number and locations of its proposed megastores, or other pertinent allegations specifically bearing on the value of AutoNation. That is, the complaint does not plead *facts* denigrating AutoNation's value; it simply pleads conclusions. Indeed, the complaint in some respects may be read as saying that there was no way at all to value AutoNation because it was a start-up.

Nor do the complaint's allegations about what happened after the Merger buttress a waste claim. In this regard, it is worth quoting the complaint's allegations in that respect in full:

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[51] *In re 3Com Corp. Shareholders Litig.*, mem. op. at 12-14.

[52] *See Steiner v. Meyerson*, mem. op. at 13-14, 1995 Del. Ch. LEXIS 95, at *16-17 (holding that a complaint stated an unfairness claim but did not state a claim satisfying the more rigorous waste standard).

[53] But, of course, the complaint fails to note that the mid-point of the valuation ranges given by Merrill Lynch well exceed $250 million, the value of the deal when the Exchange Ratio was originally fixed. *See* note 7, *supra*.

> 47. The folly of the Merger was unveiled when AutoNation demonstrated that it could not profit — indeed it could not avoid enormous losses — in its used car business. On January 29, 1998, Republic reported that it had taken a $150 million restructuring charge against earnings to combine its franchised AutoNation dealership for new cars and AutoNation's used-car operations into one automotive retail division. Further, in January 1998, Republic told analysts that it would no longer report business segment information on AutoNation's used car business separately from new car sales. Thus, to conceal the ill-conceived nature and poor results of its used-car AutoNation acquisition, Republic buried its used-car tracks under its new-car business.

At oral argument, the plaintiff cited this paragraph as stating the most compelling facts supporting its waste claim.

What is most striking about this paragraph is what it does not say. It does not say that Republic is no longer operating used car megastores; it says that "Republic told analysts that it would no longer report business segment information on AutoNation's used car business separately from new car sales." Somehow I am supposed to infer from the restructuring charge that the AutoNation concept "could not profit" and that the restructuring was designed to conceal the "ill-conceived nature" of the Merger.

But at bottom, is there any "there there" from which I can infer any such thing? The amended complaint was filed nearly two years after the Merger. The plaintiff has had the opportunity to develop, through many sources, facts to plead. Yet it cannot even straightforwardly plead that the AutoNation operations in fact lost money for Republic after the Merger. Even taking as true the implicit and wholly conclusory assertion that the used car concept was not profitable in its first year and a half and the allegation that Republic took a charge against earnings to consolidate its new and used car operations "into one retail automobile division," the complaint fails to state facts from which one can infer that the Merger was so irrational that no reasonable investor could support it as a fair exchange. It is hardly uncommon for new businesses to not profit in their first few years of operations; the marketplace may, as the current "Internet company" vogue proves, still place a high value on them. Moreover, the fact that Republic decided to consolidate its automobile operations in one division hardly supports the inference that it did so to bury the "poor results of its used-car AutoNation acquisition." Lacking in the complaint is any basis in fact (e.g., an allegation that Republic has abandoned the used car industry altogether because it was unprofitable or that it is not using the megastore locations

identified and open pursuant to AutoNation's business plan) that would support the inflammatory conclusions asserted.[54]

Also of importance is the fact that there is no allegation of facts that would have led a person of ordinary business judgment to conclude that it was certain or even likely that the AutoNation concept would fail *as of the time the Merger was consummated.* Risk and reward are both elements of capitalism, and the former goes with the opportunity for the latter. The fact that a purchase transaction did not yield hoped-for returns does not mean that the assets purchased were valueless at the time of the purchase.

At best, the complaint barely states a claim premised on the bottom-line proposition that the Merger was unfair because Republic paid a rather high price for a risky, start-up company owned by key Republic insiders.[55] The complaint does not plead facts that, if true, would support an inference that no person of sound business judgment would have believed it a good idea for Republic to consummate the Merger.

I am conscious that my decision is not the "safe" one, in the sense that it is almost always possible for a trial judge, given our liberal notice pleading standards, to craft a logical basis for determining that a claim is best resolved after discovery. Taking that option in this case would work an injustice. The plaintiff filed this action in April 1996. Only after threats of dismissal for failure to prosecute did the plaintiff file the amended complaint, some two years later. During the entire course of the litigation, the plaintiff has made little or no effort to prosecute its claims.

Not only that, the plaintiff scrupulously avoided the inclusion in its complaint of factual statements in the Proxy Statement that it has not claimed are false in its disclosure count, and which, if true, undercut both its fairness and waste claims.[56] *The plaintiff has even blinded itself and therefore me to the fact that Republic is now called AutoNation because its automobile retailing operations are its leading business.* Although I cannot rely upon those facts in ruling on this motion, the complaint's exclusion of them is noteworthy because it demonstrates the necessity for the court to require a complaint to survive on well-pleaded factual allegations, not just conclusory adjectival assaults. The costs to stockholders of representative litigation are too substantial to do otherwise.

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[54]The plaintiff's briefs contain the same sort of conclusory rhetoric. For example, the plaintiff's letter reply in support of its waste claim states that Republic made a "worthless investment in AutoNation, a mere concept which Republic abandoned barely one year after the closing" and that Republic "got nothing" in return for buying AutoNation. Yet no facts are stated to support these assertions.

[55]*In re 3Com Shareholders Litig.*, mem. op. at 14 ("[b]are allegations" that stock options were "excessive or even lavish" are insufficient to demonstrate that the corporation did not benefit from the grants and that "they, therefore, amounted to gratuity and corporate waste").

[56]*See, e.g.*, the facts adverted to in notes 7, 10, and 11, *supra*.

Indeed, these costs have caused me to consider whether there is a sufficient policy basis to continue to allow plaintiffs to claim that transactions that fully informed, disinterested stockholders have approved were wasteful. With the reader's indulgence, I will now turn to that issue, which, though not case-dispositive, has important practical implications for corporations and stockholders.

4. Why Doesn't A Fully Informed, Uncoerced Vote Of Disinterested Stockholders Foreclose A Waste Claim?

Although I recognize that our law has long afforded plaintiffs the vestigial right to prove that a transaction that a majority of fully informed, uncoerced independent stockholders approved by a non-unanimous vote was wasteful, I question the continued utility of this "equitable safety valve."[57]

The origin of this rule is rooted in the distinction between voidable and void acts,[58] a distinction that appears to have grown out of the now largely abolished *ultra vires* doctrine. Voidable acts are traditionally held to be ratifiable because the corporation can lawfully accomplish them if it does so in the appropriate manner. Thus if directors who could not lawfully effect a transaction without stockholder approval did so anyway, and the requisite approval of the stockholders was later attained, the transaction is deemed fully ratified because the subsequent approval of the stockholders cured the defect.

In contrast, void acts are said to be non-ratifiable because the corporation cannot, in any case, lawfully accomplish them.[59] Such void acts

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[57]R. F. Balotti and J. A. Finkelstein, 1 *The Delaware Law of Corporations & Business Organizations* § 4.35, at 4-234 (3rd ed. 1997) (hereinafter "*Balotti & Finkelstein*").

[58]In *Michelson v. Duncan*, our Supreme Court stated that:

> The essential distinction between voidable and void acts is that the former are those which may be found to have been performed in the interest of the corporation but beyond the authority of management, as distinguished from acts which are *ultra vires*, fraudulent or gifts or waste of corporate assets. The practical distinction, for our purposes, is that voidable acts are susceptible to cure by shareholder approval while void acts are not.
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> * * *
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> It is the law of Delaware, and general corporate law, that a validly accomplished shareholder ratification relates back to cure otherwise unauthorized acts of officers and directors.... It is only where a claim of gift or waste of assets, fraud or *ultra vires* is asserted that less than unanimous shareholder ratification is not a full defense.

407 A.2d at 218-19 (citations omitted); *see also Keenan v. Eshleman*, Del. Supr., 2 A.2d 904, 909 (1938) (earlier Delaware case adopting this rule).

[59]C.R.P. Keating and J. Perkowitz-Solheim, 2A *Fletcher Cyclopedia Corporations* § 752, at 500 (rev. ed. 1992) (hereinafter "2A *Fletcher*"); *see also* 2 V. Morawetz, *A Treatise On The Law Of Private Corporations* § 622, at 588 (2d ed. 1886) (hereinafter "*Morawetz*") ("Even the majority

are often described in conclusory terms such as "*ultra vires*" or "fraudulent" or as "gifts or waste of corporate assets."[60] Because at first blush it seems it would be a shocking, if not theoretically impossible, thing for stockholders to be able to sanction the directors in committing illegal acts or acts beyond the authority of the corporation, it is unsurprising that it has been held that stockholders cannot validate such action by the directors, even on an informed basis.[61]

One of the many practical problems[62] with this seemingly sensible doctrine is that its actual application has no apparent modern day utility insofar as the doctrine covers claims of waste or gift, except as an opportunity for Delaware courts to second-guess stockholders. There are several reasons I believe this to be so.

First, the types of "void" acts susceptible to being styled as waste claims have little of the flavor of patent illegality about them, nor are they categorically *ultra vires*. Put another way, the oft-stated proposition that "waste cannot be ratified" is a tautology that, upon close examination, has

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at a shareholders' meeting cannot ratify an act in violation of the company's charter, for the powers of the majority are derived wholly from the charter itself."). I do not mean to imply by using this phraseology that the act itself is necessarily "'illegal' in the sense that the [act] is expressly or impliedly prohibited by a statute or the charter, or against morals, or against public policy." S. M. Flanagan, 7A *Fletcher Cyclopedia Corporations* § 3400, at 12 (rev. ed. 1997) (hereinafter "7A *Fletcher*"). Rather, I refer to an act that is beyond the corporation's power either because it is illegal or, if not illegal, is otherwise beyond the authority of the corporation under its charter to accomplish.

[60]*E.g.*, *Michelson v. Duncan*, 407 A.2d at 218-19.

[61]One of the most emphatic iterations of this approach was issued by the United States Supreme Court in *Central Transportation Co. v. Pullman's Palace Car Co.* In that case, the Court stated in part:

> A contract of a corporation, which is *ultra vires*, in the proper sense, that is to say, outside the object of its creation as defined in the law of its organization, and therefore beyond the powers conferred upon it by the legislature, is not voidable only, but wholly void, and of no legal effect. The objection to the contract is, not merely that the corporation ought not to have made it, but that it could not make it. The contract cannot be ratified by either party, because it could not have been authorized by either. No performance on either side can give the unlawful contract any validity, or be the foundation of any right of action upon it.

139 U.S. 24, 59-60 (1891).

[62]The multitude of problems caused by the broader doctrine of *ultra vires*, of which the waste vestige is a small part, have been largely addressed through statutory and case law changes that have essentially whittled the doctrine down to nothing. *See, e.g.*, Robert C. Clark, *Corporate Law* § 16.1, at 675 (1986) (hereinafter "*Clark*") (describing the "*ultra vires* problem" as now being one "largely of historical interest" in the United States). As one distinguished commentator noted in 1927, "The doctrine of *ultra vires* while modern in development seems to rest on notions about corporations which originated at a time when corporations were created by special act and largely for public purposes for the exercise of special franchises." H. W. Ballantine, *Ballantine on Corporations* § 69, at 244 n.25 (1927) (hereinafter "*Ballantine*"); *see also* N. D. Lattin, *The Law of Corporations*, at 196 n.54 & 206 (1959) (hereinafter "*Lattin*") (noting criticism of the *ultra vires* doctrine and indicating that the doctrine resulted from an "attempt to limit the corporation as a matter of social policy" that "failed").

little substantive meaning. I mean, what rational person would ratify "waste"? Stating the question that way, the answer is, of course, no one.[63] But in the real world stockholders are not asked to ratify obviously wasteful transactions. Rather than lacking any plausible business rationale or being clearly prohibited by statutory or common law, the transactions attacked as waste in Delaware courts are ones that are quite ordinary in the modern business world.[64] Thus a review of the Delaware cases reveals that our courts have reexamined the merits of stockholder votes approving such transactions as: stock option plans;[65] the fee agreement between a mutual fund and its investment advisor;[66] corporate mergers;[67] the purchase of a business in the same industry as the acquiring corporation;[68] and the repurchase of a corporate insider's shares in the company.[69] These are all garden variety transactions that may be validly accomplished by a Delaware corporation if supported by sufficient consideration, and what is sufficient consideration is a question that fully informed stockholders seem as well positioned as courts to answer.[70] That is, these transactions are neither *per se ultra vires* or illegal; they only become "void" upon a determination that the corporation received no fair consideration for entering upon them.

Second, the waste vestige is not necessary to protect stockholders and it has no other apparent purpose.[71] While I would hesitate to permit

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[63]For a good illustration of a stark justification of the rule that approaches the issue in this rather tautological and therefore inarguable way, *see* George D. Hornstein, 1 *Corporation Law and Practice* § 358, at 457-58 (1959) (hereinafter "*Hornstein*") ("The power of less than all to deal with the property of all shareholders, however, is not absolute. Less than all cannot — either in advance or after the event — validate out-right misappropriation, or transactions euphemistically called a 'gift' of corporate property, or other action which constitutes a fraud upon dissentients. . . . To hold otherwise — to rule that a fraud may be condoned without unanimous consent — would be a travesty on justice.").

[64]*See Clark* § 5.3.2, at 178 (noting that the difference between forms of corporate misconduct that cannot be ratified (e.g., waste) "and ordinary unfairness is just a matter of degree").

[65]*E.g., Gottlieb v. Heyden Chemical Corp.*, Del. Supr., 91 A.2d 57 (1952); *Rosenthal v. Burry Biscuit Corp.*, Del. Ch., 60 A.2d 106 (1948).

[66]*Saxe v. Brady*, 184 A.2d 602.

[67]*Weinberger v. United Financial Corp. of California*, Del. Ch., C.A. No. 5915, mem. op. at 28, 1983 Del. Ch. LEXIS 443, at *34, Hartnett, V.C. (Oct. 13, 1983) (finding no evidence of waste in case involving merger approved by fully informed stockholder vote).

[68]*Lewis v. Hat Corp. of America*, Del. Ch., 150 A.2d 750 (1959).

[69]*Kaplan v. Goldsamt*, Del. Ch., 380 A.2d 556 (1977).

[70]*Lewis v. Vogelstein*, Del. Ch., 699 A.2d 327, 336 (1997) ("Courts are ill-fitted to attempt to weigh the 'adequacy' of consideration under the waste standard or, *ex post*, to judge appropriate degrees of business risk.").

[71]One early commentator observed that the broader doctrine of *ultra vires*, if properly applied so as not to injure third parties who dealt with corporations without knowledge that the corporations were acting beyond their authority, could "for the most part" only adequately be explained as necessary to protect stockholders. *Ballantine* § 69, at 245. Modern commentators agree:

With today's reliance on the business judgment rule analysis rather than on an