I. INTRODUCTION

Plaintiff California Public Employees' Retirement System ("CalPERS") brings this action, both derivatively and as a purported class action, against Nominal Defendant Lone Star Steakhouse & Saloon, Inc. ("Lone Star"), a Delaware corporation, and several of its current and former officers and directors. CalPERS, through its amended complaint, derivatively attacks the "repricing" of options owned by executives and board members, certain related transactions between Lone Star and Lone Star's largest stockholder, who, at the time, was also its chairman, and the severance packages granted key executives which are alleged to have served as entrenchment devices. CalPERS, through its direct claims, challenges certain actions of Lone Star's board as an unlawful impairment of the shareholders' voting rights and as an illegal classification of directors.

CalPERS made no pre-suit demand upon the Lone Star board. Accordingly, the Defendants have moved to dismiss the derivative claims under Court of Chancery Rule 23.1 for failure to make demand upon the board or, in the alternative, for failure to plead adequately that demand on the board was excused. The Defendants have also moved to dismiss all claims under Court of Chancery Rule 12(b)(6) for failure to state a claim and under various theories that certain claims are time-barred, moot, or precluded by the exculpatory provision in Lone Star's certificate of incorporation authorized by 8 *Del. C.* § 102(b)(7). For the reasons set forth below, the motions to dismiss are granted in part and denied in part.

II. THE PARTIES[1]

CalPERS owns approximately 293,000 of the roughly 24 million outstanding shares of Lone Star.

Defendants are current and former officers and directors of Lone Star. Defendant Jamie B. Coulter ("Coulter") is the current Chief Executive Officer and a former director and Chairman of the Board of Lone Star. Coulter is also the largest single shareholder of Lone Star, owning 2.4 million shares and 2.6 million currently exercisable options. Defendant John D. White ("White") is a director, Executive Vice President, and Treasurer of Lone Star. He is the former Chief Financial Officer of Lone Star. Prior to joining Lone Star, White was the Senior Vice President of Finance for Coulter Enterprises, Inc. ("CEI"), a company then owned by

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[1]The factual context for consideration of the pending motions is drawn from the well-pled allegations of the amended complaint. *See infra* notes 5-8, 42-44 & accompanying text.

Coulter. White has been a shareholder of Total Entertainment Restaurant Corp. ("TENT"), another Coulter-affiliated business, since before its initial public offering ("IPO")—shares "given" to him by Coulter according to the amended complaint. Defendants Fred B. Chaney ("Chaney"), William B. Greene ("Greene"), and Clark R. Mandigo ("Mandigo") are members of Lone Star's board of directors. Mandigo is also a shareholder of TENT. Defendant Michael J. Archer ("Archer") is a former director and Senior Vice President of Operations of Lone Star and is now Chief Operating Officer of Lone Star's Del Frisco/Sullivan unit. Archer is also a TENT shareholder. Defendant William H. Tilley ("Tilley") is a former director of Lone Star. Tilley is also the majority shareholder of Pacific Ventures, Ltd., which in turn owns 50% of Restaurants of Micronesia. Restaurants of Micronesia is a Lone Star licensee and operates a Lone Star restaurant in Guam. He is also the principal shareholder of California Star Restaurants, a Lone Star licensee that operates Lone Star restaurants in California. Finally, Tilley is a shareholder of TENT. Defendant Dennis L. Thompson ("Thompson") was previously a director (1992-98) and Senior Vice President (1992-97) of Lone Star. Thompson was also an officer, director, and shareholder of a corporate franchisee of Lone Star from 1985-95 and has served on the board of directors of TENT since 1997.

III. FACTUAL BACKGROUND

Lone Star, founded by Coulter, owns and operates a number of restaurants, including Lone Star Steakhouse & Saloon, Del Frisco's Double Eagle Steak House, and Sullivan's Steakhouse. Lone Star went public in 1992. Coulter then became Lone Star's CEO and Chairman of the Board.

Lone Star has a history of dealing with other Coulter businesses. A separate entity, CEI, which was owned solely by Coulter until it was purchased by Lone Star in October 1998, has provided accounting and administrative services under an annual contract with Lone Star since at least 1993. In addition, Lone Star reimbursed CEI for Coulter's use of aircraft and pilot services in 1996-98. These reimbursed amounts had been paid by CEI to another wholly-Coulter-owned entity and amounted to approximately $2.2 million over a thirty-three month period. There were also several short-term loan transactions between Lone Star and CEI.

In October 1998, Lone Star purchased CEI for almost $11.5 million which consisted of a $10.5 million sale price plus Lone Star's assumption of nearly $1 million of CEI's liabilities. The transaction was approved by a three-member special committee of the board of directors. Tilley was the chairman of the committee and the two other members were Chaney and Mandigo. Steven Wolosky, Esquire ("Wolosky") of the law firm Olshan,

Grundman, Frome & Rosenzweig ("Olshan") informed the committee that no independent counsel would be necessary because Olshan had already drafted a purchase agreement. Wolosky and his firm had acted as legal counsel for many of Coulter's businesses, including CEI, TENT, and Lone Star, and Wolosky had been a shareholder and director of TENT. Upon his advice, the committee did not seek the services of independent legal counsel to represent Lone Star in the transaction. The committee did employ the services of investment bankers, Houlihan Lokey Howard & Zukin ("Houlihan"), to prepare a valuation report. Houlihan's report valued CEI between $10-11 million, but the valuation disclosed that it was based, in part, on unverified information provided by CEI and Lone Star management. This undocumented and unverified information included a recent offer to purchase CEI for $20 million, an estimate of the costs of replacing the services that CEI provided to Lone Star, and cash flow and revenue forecasts that exceeded CEI's historical performance. CalPERS contends that the $20 million offer was fabricated; no one ever investigated the costs of replacing CEI's services; and the cash flow and revenue forecasts failed to reflect either the recent loss of service contracts with Pizza Hut and KFC franchises[2] or the impending loss of TENT's service contract. White, not a member of the special committee, was assigned the task of representing Lone Star for the purpose of negotiating the acquisition. Less than one week later, White and Coulter (CEI's owner) agreed to the nearly $11.5 million transaction and the special committee approved it.

CalPERS also alleges that, during 1996 and 1997, Coulter was not attentive to his duties at Lone Star because his focus was on the completion of an initial public offering of TENT, another Coulter entity. At this time Lone Star's board of directors was comprised of Coulter, White, Mandigo, Chaney, Tilley, Nickel, Thompson, and Archer. All of the directors, except Nickel and Chaney, were TENT shareholders and Thompson was appointed to TENT's board after the public offering in 1997. Coulter's subsequent relationship with TENT is unclear from the amended complaint. After the IPO, in March 1997, Coulter was the Chairman of TENT's board of directors. By October 1998, however, there may have been some friction because shortly after Lone Star purchased CEI, Coulter was removed as TENT's Chairman and the CEI service contract was discontinued.

A few months later, in January 1999, the Lone Star board amended Coulter's employment contract with Lone Star. Coulter's previous contract contained non-competition and non-solicitation provisions both of which

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[2]These franchises had once been owned by Coulter but were awarded to Coulter's ex-wife in a divorce settlement.

applied in the event that Coulter elected to terminate his employment in response to a change of control at Lone Star. Coulter's contract had included these provisions since 1992, the year Lone Star became a public company. The new contract waived the non-compete and non-solicitation provisions if Coulter, upon ten-days notice to Lone Star, elected to leave the company within three years following any change of control. CalPERS alleges that Lone Star received no offsetting benefit in exchange for this change to Coulter's contract.

Between April 1996 and December 1998, Lone Star's share price declined from $44.00 per share to $7.88. Beginning in 1998 the board of directors began aggressively repurchasing company stock, authorizing the repurchase of 2.6, 8.75, and 5.6 million shares in 1998, 1999, and 2000 respectively. These repurchases reduced the number of outstanding shares by 41%.

CalPERS also challenges the "repricing" of employees' and outside directors' stock options on five occasions. In April 1997, 8.1 million employees' options with original exercise prices ranging from roughly $19-$40 per share were repriced to $18.25 per share. Of these repriced options, Coulter owned 2.6 million and White owned 1 million. In September 1997, outside directors' options were repriced. The amended complaint does not specify many of the details, but it does note that 52,000 of Chaney's and 42,800 of Mandigo's options, with original strike prices between approximately $19 and $40 per share were repriced to $18.81. Employees' options were again repriced in December 1998. At that time, 768,000 options with a weighted average exercise price of $16.91 per share were repriced to $8.00. Archer owned 646,000, or slightly more than 84%, of those shares. Outside directors' options were repriced again in September 1999. Of the 148,400 options repriced, 40,000 belonged to Greene, 42,800 to Mandigo, and 65,600 to Chaney. Except for some having lower original exercise prices, these options were repriced from $18.25 to $7.94 per share. In January 2000, employees' options were repriced a third time. The repricing affected almost 4.6 million options, with an average exercise price of $18.25, repricing them to $8.46875 per share. Coulter still owned 2.6 million of these options and White still owned 1 million.

The amended complaint does not set forth whether a committee or the full board approved either the employees' or outside directors' options repricings in 1997. The employees' options repricings in 1998 and 2000 were approved by the Stock Options Committee, which was comprised of Mandigo, Chaney, and Tilley in 1998 and of Mandigo, Chaney, and Greene in 2000. The 1999 repricing of outside directors' options was approved by Coulter and White.

At least as early as February 2000, CalPERS voiced dissatisfaction

with the management of Lone Star. On February 22, 2000, CalPERS listed Lone Star on its Corporate Governance Focus List of under-performing stocks for the year. On May 1, 2000, CalPERS filed proxy materials to initiate a shareholder resolution seeking to amend the bylaws to require that the board consist of a majority of outside, independent directors. This was followed by a letter to other shareholders urging support for the resolution. The resolution was adopted over the opposition of Coulter and the other directors at the 2000 annual shareholders' meeting. At that meeting, shareholder Guy Adams ("Adams") sharply questioned compensation increases to Coulter and White of 241% and 190% respectively during a period of declining profits and share price for Lone Star. Adams also questioned the wisdom of repricing millions of predominantly incentive options belonging to White and Coulter given the company's weak performance under their leadership. The Council of Institutional Investors ("CII") sent a letter to Lone Star's board of directors on July 14,2000. In that letter, CII requested a board resolution requiring a majority of independent directors and sought to have Lone Star declassify the board.

CalPERS served demand to inspect Lone Star's books and records, pursuant to 8 *Del. C.* § 220, on November 9, 2000. The demand letter requested documents related to stock options repricings, the acquisition of CEI, and Lone Star's dealings with Coulter. The board and CalPERS disagreed regarding the scope and propriety of the demand. Litigation on that issue was ultimately avoided through negotiation and subsequent production, which was completed by August 2001.

On January 3, 2001, the Lone Star board adopted change of control agreements for senior management, including Coulter and White. The agreements, which would provide compensation to departing managers, were designed to be activated by any change of control at Lone Star. As originally adopted, it is alleged, the agreements would have obligated Lone Star to pay departing executives an amount that would have exceeded one-third of the company's market capitalization if Lone Star were to be purchased for as little as $12 per share. Later clarification of the how the agreements would operate reduced that amount to approximately one-eighth of Lone Star's market capitalization—still a significant potion of the company's value. In addition, these agreements define "change of control" to include the "failure of the stockholders to re-elect a majority of the currently sitting directors (the "Existing Directors") *unless the new candidates are approved by a majority of the Existing Directors*[.]"[3] The adoption of these agreements was disclosed publicly on March 26, 2001,

[3]Pl.'s Am. Compl., ¶ 87 (emphasis added).

when Lone Star's 1 O-K was filed with the Securities Exchange Commission. Shareholder response was not enthusiastic. CalPERS met with Mandigo, Chaney, and Greene on April 17, 2001. CalPERS expressed its concerns about the golden parachutes and requested a reduction in the benefits provided. CalPERS' pointed out that under the agreements departing managers would be entitled to receive, *inter alia*, the exchange of any vested or non-vested stock options for a cash payment equal to the transaction price. It appeared that there would be no offset for the strike price of the exchanged options. Mandigo, Chaney, and Greene disagreed with that interpretation, but they did agree to consider including a clarification that there would be an offset of the strike price in later public filings of Lone Star. Ultimately, CalPERS requested that the agreements be rescinded. The agreements were not rescinded, but Lone Star filed an amended 10-K on April 25, 2001, clarifying that the payment for options exchanged under the agreements would include an offset for the strike price.

On March 26, 2001, Adams filed proxy materials challenging Coulter's seat on Lone Star's board and sent a proposed shareholder letter to the board on April 6. In that letter, Adams criticized the directors' lack of independence, Lone Star's stock performance, the options repricings, and the golden parachutes. The Lone Star board vigorously opposed Adams' proxy challenge for Coulter's board seat. Nonetheless, Adams was elected to the board, unseating Coulter, on July 6, 2001.

IV. SYNOPSIS OF CLAIMS

Plaintiffs amended complaint consists of the following fourteen claims:

- *Count I* is a derivative claim for breach of fiduciary duty based on the repricing of employees' and directors' options.
- *Count II* is a derivative claim that seeks to void the repricing of employees' options as interested transactions that were not properly ratified.
- *Count III* is a derivative claim that seeks to void the repricing of outside directors' options as an *ultra vires* act and a breach of fiduciary duty.
- *Count IV* is a derivative claim for breach of fiduciary duty based on the board's having permitted Coulter to shirk his duties as CEO and Chairman while preparing TENT for its initial public offering.

- *Count V* is a derivative claim for breach of fiduciary duty with regard to the acquisition of CEI by Lone Star.
- *Count VI* is a derivative claim that seeks to void the acquisition of CEI as an improperly ratified interested transaction.
- *Count VII* is a derivative claim that seeks to void payments made to CEI by Lone Star under the 1997 and 1998 service agreements as improperly ratified interested transactions.
- Count VIII is a derivative claim for breach of fiduciary duty in relation to the payments made to CEI in 1997 and 1998.
- *Count IX* is a derivative claim for breach of fiduciary duty based on allegations of entrenchment.
- *Count X* is a derivative claim that seeks to void the amendment to Coulter's employment contract—suspending application of the contract's non-compete and non-solicitation clauses in the event of a change of control—as waste and as an improperly ratified interested transaction.
- *Count XI* is a derivative claim for breach of fiduciary duty in adopting the amendment to Coulter's employment contract.
- *Count XII* seems to be a "catch-all" derivative claim for breach of fiduciary duty apparently on the basis of the combined weight of all the suggestions of wrongdoing contained in the amended complaint.
- *Count XIII* is a class action direct claim for breach of fiduciary duty based on the existing director provisions contained in the change of control agreements or golden parachutes for management because it is claimed that these provisions constitute an unlawful impediment to the shareholders' exercise of voting rights.
- *Count XIV* is a class action direct claim for breach of fiduciary duty alleging that the existing director provisions create an illegal classification of directors.

V. ANALYSIS

A. Demand Requirement

Defendants have moved to dismiss all derivative claims (Counts I-XII) for failure to allege with particularity facts demonstrating that demand, as required under Rule 23.1, would be futile. Demand futility is determined

by application of the two-pronged *Aronson* test.[4] Under *Aronson*, demand will be excused as futile where the "particularized facts alleged in the complaint create a reasonable doubt (*i.e.*, reason to doubt) that (1) the directors upon whom demand would be made were disinterested and independent or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment."[5] Thus, the inquiry of the Court is whether the plaintiff has "alleged particularized facts creating a reasonable doubt that the actions of the defendants were protected by the business judgment rule."[6] Where the amended complaint alleges particularized facts, the plaintiff is entitled to the reasonable inferences flowing from those facts.[7] The plaintiff is not entitled to rely upon conclusory allegations.[8]

The original complaint was filed on October 16, 2001. At that time the board members were defendants White, Mandigo, Chaney, and Greene, and non-defendant Adams. While the composition of Lone Star's board changed before the filing of the amended complaint on January 9, 2002, the amended complaint did not add any derivative claims that were not included in the original complaint. Thus, the board as constituted on October 16, 2001, is the board for purposes of evaluating whether demand is required or excused.[9]

1. Disinterest and Independence: First Prong of the *Aronson* Test

A plaintiff's burden in seeking to justify a failure to make demand on the board under *Aronson* has been described as follows:

> The *Aronson* Court . . . defined interest as "mean[ing] that directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally."

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[4]*Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984). *See Brehm v. Eisner*, 746 A.2d 244, 256 (Del. 2000).

[5]*Zupnick v. Goizueta*, 698 A.2d 384, 386 (Del. Ch. 1997). *See also Aronson*, 473 A.2d at 814.

[6]*Brehm*, 746 A.2d at 255.

[7]Id.

[8]Id.

[9]*See, e.g.*, *Haseotes v. Bentas*, 2002 Del. Ch. LEXIS 106, at *14 (Del. Ch.); *Needham v. Cruver*, 1993 Del. Ch. LEXIS 76, at *8-9 (Del. Ch.); *Harris v. Carter*, 582 A.2d 222, 229-32 (Del. Ch. 1990).

> . . . [I] n the absence of self-dealing, it is not enough to establish the interest of a director by alleging that he received *any* benefit not equally shared by the stockholders. Such benefit must be alleged to be *material* to that director. Materiality means that the alleged benefit was significant enough " *in the context of the directors economic circumstances*, as to have made it improbable that the director could perform her fiduciary duties to the . . . shareholders without being influenced by her overriding personal interest."
>
> On the separate question of independence, the *Aronson* Court stated that "[ilndependence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences." Such extraneous considerations or influences may exist when the challenged director is controlled by another. To raise a question concerning the independence of a particular board member, a plaintiff asserting the "control of one or more directors must allege particularized facts manifesting 'a direction of corporate conduct in such a way as to comport with the wishes or interests of the corporation (or persons) doing the controlling. The shorthand shibboleth of 'dominated and controlled directors' is insufficient." This lack of independence can be shown when a plaintiff pleads facts that establish "that the directors are 'beholden' to [the controlling person] or so under [his] influence that their discretion would be sterilized."[10]

a. Guy Adams

All parties agree that Adams, who unseated Coulter from Lone Star's board, is disinterested and independent.

b. William B. Greene

Greene became a director of Lone Star in August of 1999, after many of the disputed transactions had already occurred. The only allegations that are remotely related to the domination of Greene by Coulter are repeated references to Greene's having once said, "Those that got most of the gold make most of the rules."[11] CalPERS would have the Court presume that

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[10] *Orman v. Cullman*, 794 A.2d 5, 23-24 (Del. Ch. 2002) (citations omitted).

[11] I do not understand CalPERS to dispute the historical accuracy of this pithy

Greene would defer to Coulter on business decisions because as the largest single shareholder, Coulter has "most of the gold." This is simply inadequate to raise a reasonable doubt regarding Greene's ability to exercise independent business judgment.

The one factual allegation of financial interest on the part of Greene is that he owned 40,000 options that were repriced in September 1999. This repricing of outside directors' options was approved by the inside directors Coulter and White. The award of options is a form of director compensation and 8 *Del. C.* § 141(h) provides that "the board of directors shall have the authority to fix the compensation of directors" absent contrary provisions in the bylaws or certificate of incorporation. Furthermore, when a director's compensation is established by a majority of disinterested directors, the business judgment rule applies to the decision.[12] The amended complaint alleges variously that this repricing of options was (1) a repayment to the outside directors who "had approved everything Coulter and White wanted" and (2) a *quid pro quo* for the employees' options repricing that took place four months later in January 2000. Both assertions are conclusory and the amended complaint offers no factual basis for either. The repayment allegation has little force, particularly as against Greene who had become a director only a month before the repricing and was not involved in approving any of the alleged self-dealing transactions. As discussed in greater detail below, the factual allegations of the amended complaint do not provide a basis to support an inference that there was a repricing scheme or conspiracy in which employee directors repriced the options of outside directors as a *quid pro quo* for prior or subsequent repricing of their own options. The amended complaint does allege with particularity certain facts that provide a reason to doubt that Greene could disinterestedly consider demand as to Count IX, the claim of entrenchment. Greene was a director throughout 2000 and

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observation attributed to Greene.

[12]*See Lewis v. Hirsch*, 1994 Del. Ch. LEXIS 68, at *10-11 (Del. Ch.) (stating that executive compensation is "ordinarily left to the business judgment of a company's board of directors"); *Tate & Lyle PLC v. Staley Cont'l, Inc.*, 1988 Del. Ch. LEXIS 61, at *19-22 (Del. Ch.) (finding business judgment rule afforded no protection where outside directors recommended their own retirement plan and where all directors approved creation of trust benefiting both inside and outside directors, but business judgment rule did protect disinterested directors' approval of compensation packages for other directors). *Cf. Telxon Corp. v. Meyerson*, 802 A.2d 257, 265-66 (Del. 2002) (noting that director self-compensation "where properly challenged" would be evaluated under an entire fairness standard like any other interested transaction); *Steiner v. Meyerson*, 1995 Del. Ch. LEXIS 95 at *32-33 (Del. Ch.) (excusing demand where challenged transaction affected compensation of outside directors, comprising a majority of the board, and where the complaint alleged that directors had "*appropriated for themselves* excessive fees and stock options") (emphasis added).

2001 when CalPERS' and other shareholders' criticism of management became quite serious. Such criticism—including CalPERS' § 220 demand and shareholder resolution, Adams' questions at Lone Star's 2000 annual meeting, and CII's letter to the board—would most likely have been perceived as a threat to the incumbent management and directors of Lone Star. Subsequently, the board approved generous golden parachute agreements for White, Coulter, and others that would be triggered by any change in control at Lone Star. Under those agreements, failure to reelect a majority of the then-incumbent directors or their designated successors would constitute a change in control. The amended complaint alleges that this and other board actions were taken in response to the perceived threat to the incumbent directors' positions and were intended to entrench the incumbent directors (or their designees) in office. These facts state a claim for entrenchment. Directors are presumptively "interested" in such actions taken for entrenchment purposes.[13] This raises a reasonable doubt about the ability of Greene to consider disinterestedly demand on Count IX for entrenchment.

c. Fred B. Chaney

Chaney became a director of Lone Star in May 1995. Therefore, he participated in a number of the decisions regarding the alleged self-interested transactions. He was a director when Coulter was allegedly permitted to shirk his duties at Lone Star in order to work on preparations for TENT's IPO. It is not, however, alleged that Chaney had any personal financial interest in the success of TENT. He was a member of the Lone Star board that approved changes to Coulter's non-competition agreement in 1998 and was a member of the Stock Option Committees that approved the employees' stock options repricings in 1998 and 2000. Chaney was a member of the special committee that approved the purchase of CEI from Coulter. Mere approval of, or acquiescence in, a challenged decision of the board, without more, is insufficient to raise a reasonable doubt as to a director's independence or disinterest.[14] Like Greene, the only factual allegation of financial interest on the part of Chaney is that he owned

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[13]*See Carmody v. Toll Bros., Inc.*, 723 A.2d 1180, 1189 (Del. Ch. 1998) (stating that there were particularized allegations that "the Toll Brothers directors acted for entrenchment purposes [and under Delaware law] that is sufficient to excuse the requirement of a demand").

[14]*See, e.g.*, *Aronson*, 473 A.2d at 817; *Stein v. Orloff*, 1985 Del. Ch. LEXIS 418, at *9 (Del. Ch.); *Kaufman v. Belmont*, 479 A.2d 282, 287 (Del. Ch. 1984); *Lewis v. Daum*, 1984 Del. Ch. LEXIS 602, at *7 (Del. Ch.). The amended complaint also asserts that Chaney is beholden to Coulter but fails to provide a factual basis for this conclusory statement. Consequently, Chaney must be considered independent of Coulter for demand requirement analysis.

options that were repriced—52,000 options in 1997 and 65,600 in 1999. Certainly the argument has somewhat more force against Chaney, who was at least on the board when the approvals took place. Nonetheless, I am not persuaded that the facts alleged raise a reasonable doubt about Chaney's disinterest. First, this represents a fairly long wait for repayment. Some of the challenged approvals occurred as far back as 1996 (*e.g.*, payments to CEI for Coulter's use of private aircraft). Second, there are no, allegations of intermediate facts to *link* the approval of any of these transactions with the stock option repricing. Third, the several transactions were approved by various groups of directors while the repricing of outside directors' options benefited only Mandigo and Chaney (and in '99, Greene, who had not approved anything).

For the same reasons I determined that Greene could not be considered disinterested for purposes of demand on the entrenchment claim in Count IX, I also have a reasonable doubt of Chaney's ability to consider disinterestedly demand on that count.

d. Clark R. Mandigo

Mandigo has been a member of Lone Star's board since March 1992. He elected Chairman of the Board when Coulter was unseated by Adams in July 2001. Mandigo is alleged to be under the control of Coulter and interested in a number of the disputed transactions for the following reasons:

- Mandigo and Coulter are lifelong friends.
- Mandigo's son's livelihood is dependent on Coulter because Coulter is the CEO of Lone Star and Mandigo's son is the general manager of a Lone Star-owned restaurant in Denver.
- Mandigo was a director and approved or acquiesced in all of Coulter's alleged self-dealing transactions. This includes serving on the Stock Option Committee that approved all the repricings of employee options and on the special committee that approved the CEI purchase.
- Mandigo was a director during the time Coulter was permitted to shirk his duties at Lone Star in preparation for the IPO of TENT. During that time Mandigo owned TENT stock, from before the IPO, and had a financial interest in the success of TENT.
- Mandigo owned 42,800 options that were repriced in 1997

and again in 1999.[15]

- Mandigo was a director during the period when the alleged acts of entrenchment occurred.

If taken separately, none of the individual allegations would be adequate to raise a reasonable doubt as to Mandigo's disinterest or independence. Our cases have determined that personal friendships,[16] without more; outside business relationships,[17] without more; and approving of or acquiescing in the challenged transactions,[18] without more, are each insufficient to raise a reasonable doubt of a director's ability to exercise independent business judgment. On these facts, however, none of the allegations stands alone "without more." Taken together, they give this Court reason to doubt that Mandigo is disinterested and independent. Furthermore, it is a reasonable inference from the alleged particularized facts that the combination of relationships between Coulter and Mandigo, along with Coulter's position as CEO of the company that employs Mandigo's son, would be sufficiently material to preclude Mandigo from being able to consider demand without improper considerations intervening.[19]

e. John D. White

White has been a director of Lone Star since 1992 and serves as its Executive Vice President and Treasurer. He was formerly the Chief Financial Officer of Lone Star. In both positions Coulter, as CEO, was and is White's superior at Lone Star. Prior to joining Lone Star, White was the Senior Vice President of Finance for CEI. At that time Coulter was the sole owner of CEI and, again, White's superior. Thus, the amended complaint

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[15]I include here CalPERS' allegation that Mandigo owned options that were repriced. I do not, however, consider that this makes Mandigo "interested," any more than owning options made Greene or Chaney "interested" for purposes of excusing demand.

[16]*See, e.g.*, *Crescent/Mach I Partners, L.P. v. Turner*, No. 2000 Del. Ch. LEXIS 145, at *40-41 (Del. Ch.).

[17]*See, e.g.*, *Goldman v. Pogo.com, Inc.*, 2002 Del. Ch. LEXIS 71, at *14 (Del. Ch.); *Orman*, 794 A.2d at 26-27; *Crescent/Mach I Partners, L.P.*, 2000 Del. Ch. LEXIS 145, at *40-41.

[18]*See, e.g.*, *Aronson*, 473 A.2d at 817; *Stein*, 1985 Del. Ch. LEXIS 418, at *9; *Kaufman*, 479
A.2d at 287; *Lewis*, 1984 Del. Ch. LEXIS 602, at *7.

[19]*See In re New Valley Corp. Derivative Litig.*, 2001 Del. Ch. LEXIS 13, at *23-27 (Del. Ch.) (holding that plaintiffs satisfied pleading burden where "the actual extent of these relationships is not altogether clear at this point" and excusing demand on a motion to dismiss under Rule 23.1).

alleges that Coulter has been White's superior with regard to White's primary employment through White's last three positions and two employers. He has been a shareholder of TENT since before its IPO. The amended complaint alleges that Coulter "gave" shares of TENT to White. White is alleged to have provided false information to Lone Star and its advisors in conjunction with the purchase of CEI from Coulter. Specifically, he told the special committee members that it would be very costly to replace the services provided by CEI even though he had no basis for this assertion since he had not researched replacement costs. In addition, he failed to provide Houlihan with information, which he possessed, that CEI would be losing the contract with TENT. That information would most likely have reduced CEI's cash flow projections and ultimately the value placed on CEI. White struck the deal with Coulter regarding the purchase of CEI without any negotiation and at a price that was approximately $0.5-1.5 million (roughly 5-1 5%) more than the Houlihan valuation of the company. The contested change of control provisions, if triggered, could result in millions of dollars of payment to White. White has benefited from options repricings in 1997 and 2000.[20]

Coulter's position as White's superior alone would be sufficiently material to give reason to doubt White's independence from Coulter.[21] Certainly, taken together with all the facts alleged, the amended complaint raises a reasonable doubt regarding White's interest in a number of the challenged transactions, his independence corn Coulter more generally, and his ability to exercise independent business judgment in evaluating demand as to each derivative claim.

For the reasons stated above, I find that demand is excused under the first prong of *Aronson* on Count IX (entrenchment) because the particularized allegations in the amended complaint raise a reasonable doubt about the disinterest and independence of a majority of the directors—White, Mandigo, Chaney and Greene. Because the amended complaint fails, based on its allegations of particularized fact, to raise a reasonable doubt about the disinterest or independence of three (Adams, Greene, and Chaney) of the five directors, demand is not excused. under the first prong of *Aronson* as to the remaining derivative claims.

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[20]As with Mandigo, I mention the allegation that White benefited from options repricing. Still, as with Greene, Chaney, and Mandigo, I note that repriced options do not alone form a sufficient basis for finding White "interested."

[21]*See Mizel v. Connelly*, 1999 Del. Ch. LEXIS 157, at *8-9 (Del. Ch.); *Steiner*, 1995 Del. Ch. LEXIS 95, at * 27-30.

2. Valid Exercise of Business Judgment: Second Prong of the *Aronson* Test

The determination of whether the amended complaint raises a reasonable doubt as to the disinterest or independence of a majority of Lone Star's directors at the time this action was filed, however, does not end the inquiry under *Aronson*. Even if a majority of the directors is found to be disinterested and independent, demand may be excused under the second prong of *Aronson* if the allegations of the complaint raise a reasonable doubt whether the challenged decision was the product of the valid exercise of business judgment.[22] Under the business judgment rule, it is presumed that the board acted on an informed basis and that the directors honestly and in good faith believed that the action was in the best interests of the corporation.[23] Thus, in order "to invoke the rule's protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them."[24] In addition, the business judgment rule may not be invoked to shelter unauthorized actions of a board of directors.[25]

a. Repricing of Directors' and Employees' Options

The allegations supporting Counts I-III raise issues that call into question whether some of the options repricings were the product of the exercise of valid business judgment.[26] Count I alleges breaches of fiduciary

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[22]*See Aronson*, 473 A.2d at 814.

[23]*Id.* at 812.

[24]Id.

[25]*See Lewis v. Hett*, 1984 Del. Ch. LEXIS 546, at *9-11 (Del. Ch.) (denying motion to dismiss under Rule 23.1 where complaint alleged adoption of severance package was *ultra vires* and could not be the product of valid business judgment).

[26]It is not alleged that any director approved or participated in the repricing of his own options and was therefore "interested" as analyzed under the first prong of *Aronson*. The complaint does allege, at least indirectly, that there was some sort of repricing scheme whereby employee directors could assure the repricing of their own options by approving the repricing of outside directors' options and vice-versa. The factual allegations about these repricings are sparse and do not reasonably support the inferences that CalPERS asks the Court to draw. The individual repricing actions were not contemporaneous. They span a thirty-three-month period with at least four months between one repricing and the next. The mix of directors changed several times during the "scheme" and the benefits accrued in varying amounts to different configurations of directors, in no ascertainable proportion between the benefits received and the benefits bestowed. For example, although White and Coulter had relatively large blocks of options repriced in '97 and '00, virtually all (84%) of the employee options repriced in '98 belonged to Archer, and none is alleged to have belonged to either White or Coulter who then approved the repricing of directors' options in '99. CalPERS' allegations do not offer a plausible theory to support the notion of an options repricing conspiracy.

duty with respect to all of the options repricings undertaken between 1997 and 2000. Count II seeks to void the repricing of employees' options as interested transactions. Count III seeks to have the repricing of outside directors' options declared void as *ultra vires* transactions. The following repricings are alleged in the amended complaint.

- *April 1997—Employees' Options.* Coulter and White respectively owned 32% and 19.8% of the options repriced. At the time the options were repriced, the board consisted of White, Coulter, Mandigo, Chaney, Nickel, Archer, and Thompson.
- *September 1997—Directors' Options.* There are few details given other than that Chaney had 52,000 options repriced and Mandigo had 42,800 options repriced.
- *December 1998—Employees' Options.* The benefits of this repricing went chiefly to Archer who held 84% of the options that were repriced. The Stock Option Committee was composed of Mandigo, Chaney, and Tilley. The board was composed of White, Coulter, Mandigo, Chaney, Tilley, and Archer.
- *September 1999—Directors' Options.* The benefits accrued to Chaney, Mandigo, and Greene who respectively owned 44%, 29%, and 27% of the options repriced at this time. The transaction was approved by White and Coulter, who along with Chaney, Mandigo, and Greene were Lone Star's directors at this time.
- *January 2006—Employees' Options.* The benefits accrued to White (22%), Coulter (57%), and other employees (22%).[27] The Stock Option Committee consisted of Mandigo, Chaney, and Greene. The board was composed of White, Coulter, Mandigo Chaney, and Greene.

The amended complaint alleges that the repricing of employees' options was undertaken without the exercise of *any* business judgment. CalPERS first asserts that the justifications given for the repricings—to retain and attract key employees—were false because there was no risk that Coulter, White, or Archer might leave and that they were seeking instead to entrench themselves in office. There are insufficient factual allegations

[27]Totals 101% due to rounding.

to support such a conclusion. CalPERS next contends that the 2000 repricing was conducted without any "analysis, evaluation, independent review, investment banking opinion, or advice from a compensation consultant or legal advisor."[28] The amended complaint affirmatively alleges that the only document in Lone Star's corporate records related to the transaction is the signed resolution of the Stock Option Committee implementing the repricing.[29] If this is true, and the Court must accept that it is for the limited purpose of ruling on a motion to dismiss, this could indicate that the Stock Option Committee failed to exercise business judgment when repricing employee options in January 2000. Such a failure excuses demand under the second prong of the *Aronson* test.[30] Importantly though, the amended complaint fails to make any such particularized allegation as to the repricing of employees' options in either 1997 or 1998. For that reason, I find that demand was required and defendants' motion to dismiss is granted as to Counts I and II insofar as they relate to the repricing of employees' options in 1997 and 1998. Demand is excused, however, as to Counts I and II with respect to the 2000 repricing of employees' options and to that extent the motion to dismiss under Rule 23.1 is denied.

Regarding the repricing of outside directors' options in 1997 and 1999, the amended complaint alleges that the underlying stock option plan does not permit repricing of options regardless of the technicalities of how repricing is accomplished.[31] The amended complaint incorporates the terms of the Lone Star's Directors' Stock Option Plan. Consequently, the Court may consider this document in ruling on the motion to dismiss.[32] Although Defendants and CalPERS offer, unsurprisingly, different views about the correct construction of the directors' plan, I decline to rule on construction of the agreement on a motion to dismiss. Article X of the agreement addresses the authority of the directors to amend or revise the terms of the plan. Section 10.1 requires shareholder approval of any amendment or revision that would "change the minimum Exercise Price set forth in Article

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[28]Pl.'s Am. Compl., ¶ 70.

[29]In their respective briefs, the parties dispute whether the failure of Lone Star to produce any documents evidencing such analysis in response to CalPERS' § 220 request to inspect books and records gives rise to an inference that such records do not exist because they dispute whether such records were within the scope of the records that Lone Star agreed to produce. For the purposes of this motion to dismiss, the Court declines to make any inference. Instead, the amended complaint's factual allegation that no such records exist is accepted.

[30]*See Aronson*, 473 A.2d at 814.

[31]The parties dispute whether "repricing" of options consists of changing the price of existing options or canceling existing options and issuing replacement options with a different exercise price. In order to rule on this motion to dismiss, the Court need not, and does not, make a determination about the mechanics of the options repricing.

[32]*See, e.g.*, *In re New Valley Corp. Derivative Litig.*, 2001 Del. Ch. LEXIS 13, at *13.

VI[.]" It appears undisputed that the repricings were conducted under the options plan without additional shareholder approval. Quite naturally, the parties disagree whether the repricings constituted a "change" to the exercise price. One plausible answer is that they did. Thus, plaintiff alleges with particularity that repricing of directors' options in 1997 and 1999 was *ultra vires*. Any action of the board that falls outside the rather broad scope of its authority is not entitled to the protection of the business judgment rule[33] and demand is excused. I therefore deny the motion to dismiss Counts I and III for failure to make demand to the extent that these counts relate to the repricing of outside directors' options.

Finally I note that the amended complaint does not make the allegation that the repricing of *employees'* options was *ultra vires*. This argument is made in CalPERS' answering brief in opposition to the motion to dismiss. Arguments in briefs do not serve to amend the pleadings.[34] Nonetheless, CalPERS argues in its answering brief that the directors' options plan and the employees' options plan are substantially identical as to whether repricing of options is permitted. For this reason, to the extent I have dismissed claims regarding the repricing of employees' options, such dismissal is without prejudice. CalPERS may request leave to amend the pleadings to allege that the employees' options repricings were *ultra vires*, if that is its contention.

b. Acquisition of CEI

The facts alleged regarding Lone Star's acquisition of CEI, an entity wholly owned by Coulter, raise a reasonable doubt as to whether the transaction was the product of the board's[35] exercise of business judgment. Thus, demand is excused as to Count V, which alleges breach of fiduciary duty in relation to the purchase, and as to Count VI, which seeks to void the acquisition as an improperly ratified interested transaction.

The Lone Star board obtained a valuation opinion from Houlihan when it considered the purchase of CEI. Where a board has relied on expert opinion and seeks to support its actions with that opinion, *Brehm. v. Eisner* has articulated the standard for assessing the allegations in the context of a motion to dismiss under Rule 23.1:

> [W]here an expert has advised the board in its decisionmaking

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[33]*See Lewis*, 1984 Del. Ch. LEXIS 546, at *9-11.

[34]*See Oman*, 794 A.2d at 28 n.59.

[35]At the time Lone Star acquired CEI, the board members were Coulter, White, Archer, Chaney, Mandigo, and Tilley.

> process, the complaint must allege particularized facts (not conclusions) that, if proved, would show, for example, that: (a) the directors did not in fact rely on the expert; (b) their reliance was not in good faith; (c) they did not reasonably believe that the expert's advice was within the expert's professional competence; (d) the expert was not selected with reasonable care by or on behalf of the corporation, and the faulty selection process was attributable to the directors; (e) the subject matter (in this case the cost calculation) that was material and reasonably available was so obvious that the board's failure to consider it was grossly negligent regardless of the expert's advice or lack of advice; or (f) that the decision of the Board was so unconscionable as to constitute waste or fraud.[36]

The allegations of the amended complaint address parts (b) and (e) of the *Brehm* analysis, that is the allegations raise a reasonable doubt as to (1) whether reliance on the Houlihan valuation was in good faith and (2) whether the directors were not grossly negligent. Taking all well-plead allegations as true, as I must, there are only two possible explanations for the special committee's reliance on the Houlihan valuation report. Either the committee members knew the report was based on grossly inaccurate data that inflated the valuation of CEI or they worked very hard not to know that information-facts which were both material and obvious. If the former is true, the committee's reliance could not have been in good faith. If the latter, the committee was grossly negligent. In either event, based on the amended complaint's allegations of particularized facts, the decision would not be the product of the valid exercise of business judgment, and demand on the board is, thus, excused.

CalPERS alleges that some of the bases of the Houlihan valuation

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[36] 746 A.2d at 262. I note that Brehm addressed a somewhat different set of issues than those before me based on the allegations of the amended complaint. First, *Brehm* articulates a standard for evaluating the demand requirement when the challenged board decision was based on expert opinion. *Id.* The improprieties alleged in the amended complaint encompass issues of both the price paid and the process utilized for evaluation and negotiation of the deal. Elements of the allegations raise issues related to the board's reliance on the Houlihan valuation, but other alleged improprieties cannot be attributed to reliance on the report. Second, the Brehm test is directed toward a due care claim. *Id.* The amended complaint raises issues associated with the contemplation, valuation, negotiation, and approval of the CEI purchase that encompass breaches of both care and loyalty. Nonetheless, the analytical paradigm stated in *Brehm* is useful for application of the second prong of *Aronson* to Counts V and VI in this case, at least to the extent that the Defendants assert reliance on Houlihan's valuation when evaluating and approving the purchase of CEI.

opinion were fabricated and unfounded. Specifically, Houlihan was told that there had been a recent offer to purchase CEI for $20 million. The complaint alleges that this offer never occurred and was fabricated by Coulter and Wolosky (Coulter's attorney who handled the transaction). Also, the estimated costs of replacing CEI's services were provided by Lone Star management. Particularly, White told the board that he had a bid for the payroll services and the cost was substantial. The amended complaint alleges that there was no bid for payroll services and that White had failed to research the replacement costs at all. Finally, Houlihan's valuation was based on cash flow in excess of CEI's historical performance even though those revenues had been reduced by the recent loss of service agreements with KFC and Pizza Hut franchises (now owned by Coulter's ex-wife) and did not take into account the anticipated loss of the TENT service agreement. Houlihan did not request or receive any documentation to support any of these figures, nor did the special committee. The valuation report disclosed that it was based on unverified information.

Given the pervasive, complex, and overlapping business and personal relationships alleged among Coulter, White, and the special committee members, it is difficult to imagine that they would not have actual knowledge of CEI's loss of the KFC/Pizza Hut contracts or that they would not have anticipated the pending loss of the TENT contract, as well. At the very least, such knowledge would seem to be more readily accessible than it was avoidable among a group of individuals who had shared long years of an assortment of business and personal relationships that were specifically related to the businesses involved. With knowledge that CEI had lost and stood to lose important service agreements, it is hard to understand how the special committee could have in good faith accepted earnings projections in excess of historical performance, particularly with no explanation or documentation provided either to the committee or to the investment bankers.

Although, I believe that the foregoing analysis provides a sufficient basis for excusing demand on Counts V and VI, I now turn to aspects of the CEI purchase that raise wider issues of the operation of the special committee and the process by which the CEI transaction took place—issues that neither implicate the validity or quality of the Houlihan valuation of CEI nor the committee's rationality or good faith in relying on it.

Assuming the truth of the amended complaint's allegations, Lone Star purchased CEI from Coulter, Lone Star's Chairman, CEO, and primary shareholder. In addition to bargaining on behalf of his own company, CEI, Coulter evidently dominated Lone Star's side of the negotiations, as well. Moreover, although a special committee was formed to evaluate and approve the transaction, the amended complaint alleges particularized facts

that support the inference that the special committee abdicated its role to Coulter and those controlled by him. The mere approval by a special committee of a self-dealing transaction does not protect the decision from heightened judicial scrutiny or confirm, *ipso facto*, that business judgment was validly exercised.[37] Thus, when it appears that the disinterested directors deferred to an interested party in all decisions related to the transaction, demand is appropriately excused under the second prong of *Aronson* because there is a reasonable doubt whether the decision "was the product of considered business judgment of independent directors."[38]

CalPERS makes several factual assertions that indicate that the process implemented by the board and special committee to entertain, to evaluate, and, ultimately, to approve the acquisition of CEI was controlled at every stage by Coulter, obviously a fiduciary of Lone Star, and his associates. Although, he was not a member of the Lone Star special committee that approved the transaction, it is reasonable to infer from the allegations of the amended complaint that Coulter controlled the timing, price, and terms of the transaction. The transaction was pursued, the amended complaint alleges, because Coulter gave Lone Star an ultimatum—either purchase CEI from him or be subjected to a 25%-35% increase in the rates for CEI's services. Coulter was permitted to dictate the terms of the sale through his attorney, Wolosky, whose firm, Olshan, had also done work for Lone Star. Wolosky told the special committee that Lone Star did not need to hire outside counsel because his firm had already drafted the purchase agreement. The special committee accepted this recommendation and did not hire independent counsel to review the terms of the deal. Furthermore, the board or special committee delegated to White the task of negotiating the price with Coulter. White, as explained above, was not independent of Coulter and thus cannot be viewed as having negotiated with Coulter with the best interests of Lone Star as his motivation. As alleged, no "negotiation" took place. Coulter merely told White how much; White recommended that figure to the committee; and the committee, without any effort to review or to evaluate White's recommendation, approved the transaction. White was appointed to negotiate on Wednesday and the acquisition of CEI was approved the following Monday at a purchase price that was approximately $0.5-1.5 million (roughly 5-15%) more than the allegedly inflated Houlihan

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[37]"Entire fairness remains applicable even when an independent committee is utilized because the underlying factors which raise the specter of impropriety can never be completely eradicated and still require careful judicial scrutiny." *Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del.1997). *See* 8 *Del. C.* § 144.

[38]*Kahn v. Tremont Corp.*, 1994 Del. Ch. LEXIS 41, at *18 (Del. Ch.) (finding an independent basis, under the second prong of Aronson, for excusing Rule 23.1 demand).

valuation of the company. In sum, the amended complaint sufficiently alleges that Coulter controlled both sides of the Lone Star-CEI transaction and effectively dictated its terms, including price.

Accordingly, these allegations are sufficient to raise a reasonable doubt as to whether Lone Star's decision to purchase CEI was the "product of a valid exercise of business judgment" and provides an independent basis for excusing demand on Counts V and VI under the second prong of Aronson.

3. Counts That Are Dismissed and Those That Survive Defendants' Motion to Dismiss Under Rule

Defendants' motion to dismiss is granted for failure to comply with Rule 23.1 on the following derivative claims:

- Count IV, which alleges breach of fiduciary duties in relation to allegedly permitting Coulter to shirk his duties at Lone Star while preparing TENT for its IPO;[39]
- Count VII, which seeks to avoid as interested transactions all payments made to CEI under service contracts in 1997 and 1998;
- Count VIII, which alleges breach of fiduciary duty related to the same payments under the 1997 and 1998 CEI service agreements;
- Count X, which alleges that the amendment to Coulter's contract was a voidable interested transaction and waste,[40]
- Count XI, which claims that the amendment to Coulter's contract was a breach of fiduciary duty; and
- Count XII, which alleges that virtually all the actions complained of constituted a breach of fiduciary duty through a systematic and deliberate course of conduct.

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[39]To be precise, the demand requirement as to Count IV could be appropriately evaluated under *Rales v. Blasband*, 634 A.2d 927 (Del. 1993), because permitting Coulter's inattentiveness may not have been based on a "conscious decision of the directors to act or refrain from acting." *Id.* at 933. Thus, under *Rales*, it is appropriate to examine whether the board considering demand could do so based on the merits of the claim, without improper influences holding sway. *See id.* at 934. The outcome is unchanged. Because I find that at least three of five directors (Adams, Greene, and Chaney) would have been able to consider demand impartially, the claim is dismissed.

[40]Although CalPERS asserts that the amendment to Coulter's contract was waste because no benefit accrued to the company, there is an insufficient factual basis asserted for this premise. In the aggregate, the allegations in the amended complaint assert that Coulter received an increase in his compensation. That is not sufficient to support a claim of waste.

Thus, Counts IV, VII, VIII, X, XI, and XII are dismissed in their entirety. I also grant the motion to dismiss under Rule 23.1 in part as to Counts I and II, which are dismissed to the extent that they relate to the repricing of employees' options in 1997 and 1998.

Demand is excused on the following derivative claims:

- Count III, which seeks to have the repricing of directors' options declared void as *ultra vires* transactions;
- Count V, which alleges that the acquisition of CEI constituted a breach of fiduciary duty;
- Count VI, which seeks to avoid the purchase of CEI as an improperly ratified interested transaction; and
- Count IX, which alleges entrenchment.

Demand is partially excused on Counts I and II, to the extent that they relate to the repricing of outside directors' options in 1997 or 1999 or to the repricing of employees' options in 2000.

B. Failure to State a Claim

Defendants further argue that the surviving claims, the derivative claims of Counts I-III, V, VI, and IX, and the direct class claims[41] of Counts XIII, and XIV, should be dismissed pursuant to Court of Chancery Rule 12(b)(6) for failure to state a claim upon which relief my be granted. In considering a motion to dismiss under Court of Chancery Rule 12(b)(6), the Court must assume the truthfulness of all well-plead facts contained in the complaint and view those facts and all reasonable inferences drawn from them in the light most favorable to the plaintiff.[42] Conclusory allegations unsupported by facts contained in the complaint, however, will not be accepted as true.[43] Dismissal is appropriate under Court of Chancery Rule 12(b)(6) only where it appears with reasonable certainty that the plaintiff would not be entitled to the relief sought under any reasonable set of facts

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[41]Counts XIII and XIV challenge the existing director provisions in the golden parachute agreements as unlawful infringement of shareholders' voting rights (Count XIII) and as an unlawful classification of directors (Count XIV).

[42]*See, e.g.*, *Grobow v. Perot*, 539 A.2d 180, 187 (Del. 1988) (stating that "upon a motion to dismiss, only well-pleaded allegations of fact must be accepted as true" and that the 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").

[43]*E.g.*, *id.* (stating that "conclusionary allegations of fact or law not supported by allegations of specific fact may not be taken as true").

properly supported by the complaint.[44]

For the reasons discussed in relation to the demand requirement, I find that Counts I and II state claims for breaches of fiduciary duty based on allegations that the repricing of employees' options in 2000 was undertaken without the exercise of any business judgment; Counts V and VI state claims for breaches of fiduciary duty based on allegations that the purchase of CEI was an improperly supervised and ratified self-interested transaction; Count IX states a claim for breach of fiduciary duty based on allegations that the change of control agreements were adopted in response to a perceived threat to incumbent management and directors and for the purpose of entrenchment; and that Counts I and III state claims that the directors' options repricings were *ultra vires*. Defendants' motion as to these claims is denied.

The two direct claims, Counts XIII and XIV, allege that the adoption of the existing director provisions in the change of control agreements constituted a breach of fiduciary duty. CalPERS complains that these provisions unlawfully impede shareholder voting rights and that they create an illegal classification of directors. If activation of the change of control agreements is so burdensome as to have the effect of coercing shareholders to vote for incumbent directors or their designees, the provisions may be impermissible.[45] Before the contested provisions were fully adopted, the Lone Star board had become aware of the increased concerns of Lone Star's existing shareholders, such as CalPERS, about the management of the company, and it is a fair inference from the allegations of the Complaint

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[44]*E.g.*, *Rabkin v. Philip A. Hunt Chem. Corp.*, 498 A.2d 1099, 1104 (Del. 1985).

[45]In *Sutton Holding Corp.*, the Court noted:

> Provisions in corporate instruments that are intended principally to restrain or coerce the free exercise of the stockholder franchise are deeply suspect. The shareholder vote is the basis upon which an individual serving as a corporate director must rest his or her claim to legitimacy. Absent quite extraordinary circumstances, in my opinion, it constitutes a fundamental offense to the dignity of this corporate office for a director to use corporate power to seek to coerce shareholders in the exercise of the vote. It is not surprising that the attempt to do so should be made. As long as there have been elections there have been those who seek to gain unfair advantage in them (and those, who like some lawyers today, can suggest and guide that effort). But courts must remain sensitive to the risk and alert to act when they legitimately can to thwart it. Thus, I suppose (but cannot on this record hold) that adoption of this 1987 provision constituted a breach of the duty of loyalty that the members of the DeSoto board at that time owed to the company and its shareholders.

Sutton Holding Corp. v. DeSoto, Inc., 1991 Del. Ch. LEXIS 85, at *3-4 (Del. Ch.) (assuming for purposes of ruling on a motion for summary judgment that the adoption of change of control provisions in corporate pension plans amounted to a breach of the directors' duty of loyalty). *See also Carmody*, 723 A.2d 1180.

that a challenge from existing shareholders (as contrasted with an external third party takeover) was the motivating force behind the board's efforts. Whether these provisions in fact have the effect of hampering the ability of shareholders to replace the existing directors, due to the allegedly outrageous costs to which Lone Star would be subjected as a result,[46] can only be determined by weighing and evaluating the evidence presented by each party. Similarly, it is impossible to determine without the presentation of evidence whether the provisions have the effect of creating an illegal classification of directors—some directors having special status, power, or authority that is not shared by all directors. From the allegations in the amended complaint, it may be inferred that certain directors are empowered to designate authorized replacements, the election of whom would not trigger the change of control provisions, a power not shared equally by all directors. Therefore, dismissal of these claims is inappropriate. The motion is denied.

C. Time-Barred Claims

Defendants also assert that all claims related to actions taken before October 16, 1998 are time-barred either by a three-year statute of limitations or by laches. Because most of these claims have already been dismissed under Court of Chancery Rule 23.1, I need not address the time bar issue except as to the repricing of directors' options in August 1997. CalPERS asserts that any statute of limitations should be considered tolled on the basis of equitable tolling or fraudulent concealment or should be considered inapplicable as plaintiff seeks only what is essentially equitable relief. As to this transaction, equitable tolling and fraudulent concealment seem to be inapplicable. Still, it is not clear to the Court whether the directors' options repriced in 1997 were the same options repriced in 1999 and whether the repricings in 1997 and 1999 may constitute a single repricing program or merely two distinct "repricing" events.[47]

I am denying defendants' motion at this time, because the underlying facts are not sufficiently developed to permit a proper determination of whether the claim is time-barred. In addition, the Court notes that allowing the claim to survive does not place an undue burden on the parties because the only issue—whether the directors' option plan permits repricing—is the same for the 1997 repricing as for the 1999 repricing, which is not time-

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[46]The parties' estimates of the potential costs of these provisions differ greatly.

[47]For this reason, and only this reason, Thompson's time-bar defense fails at this time. Thompson's service to Lone Star, both as employee and director, had ended more than three years before commencement of this action.

barred.

D. Mootness

Defendants assert that certain of the options that were repriced either expired without being exercised or were cancelled in subsequent repricings. Although I agree that the validity of repriced options that ultimately expired without being exercised is a moot question, it is impossible for the Court to determine, absent further development of the record, whether this has, in fact, happened. In addition, the presentation of evidence is required to establish which subset of the repriced options in question would be affected. For this reason, defendants' motion to dismiss for mootness is denied.

E. Breach of Care Claims

Defendants assert that any claim for breach of the duty of care is precluded, pursuant to 8 *Del. C.* § 102(b)(7), by an exculpatory provision of Lone Star's Certificate of Incorporation. If any surviving claims were based *solely* upon breach of the duty of care and sought *solely* monetary damages, this argument might have merit.[48] All surviving breach of fiduciary duty claims may implicate the duty of loyalty for which the directors may not be afforded protection under § 102(b)(7), and, in several instances, the remedy sought is not limited to damages. Defendants' motion to dismiss any claims on the basis of an exculpatory provision in Lone Star's Certificate of Incorporation is denied.

VI. CONCLUSION

For the foregoing reasons, I grant Defendants' motions to dismiss as to Counts IV, VII, VIII, X, XI, and XII in their entirety for CalPERS' failure to comply with Court of Chancery Rule 23.1. These Counts are dismissed with prejudice pursuant to Court of Chancery Rule 15(aaa). I also grant Defendants' motions to dismiss as to Counts I and II to the extent these claims relate to the repricing of employees' options in 1997 and 1998 for

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[48] *See* 8 *Del. C.* § 102(b)(7) (stating that provisions in the certificate of incorporation may limit the liability of directors for money damages for breaches of fiduciary duties, but such provisions may not exculpate a director for the breach of the duty of "loyalty to the corporation or its stockholders"); *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001); *Malpiede v. Townson*, 780 A.2d 1075, 1095 (Del. 2001).

CalPERS' failure to comply with Court of Chancery Rule 23.1. Partial dismissal of Counts I and II is without prejudice. The motions to dismiss are denied as to Counts III, V, VI, IX, XIII, and XIV. The motions to dismiss as to Counts I and II are denied to the extent these claims relate to the repricing of employees' options in 2000 or to the repricing of directors' options.

IT IS SO ORDERED.

FLEETBOSTON FINANCIAL CORP. v. ADVANTA CORP.

No. 16,912-NC

Court of Chancery of the State of Delaware, New Castle

January 22, 2003

Arthur G. Connolly, III, Esquire, of Connolly, Bove, Lodge & Hutz LLP, Wilmington, Delaware; Peter J. Kahn, Esquire, Dennis M. Black, Esquire, and Brian J. Buckelew, Esquire, of Williams & Connolly, LLP, Washington, D.C., of counsel; John A. Houlihan, Esquire, Steven M. Cowley, Esquire, and Mary Patricia Cormier, Esquire, of Edwards & Angell, LLP, Boston, Massachusetts, of counsel; and David H. Angeli, Esquire, of Stoel Rives, LLP, Portland, Oregon, of counsel, for plaintiffs and counterclaim-defendants.

Todd Charles Schiltz, Esquire, of Wolf, Block, Schorr and Solis-Cohen LLP, Wilmington, Delaware; and Jay A. Dubow, Esquire, Matthew A. White, Esquire, Nathan E. Kase, Esquire, and Robyn D. Kotzker, Esquire, of Wolf, Block, Schorr and Solis-Cohen, LLP, Philadelphia, Pennsylvania, of counsel, for defendants and counterclaim-plaintiffs.

JACOBS, *Vice Chancellor*

This action, commenced on January 22, 1999 by Fleet National

Group, Inc. and certain affiliates (collectively, "Fleet")[1] against Advanta Corp. and certain of its affiliates (collectively, "Advanta"),[2] arises out of the February 1998 acquisition by Fleet of Advanta's $12.1 billion consumer credit card business. In its multi-count complaint, Fleet claimed that it was wrongfully caused to overpay for Advanta's credit card business, as a result of which Fleet seeks to recover approximately $141 million in-damages. In its answer, Advanta denied Fleet's allegations of wrongdoing and asserted counterclaims seeking damages of $101 million.

During the first two years of the lawsuit, two summary judgment motions were presented and decided. On January 5, 2000, this Court granted Fleet's motion, and dismissed Counts I and II of Advanta's counterclaim.[3] Thereafter, in an Opinion issued on October 11, 2001, the Court granted Fleet's motion for partial summary judgment on Count IX of its complaint, and Fleet's motion for summary judgment dismissing Counts III and IV, and a portion of Count VII, of Advanta's counterclaim.[4]

Thereafter, the matter was scheduled for trial. After the parties completed discovery and resolved certain claims and issues by stipulation, the claims and counterclaims remaining in dispute were tried from November 13 through December 12, 2001. This is the decision of the Court, following post-trial briefing, on the balance of the parties' claims and counterclaims.

I. FACTS COMMON TO ALL CLAIMS

What follows next are the facts that are common to all of the various claims and counterclaims. Because of the diversity and disconnectedness of the groupings of facts that underlie each claim, the facts will be discussed in the particular Analysis section that relates to that claim.

The transaction that gave rise to this lawsuit was the acquisition by Fleet of most of Advanta's consumer card credit business (the "Business") on February 20,1998. The terms of that transaction were defined by the October 28, 1997 Contribution Agreement entered into by Fleet and

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[1]The Fleet entities, which are the plaintiffs in this action, are Fleet National Group, Inc., Fleet National Bank, Fleet Bank (RI), National Association, Fleet Credit Card Services, LP, and Fleet Credit Card Holdings, Inc.

[2]The Advanta entities, which are the defendants in this action, are Advanta Corp., Advanta National Bank, Advanta Insurance Company, and Advanta Life Insurance Company.

[3]*Fleet National Group v. Advanta Corp.*, 2000 Del. Ch. LEXIS 4 (Del. Ch. Jan. 5, 2000) (Jacobs, V.C.).

[4]*Fleet National Group v. Advanta Corp.*, 2001 Del. Ch. LEXIS 125 (Del. Ch. Oct. 11, 2001) (Jacobs, V.C.)

Advanta.[5] Under that Agreement, the transaction was structured as a partnership to which the assets and liabilities of Advanta's credit card business were contributed. Fleet was to own a 95% interest in the partnership, with Advanta owning the remaining 5%. The consideration for those contributed assets was Fleet's assumption of contributed liabilities having a value which exceeded the value of the contributed assets by an amount equal to the "Agreed Deficit."

Under the Contribution Agreement, the Agreed Deficit was fixed as of February 20, 1998 and was defined by the following formula: (i) $5 10 million, plus (ii) a "Special Adjustment" of approximately $43 million, minus (or plus) (iii) an "Agreed Adjustment." The Agreed Adjustment would increase (or decrease) the Agreed Deficit by an amount that depended upon both the volume (amount) of "Managed Receivables," and the portion of Managed Receivables that were subject to promotional "Introductory [Interest] Rates."[6]

The effect of the Agreed Adjustment would be to increase the Agreed Deficit—meaning that Fleet would assume more liabilities, thereby paying more—if, at the Closing, the Managed Receivables were more than $12.1 billion, or if the level of Introductory Rate Balances was less than $2,192,520. Conversely, Fleet would assume fewer liabilities, thereby paying less, if the Managed Receivables were less than $12.1 billion or if the Introductory Rate Balances were less than $2,192,520. Essentially, the claims in this lawsuit concern one or more elements of the formula by which the transaction consideration Fleet paid (*i.e.*, the Agreed Deficit) was to be calculated.

II. THE REMAINING CLAIMS AND COUNTERCLAIMS

Three claims asserted by Fleet and two counterclaims asserted by Advanta remain to be decided. They are next summarized.

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[5]The Contribution Agreement was originally executed on October 28, 1997, and was amended on February 20, 1998. See PX 1. Unless otherwise stated, references to the "Contribution Agreement" are to the Contribution Agreement as amended.

[6]"Managed Receivables" and "Introductory Rate Balances" are terms that are defined in the Contribution Agreement.

A. Summary Of Fleet's Claims

1. The "Miscoding" Claim

Fleet's first claim is that Advanta concealed from Fleet that it had miscoded the interest rates on approximately $1 billion of new accounts receivable ("balance transfers" or "BTs") that Advanta had generated in October, November, and December of 1997 during an ambitious marketing campaign. The miscoding caused more than 500,000 accounts to accrue interest at significantly higher rates than Advanta had promised to the affected customers. Another effect of the miscoding, Fleet claims, was to understate by about $1 billion the amount of Advanta's Introductory Rate Balances as of February 20, 1998. Fleet contends that Advanta knew of the miscoding problem months before the February 20, 1998 Closing, yet did not disclose the known facts to Fleet, which discovered the problem two months after the Closing, in April 1998.

As a result of the miscoding errors, Fleet ultimately refunded to (former Advanta) customers approximately $42 million. Of that amount, Fleet seeks to recover $4.2 million in this lawsuit.[7] In addition, Fleet seeks to recover approximately $3.3 million it expended to remedy Advanta's miscoding errors. The sum of these amounts ($ 4.2 million plus $3.3 million = $7.5 million) plus prejudgment interest, represents the damages to which Fleet claims entitlement on alternative theories of misrepresentation, unjust enrichment, and breaches of the Contribution Agreement.

2. The Introductory Rate Balance Claim

Fleet's second claim is that at the Closing Advanta understated the level of Introductory Rate Balances by almost $1 billion, and that as a result Advanta overstated the Agreed Deficit, thereby causing Fleet to overpay for the consumer credit card business. At the Closing, Advanta presented an estimated Introductory Rate Balance level of $1.7 billion. Fleet claims that if properly computed, the Introductory Rate Balance level, which tracks the definition in the Contribution Agreement, should have been $2.67 billion. Fleet claims that the approximate $1 billion understatement of the Introductory Rate Balances caused Fleet to overpay for the consumer credit card business by $21,199, 200. Fleet seeks damages in that amount, plus prejudgment interest.

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[7]The $4.2 million that Fleet seeks to recover is the portion of the refunded $42 million of excess interest that had accrued as of February 28, 1998.

3. The "Relationship Management" Claim

Fleet's third claim is that Advanta violated certain covenants in the Contribution Agreement by engaging in an unprecedented "relationship management" campaign that increased credit card receivables at interest rates which were unprofitable and below Advanta's own cost of funds. Advanta did that, Fleet urges, to maximize the level of Managed Receivables—an important variable in the formula that would determine the consideration Fleet would pay. The result, Fleet argues, was to load up the acquired consumer credit card receivables portfolio with money-losing accounts. Fleet claims that it is entitled to damages of $7.6 million, plus prejudgment interest, on its claim that Advanta violated covenants in the Contribution Agreement to conduct marketing campaigns in the ordinary course and consistent with past practices.

Advanta vigorously contests all of these claims.

B. Summary of Advanta's Counterclaims

1. The "SmartMove Accounts" Counterclaim

Advanta's first counterclaim is for damages arising out of Fleet's refusal to accept Advanta's tender of certain "SmartMove" Accounts to Fleet on March 15, 1999. To elaborate, at the Closing, Advanta and Fleet executed Interim Servicing Agreements that obligated the parties to provide certain support services for each other through 1998, with each party invoicing the other for the services rendered. Typically, each party offset the other party's invoices against the other amounts due.

The parties agree that as a result of their mutual offsets, a balance is due to Fleet. The parties dispute the precise amount of that balance, however. One of Fleet's interim obligations was to service certain Advanta "Qualified SmartMove Accounts" and then remit the collections to Advanta. That obligation would terminate when Fleet accepted Advanta's valid tender of those accounts to it. The sole question is on what date were the SmartMove Accounts effectively tendered. If the effective tender date was March 15, 1999, as Advanta contends, then Advanta owes Fleet $1.63 million on this claim. If, however, the effective tender date was May 10, 1999, as Fleet contends, then Advanta owes Fleet $1.7 million. Advanta seeks damages on its counterclaim for whichever of these amounts the Court determines is proper, plus prejudgment interest.

2. The "Improper Solicitation" Counterclaim

Advanta's second counterclaim is for damages claimed to have resulted from an erroneous solicitation, by Fleet in September 1998, of Advanta's business card customers. The solicitation was concededly improper because Fleet had acquired only Advanta's personal—and not its business—credit card portfolio. Advanta contends that it was damaged in the amount of $3,612,303—an amount it claims represents the costs of communicating with the improperly solicited customers to mitigate the harm, plus the other damages caused by the attrition of Advanta's customer base. Advanta claims damages in that amount, plus prejudgment interest, based on its claim that Fleet tortiously interfered with Advanta's business cardholders. Not surprisingly, Fleet ardently disputes these counterclaims as well.

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The Court next considers and decides the parties' claims and counterclaims. Fleet's claims are addressed in Part III, *infra*, of this Opinion. Advanta's counterclaims are addressed in Part IV. Finally, in Part V, the Court discusses the matter of prejudgment interest.

III. ANALYSIS OF FLEET'S CLAIMS

A. The Miscoding Claim

1. Pertinent Facts And Contentions

During the Fall of 1997, Advanta embarked upon an ambitious marketing campaign designed to attract new balance transfers. That campaign involved offering prospective credit card customers promotional interest rates for a fixed period of time. A series of computer miscoding errors, however, caused over $1.1 billion of new balance transfers to be charged higher interest rates than the promotional interest rates Advanta had promised. Although Advanta made assiduous efforts to fix the problem, it failed to accomplish that by the February 20, 1998 Closing. Of equal importance, Advanta did not disclose the miscoding problem to Fleet, and, as a result, Fleet did not learn of it until April 1998—two months after the Closing.

Immediately after learning of the miscoding, problem, Fleet's CEO directed that intensive efforts be undertaken to remedy the miscoding errors, and to refund the excess interest to its new customers, as soon as

possible. Despite Fleet's best efforts, it took six months, until October 1998, to resolve the miscoding problem. Ultimately, Advanta's miscoding errors were found to have affected 549,971 (formerly Advanta) customer accounts and resulted in Fleet refunding $41,820,842 of excess interest to those new customers. Fleet seeks to recover $4.2 million of that amount, which it claims was the accrued excess interest liability up to February 28, 1998. Fleet also claims that it also incurred $3.3 million of incremental costs to correct the miscoding errors and to refund the excess interest. The sum of those two amounts—$7.5 million—is the total recovery that Fleet seeks on this claim.

Fleet bases its claim upon alternative contract and tort theories, as well as a theory of unjust enrichment.[8] Fleet contends that Advanta breached two provisions of the Contribution Agreement: *first*, § 6.07(a)(v), which obligated Advanta to provide "prompt notice to Fleet" upon the occurrence of any "Material Adverse Effect" occurring between October 28, 1997 and the Closing; and *second*, § 1.06(f) of the First Amendment to the Contribution Agreement, which obligated Advanta to provide Fleet with an accurate Closing Balance Sheet of the Business as of the date required for its submission. Fleet contends that these provisions were breached, because (i) the miscoding problem was a Material Adverse Effect of which Advanta was required to give Fleet prompt notice, and (ii) the Closing Balance Sheet was inaccurate because it did not reflect the excess interest liability caused by the miscoding problem.

Fleet first claims that Advanta's failure to disclose the miscoding problem and its economic impact were material misrepresentations and omissions that are actionable in tort. Fleet contends that Advanta is liable under the doctrine that, even without an affirmative misrepresentation, an omission to disclose a material fact is actionable in tort.

Specifically, Fleet claims that Advanta is liable for concealing from Fleet its knowledge that (i) there were significant miscoding errors that, by February 28, 1998, had affected over 11% of the acquired Business's Managed Receivables, and (ii) those errors had not been resolved, and (iii) as a result, new balance transfers would continue to be erroneously processed. Fleet argues that the evidence shows that Advanta

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[8]Although Fleet invokes unjust enrichment as an alternative theory of recovery, that claim necessarily depends upon Fleet succeeding on its contract or tort claims. Fleet's claim is that Advanta was "unjustly enriched" by retaining the $4.2 million of excess interest, plus the additional amounts required to fix the problem (claimed to total $3.5 million). But, for Advanta's retention of those amounts to be "unjust," the retention would have to be illegal. Because Fleet's unjust enrichment claim rests upon the validity of its contract and tort claims, the unjust enrichment theory adds nothing independent to the analysis, for which reason that theory will not be further addressed in this Opinion.

intentionally—or alternatively and in any event, negligently—concealed those facts.

Fleet also contends that Advanta is contractually liable for having affirmatively misrepresented material facts in breach of Sections 4.03(b) and 8.03(b) of the Contribution Agreement. In § 4.03(b), Advanta represented and warranted that "no event has occurred or fact or circumstance arisen that, individually or taken together with all other facts, circumstances, and events, has had, or is reasonably likely to have a Material Adverse Effect upon the acquired Business.[9] Section 8.03(b) required that the above representation "shall be true and correct . . . on and as of the Closing Date [February 20,1998], with the same effect as though [it] had been made on and as of the Closing Date . . . ."[10] Fleet further claims that Advanta overstated the value of the contributed assets on the Closing Balance Sheet by not disclosing its liability to refund $4.2 million of excess interest that, as of the Closing date, had accrued because of the miscoding.

Advanta does not dispute that the miscoding error occurred, or its magnitude. What Advanta argues is that it did not how that the problem was extensive. Only later did it learn the true dimension of the problem. Indeed, Advanta argues, as of the Closing, all it knew was that the problem was of the $80,000 to $100,000 order of magnitude—an immaterial amount given the $12 billion value of the credit card business being acquired. Therefore, Advanta argues (i) it could not conceal from Fleet facts that it did not know and (ii) Advanta's management did disclose to Fleet what it knew in a Monthly Business Review delivered to Fleet before the Closing.

That factual contention is the underpinning of Advanta's defense. Specifically, Advanta argues that it made no intentional misrepresentation, because it did not misstate any facts of which it was aware as of the Closing. To prove actionable misrepresentation, Advanta says, Fleet was required to (but did not) show that Advanta made false statements of material fact with knowledge or reckless disregard of the falsity. Second, Advanta made no negligent misrepresentations, because Advanta disclosed to Fleet all the facts that its management knew before the Closing.

Advanta further argues that Fleet's tort theories of misrepresentation, and one of Fleet's breach of contract theories, must fail, because §§ 4.02 and 8.03 of the Contribution Agreement require that misdisclosed (or nondisclosed) facts rise to the level of a "Material Adverse Event." Advanta contends that Fleet has not shown that the miscoding problem was

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[9]PX 1 at A-03130.
[10]*Id.* at A-03163.

a Material Adverse Event.[11] Of equal demerit, Advanta insists, are Fleet's remaining tort and breach of contract claims. The reason is that those claims-rest upon the proposition that Advanta did not submit an accurate Closing Balance Sheet-a proposition that fails because Advanta's public accounting firm, Arthur Andersen & Co. ("Andersen"), determined not to adjust the Closing Balance Sheet for the excess interest liability which (Andersen had found) was "immaterial and subjective" for accounting purposes.

Advanta also raises three affirmative defenses. First, it argues that Fleet is barred from recovering in tort for misrepresentation because under Pennsylvania's "economic loss doctrine" a party cannot recover for purely economic losses that flow from a contractual relationship.[12] Second Advanta contends that Fleet's claims are barred under $4.20 of the Contribution Agreement, which provides that (i) except for Advanta's explicit representations and warranties, Advanta makes no further representations or warranties regarding the contributed assets, and that (ii) those assets are to be accepted "AS IS . . . without any representation or warranty whatsoever."[13] Because Fleet has not established a breach of any contractual representation or warranty, Fleet is bound by that clause.

Advanta's third affirmative defense is that under § 1.01 of the Contribution Agreement, Fleet assumed all liabilities on Schedule 2. That Schedule included "[a]ll liabilities resulting from or arising out of the Company Contributed Assets . . . to the extent such liabilities arose from the operations of the Business in the ordinary course in a manner substantially similar to the operation of a credit card business by one or more of the 20 largest credit card issuers in the United States."[14] That precludes a recovery, Advanta insists, because the miscoding errors arose out of Advanta's "ordinary course of business" and because at any large

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[11]"Material Adverse Effect" is defined in § 2.01(DDD) of the Contribution Agreement as including any effect that "is material and adverse to the assets, liabilities, financial position, business or results of operations of the Business, taken as a whole . . . ." PX1 at 03125. Advanta contends that the miscoding problem, while constituting an "adverse" effect upon the financial position of the Business, was certainly not "material" in any dollar sense, even accepting Fleet's position that as of February 20,1998 the excess interest liability was $4.2 million. Nor, urges Advanta, was the miscoding problem a Material Adverse Effect in any legal sense because it was not an effect that would be "consequential to the company's earnings power over a commercially reasonable period, which . . . would be measured in years rather than months." Advanta Post-Trial Br. at 24 (citing *In Re IBP S'holders Litig.*, 2001 WL 675330, at *42, (Del. Ch. June 18, 2001) (Strine, V.C.)). Advanta emphasizes that the problem, once discovered by Fleet, was fixed in six months.

[12]Both sides appear to agree that Pennsylvania law governs Fleet's tort and contract claims, although the parties also cite Delaware case authority in support of their positions.

[13]PX1, § 4.20 at A-03140-41 (capitals in original).

[14]PX1, Schedule 2 at A-03522.

credit card company programming errors like these do happen.

Finally, Advanta urges that, even if Fleet is found to have established its entitlement to recover for the miscoding errors, Fleet failed to prove the damages it claims to have suffered. According to Advanta, Fleet's claim for $4.2 million in excess interest is infirm because it rests upon a witness's flawed estimate of the amount that was overbilled as of February 28, 1998, rather than upon proof of what Fleet actually refunded on Advanta's behalf. Also, $2.3 million of the $4.2 million is claimed to represent amounts that were billed *after* February 28, 1998 by Fleet, not Advanta. Lastly, Fleet's damages estimate is undercut by an internal memorandum by a senior Fleet executive which shows that Fleet over-rebated $4.5 million.[15]

Advanta also attacks Fleet's claim for the $3.3 million in incremental costs incurred to fix the miscoding problem. The basis for the attack is that, except for $226,000 paid to First Data Resources ("FDR"), a credit card processor, none of the $3.3 million represents an identifiable incremental, out-of-pocket cost that Fleet actually incurred. According to Advanta, Fleet hired no extra persons to handle the problem, acquired no new facilities or equipment, nor incurred any additional telephone costs. Rather, Fleet retained the same level of staff and infrastructure and paid the same salaries. For these reasons, Advanta concludes, the claim for $3.3 million of incremental costs fails for lack of proof.

In the Discussion that follows, only two of these claims, and the defenses relating thereto, are considered, because to address all the claims would unnecessarily protract this lengthy Opinion. As explained more fully *infra*, the Court concludes that Advanta's failure to disclose the facts relating to the miscoding problem at or before the Closing constituted violations of Advanta's duties under contract and tort law, specifically, (i) Advanta's obligation under § 1.06(f) of the First Amendment to the Contribution Agreement to provide to Fleet an accurate Closing Balance Sheet and (ii) Advanta's duty under tort law to exercise due care to disclose facts material to the subject matter of the contract. The Court also finds that none of Advanta's affirmative defenses bars Fleet from recovering against Advanta for those violations.

2. Discussion

a. *The Facts That Advanta Knew And Disclosed To Fleet*

Before turning to the specific liability issues that flow from

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[15]Advanta is referring to PX 146.

Advanta's nondisclosure of the facts relevant to the miscoding, the Court must first determine what facts Advanta knew, and what facts it disclosed to Fleet, as of the Closing. As noted, Advanta claims that although it knew there was a miscoding problem it was unaware of that problem's full scope or dollar magnitude. Advanta insists that at the time of the Closing, all it knew was that the miscoding problem was of the $80,000 to $100,000 order of magnitude—insignificant in a $12 billion transaction. Advanta also claims that the problem was 80% fixed, and was on its way to being fully resolved. Lastly, Advanta contends that all the facts that it knew were disclosed to Fleet before the Closing. The evidence, however, discredits these contentions.

The evidence shows that, by January 1998, Advanta recognized that it faced "a significant breakdown in a process that was critical to the business."[16] In November and December 1997, customer service call volumes were significantly "over forecast primarily due to unexpected balance transfer errors and general acquisition related inquiries."[17] By December 1997, Advanta's Settlement Group knew that the miscoding problem affected at least $10 million in balances. At a meeting of a special Advanta task force convened on December 17, 1997 to deal with balance transfer problems, the miscoding problem was viewed by one of the participants as "a very highly visible issue" about which there was "a high level of awareness or a high level of sense of importance in getting these issues resolved."[18] As of January 27, 1998, Advanta personnel were reporting that 15,000 accounts had been affected (an estimate that continued to grow), that 500 hours would be required just to make the necessary adjustments to those accounts, and that no systematic "fix" had yet been found.[19]

Although there is some indication that Advanta personnel initially viewed the miscoding problem as "80% fixed," by January 16, 1998 they had concluded that their initial assessment was incorrect, and that the actual percentage of "fixed" accounts would be much less than 80%.[20] Indeed, as the end of January 1998 drew near—only weeks before the Closing—Advanta's customer service group recognized that the problem was not close to being fixed and that "another negative period [was] on the horizon as we deal with customer issues around the BT process problems."[21]

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[16]Trial Tr. at 823.
[17]DX 55 at 2486-87.
[18]Trial Tr. at 754, 855.
[19]PX 61 at 38641; Trial Tr. at 790.
[20]Trial Tr. at 779-782.
[21]PX 61 at 38641-42.

Thus, by the time of the Closing, Advanta personnel knew—and its senior management ought to have known—that on the eve of the sale of its consumer credit card business to Fleet Advanta was experiencing a serious miscoding problem. That problem would only become worse, because as Advanta personnel recognized, there would be "a big stream of post acquisition BT activity."[22] The gravity of the problem is underscored by the fact that as by February 28, 1998, Advanta's miscoding errors had affected 549,971 accounts valued at $1.134 billion—approximately 11% of the value of the Business being acquired.

In its Post-Trial Brief, Advanta contends that it "disclosed [to Fleet] what information it had,"[23] but the record shows otherwise. The disclosure upon which Advanta relies did not occur in any direct communication from senior Advanta officials alerting their counterparts at Fleet to the specific problem. Rather, whatever disclosure was made to Fleet was indirect and oblique. The disclosure is found on pages 12 and 13 of the 15-page Monthly Business Review for December 1997.[24] That document, Advanta says, "clearly explain[ed]" the problem and "disclosed customer service issues and balance transfer errors."[25] In fact, those pages reveal nothing that would alert a reasonably intelligent reader to the existence, nature, or scope of the miscoding problem. At the trial, William Rosoff, Advanta's President and Vice Chairman, admitted that that document was insufficient to put Fleet on notice of the existence of a serious balance transfer problem.[26]

In short, Advanta did not disclose to Fleet either at or before the Closing the known facts about the serious miscoding problem of which Advanta's own personnel were aware and for which no systemic fix was on the horizon.[27] The issue, therefore, is whether Advanta is liable to Fleet for

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[22]PX 432.

[23]Advanta Op. Post-Trial Br. at 2.

[24]DX 55.

[25]Advanta Op. Post-Trial Br. at 13.

[26]Trial Tr. at 1442-1443.

[27]In their briefs, the parties devote much discussion to the issue of whether Advanta knowingly or intentionally concealed this information from Fleet. If, in fact, Advanta intentionally concealed this information, such conduct would have amounted to deception, and, quite possibly, fraud. Fleet assiduously argues that Advanta's concealment of the known facts was intentional because the facts were known to Advanta personnel below the senior management level and because senior management was made aware of the efforts to correct the problem. As the proponent of that claim, Fleet has the burden of proof. And while there is evidence from which it can be inferred that Advanta intentionally concealed the known facts from Fleet, Advanta senior management testified that, to their knowledge, the miscoding problem was not one of significant magnitude. Although that testimony is to a degree self-serving, there is no evidence that negates the possibility that Advanta's lower echelon management failed to communicate the gravity of the problem to senior management. Such a

not disclosing the known facts that related to the miscoding problem. For the reasons now discussed, the answer to that question is "yes."

b. *The Bases For Advanta 's Liability To Fleet*

(i) Section 1.06(f) of the Contribution Agreement

Fleet contends, and Advanta concedes, that § 1.06(f) of the Contribution Agreement required Advanta to provide Fleet with an accurate Closing Balance Sheet of the Business as of February 28, 1998.[28] It is undisputed that Advanta did not disclose to Fleet the existence or extent of Advanta's liability to refund to its customers the "excess interest" resulting from the miscoded balance transfers. The inevitable result of that nondisclosure was that Advanta overstated on the Closing Balance Sheet the value of the assets it was transferring. In that respect, Advanta violated § 1.06(f) of the Contribution Agreement. Advanta denies that its nondisclosure of the excess interest liability constituted a breach of § 1.06(f), because Advanta did not "knowingly" fail to disclose the miscoding-caused interest accrual on the Closing Balance Sheet. Moreover, Advanta asserts that as an accounting matter, the "[interest accrual] adjustments were properly 'passed'" because "Arthur Andersen [Advanta's outside auditor] had concluded that the amounts were immaterial and 'subjective.'"[29]

Advanta's argument is flawed for several reasons. First, the duty imposed on Advanta by § 1.06(f) to provide an accurate Closing Balance Sheet is unqualified and unconditional. No language in that provision limits the universe of culpable misstatements to those that are "knowing" (as Advanta implicitly suggests), or carves out from its coverage misstatements or omissions that are "unknowing." Hence, Advanta's argument that it committed no breach because its overstatement of assets was "unknowing" is not a defense.

Equally unpersuasive is Advanta's argument that its accounting firm, Andersen, approved the noninclusion of the accrued excess interest

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breakdown in communication would explain why the known facts relating to the miscoding problem were not communicated to Fleet, since one must assume that a communication of such gravity would be by senior management. The end result is that, on the issue of whether Advanta's nondisclosure of the known facts was intentional, the evidence is in equipoise. I therefore am unable to conclude that Advanta's nondisclosure of the known facts was intentional, but I do conclude, elsewhere in this Opinion, that it was the product of negligence.

[28]PX 3 at A-03636 (First Amendment § 1.06(f)); Fleet Post-Trial Reply Br. at 14; Advanta Revised Op. Post-Trial Br. at 28.

[29]Advanta Op. Post-Trial Br. at 28.

adjustment on the Closing Balance Sheet because that adjustment was "immaterial and subjective." On the contrary, the evidence relating to this defense establishes that Anderson believed an adjustment should be made, and that the propriety of its non-inclusion has not been established to the Court's satisfaction.

The only documentary support for Advanta's position is found in a note in Andersen's workpapers, prepared on January 30, 1999, which says "Subjective amount—disclose in footnotes."[30] Eighteen days later, however, Andersen's Marc Williamson drafted a detailed memorandum entitled "Interest Rate Rebate Analysis," wherein Williamson proposed a $3.7 million adjustment "to reduce the interest overaccrued as a result of a BT program which transferred balances at 13.99% as opposed to the correct amount offered to customers of 3.99%."[31] Similarly, on February 10, 1999—eleven days after Andersen's workpapers were prepared—David Weinstock, an Advanta financial officer, circulated to Elizabeth Mai, Advanta's General Counsel, and to Phil Browne, another Advanta financial officer, an updated draft Closing Balance Sheet that incorporated the $3.7 million adjustment.[32] Mr. Browne reviewed and signed off on the draft Closing Balance Sheet, including the page that disclosed the $3.7 million adjustment.[33] Despite that, Advanta did not make the adjustment on any of the Closing Balance Sheets that it presented to Fleet, nor did it even disclose the problem in a footnote as the Andersen workpapers had proposed.

According to John Lafferty, the Andersen partner with overall responsibility for Advanta's Closing Balance Sheet audit, the adjustment was not made because it was immaterial from a GAAP perspective when netted against all of the other proposed adjustments that Advanta did not include on the Closing Balance Sheet.[34] Even if that were appropriate as an accounting matter, as a legal matter that did not excuse Advanta from complying with its disclosure obligation under § 1.06(f) in these circumstances. Given the gravity of the miscoding problem, Advanta cannot hide behind that accounting judgment without demonstrating the reasonableness of that judgment. Advanta has made no effort to do that, and the evidence of record shows that the judgment not to disclose the existence of the miscoding problem in some meaningful form was

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[30]PX 80 at A-01857.

[31]PX 279. Mr. Williamson did not suggest that the amount was "subjective," or that Andersen required additional detail from Fleet, as Advanta suggests in its brief. *See* Advanta Post-Trial Br. at 25.

[32]*See* PX 275 at 5685, 5694; Trial Tr. at 2001-2002.

[33]*Id.*

[34]Lafferty Dep. (9/8/2000) at 305-307.

unreasonable.

As earlier discussed, even Advanta's own accounting personnel believed that the adjustment should be made. Mr. Lafferty testified that Andersen "most definitely" thought that the adjustment had been made and posted it to a "proposed adjustment" sheet.[35] John Calamari, Advanta's then Chief Accountant, similarly recalled that Andersen believed the adjustment was appropriate.[36] But the adjustment was not made, and the only reason proffered is that Anderson thought it was not material, but Advanta offers no explanation of why. On what basis was it reasonable to exclude from the Closing Balance Sheet an adjustment that all the relevant players at Advanta and Anderson believed was appropriate? And if the adjustment was to be excluded from the Closing Balance Sheet, then why was it reasonable not to make, at a minimum, full disclosure in a footnote of the miscoding problem and the proposed adjustment it might require? Advanta makes no effort to address these questions. In these circumstances the Court cannot, therefore, accept Advanta's defense that the Closing Balance Sheet adjustment was properly excluded as immaterial.

Next, Advanta contends that even if it is found to have breached § 1.06(f) of the Contribution Agreement, it is protected from liability by two other provisions of that Agreement. The first is the "as is" clause, which appears in § 4.20 of the Contribution Agreement. Article IV of that Agreement sets forth the express representations and warranties Advanta made to Fleet concerning its consumer credit card business, and then provides that no other representations or warranties were being made:

> Except as otherwise set forth in this Agreement, the Company Contributed Assets to be contributed and transferred hereunder are to be contributed and transferred and are to be accepted by the LLC in an "AS IS" condition, without any representation or warranty whatsoever. EXCEPT AS OTHERWISE SET FORTH IN THIS AGREEMENT, THE COMPANY MAKES NO REPRESENTATION OR WARRANTY WHATSOEVER, EXPRESS OR IMPLIED, AS TO THE COMPANY CONTRIBUTED ASSETS . . . .[37]

Advanta contends that because it made no express representations or warranties relating to the miscoding issue, Fleet was contractually obligated to receive the assets of the Business "as is," and assumed the financial

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[35]Lafferty Dep. (9/8/2000) at 305-506.

[36]Calamari Dep. (1 1/8/2000) at 134-135.

[37]PX 1, § 4.20 at A-3140-41 (capitals in original).

responsibility to remedy any infirmities in those assets, including the miscoding problem. The difficulty with that argument is that, under Pennsylvania law, an "as is" clause covers only defects that were unknown at the time the contract was executed.[38] "As is" clauses do not insulate sellers from liability for failing to disclose known defects, as Advanta did here.

Advanta's second affirmative defense is that under § 1.01 of the Contribution Agreement, Fleet assumed all of the Liabilities on Schedule 2 (the "Company Transferred Liabilities"), which include:

> (B) All liabilities resulting from or arising out of the Company Contributed Assets prior to the Closing Date to the extent such liabilities arose from the Operations of the Business in the ordinary course in a manner substantially similar to the operation of a credit card business by one or more of the 20 largest credit card issuers in the United States.

This provision applies, Advanta claims, because the miscoding errors arose from the operation of Advanta's consumer credit card business in the ordinary course and because "the record shows that computer programming errors are known to happen at other large credit card companies—including Fleet."[39]

This argument is flawed, because although the miscoding error arose in the "course" of Advanta's business, the errors were anything but "ordinary." According to Lorene Storm, a former FDR employee who is currently employed by Fleet, the recovery was "[m]uch, much larger" than anything she had encountered during her nine years at FDR. Indeed, Ms. Storm was unaware of any other recovery in which the dollars of affected balances amounted to even one percent of the issuer's total managed receivables.[40] Here, in contrast, as of February 20, 1998, the miscoding issue had infected more than 11% of the credit card company's receivables.[41] It was Advanta's burden to prove that miscoding errors of that massive magnitude were typical of "the operation of a credit card business by one or more of the 20 largest credit card issuers in the United States." Advanta fell woefully short of carrying that burden.

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[38] *PBS Coals, Inc. v. Burnham Coal Co.*, 558 A.2d 562, 564 (Pa. Super. 1989).

[39] Advanta Post-Trial Br. at 32.

[40] Trial Tr. at 665.

[41] As of February 28, 1998, Advanta had $11.839 billion of total managed receivables, of which the mispriced balance transfers accounted for more than $1.34 billion. Tr. 1076-77, 1099-1101.

(ii) Negligent Misrepresentation

Advanta's nondisclosure of the known facts relating to the miscoding problem also renders it liable in tort. As previously found, Advanta personnel below the senior management level were aware of material facts that were not disclosed to Fleet.[42] Even if senior management were not aware of all the known facts (perhaps because no mechanism was in place to assure that the facts would be communicated to them), that information was so highly important that senior management "ought to have known" of it.[43] Advanta interposes two doctrinal defenses to Fleet's negligent misrepresentation claim. The first is the "economic loss" doctrine, which under Pennsylvania law precludes parties from recovering, under theories of tort liability, purely economic losses that flow from a contractual relationship.[44] The second is Pennsylvania's "gist of the action" doctrine, which bars a claim in tort if the true nature or gist of the alleged wrong is breach of contract rather than tort.[45] The Court concludes that neither defense bars Fleet's tort claim.

With respect to the economic loss doctrine, the cases Advanta cites indicate that, where negligence claims are asserted, that doctrine is applied primarily in the products liability and construction law contexts.[46] No effort was made to justify extending that doctrine to these quite different circumstances. As for the "gist of the action" argument, Advanta urges that the doctrine applies because, but for the parties' contract, Advanta would owe no duty of any kind to Fleet in connection with the sale of Advanta's consumer credit card portfolio. But it does not necessarily follow from the fact that the parties entered into a contractual relationship, that as a result all tort duties are displaced.[47] If (hypothetically) § 1.06(f) had not required the disclosure of the liability caused by the miscoding, Advanta would still

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[42]Although the known facts relating to the miscoding problem were material, it does not necessarily follow that the miscoding problem constituted a Material Adverse Effect within the meaning of the Contribution Agreement. Because liability is predicated upon other grounds, it is unnecessary to reach that issue.

[43]*Bortz v. Noon*, 729 A.2d 555, 561 (Pa. 1999) ("The elements of negligent misrepresentation differ from intentional misrepresentation in that the misrepresentation must concern a material fact and the speaker need not know his or her words are untrue, but must have failed to make a reasonable investigation of the truth of these words.")

[44]*See Duquesne Light Co. v. Westinghouse Electric Corp.*, 66 F.3d 604, 618 (3d Cir. 1995).

[45]*See Redev. Auth. of Cambria v. Intern. Ins.*, 685 A.2d 581, 590 (Pa. Super. 1996); *see also Bohler-Uddeholm Am., Inc. v. Ellwood Group*, 247 F.3d 79, 104 n.11 (3d Cir. 2001).

[46]*Cambria*, 685 A.2d at 590, *Bohler-Uddeholm*, 247 F.3d at 104 n.11; *Palco Linings, Inc. v. Pavex, Inc.*, 755 F. Supp 1269, 1271-72 (M.D. Pa. 1990).

[47]*See Am. Guar. & Liab. Ins. Co. v. Fojanini*, 90 F. Supp. 2d 615, 622 (E.D. Pa. 2000); *Fox's Foods, Inc. v. Kmart Corp.*, 870 F. Supp. 599, 608-09 & n.11 (M.D. Pa. 1994).

have a duty arising in tort to disclose that information before Fleet closed on the transaction. For this reason, the misrepresentation was not rooted solely in the contract thereby rendering the gist of the action contractual.[48] Advanta's two doctrinal affirmative defenses are, therefore, rejected.

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Having concluded that Advanta is liable to Fleet for the costs of rectifying the miscoding error for which Advanta was responsible, I turn to Fleet's damages claim.

c. *Fleet's Damages*

As earlier noted, Fleet's $7.5 million damage claim has two components: (i) $4.2 million, representing the portion of the almost $42 million of excess interest, refunded by Fleet to former Advanta customers, that had accrued as of February 28, 1998, plus (ii) $3.5 million of out-of pocket expense (other than the interest refunds) that Fleet claims it incurred to rectify the miscoding problem. Advanta challenges both components. I find, for the reasons next discussed, that Advanta's criticisms lack merit.

The main thrust of Advanta's attack on Fleet's damages claim is that Fleet was unable to "proffer an exact amount" of the damages that it incurred as a result of Advanta's miscoding. But, under Pennsylvania law a plaintiff is not required to establish damages with exactitude; "reasonable certainty" is sufficient.[49]

Moreover, any uncertainty must be resolved against Advanta, because "[a] party who has, by his breach, forced the injured party to seek compensation in damages should not be allowed to profit from his breach where it is established that a significant loss has occurred."[50]

Advanta attacks Fleet's $4.2 million excess interest claim on the ground that it represents an estimate, as distinguished from an actual refund, of the excess interest caused by the miscoding error. Advanta contends that before Fleet can recover any monies from Advanta, it must prove that Advanta actually sent out a bill with too high an interest rate and that the customer actually paid that bill.[51] This argument ignores the

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[48]Where the misrepresentation are rooted in the agreement, however, a contract action will arise. *Werner Kammann Maschinenfabrik v. Max Levy Autograph, Inc.*, 2002 U.S. Dist. LEXIS 1460, at *21 (E.D. Pa. Jan. 31, 2002).

[49]*Exton Drive-In, Inc. v. Home Indem. Co.*, 261 A.2d 319, 324 (Pa. 1969); *see also Falcon Tankers, Inc. v. Litton Sys., Inc.*, 380 A.2d 569, 588 (Del. Super. 1977).

[50]*Restatement (Second) of Contracts* § 352, cmt. a (1981).

[51]Advanta Op. Post-Trial Br. at 15.

realities of the case and the nature of the harm caused by Advanta's conduct.

It is undisputed that because of the miscoding errors, interest higher than the promotional rate ("excess interest") had accrued on accounts that eventually totaled over $1 billion. When Fleet acquired the Business, it acquired and paid for a collection of asset and liability accounts. The asset accounts included cash, accounts receivable (including interest that had been billed but not received) and an "unbilled accrual" account, representing interest that had accrued but had not yet been billed. Whether or not the interest had been *billed* or *paid* as of February 28, did not matter because any credits for amounts that had *accrued* as of February 28 caused a reduction of the assets for which Fleet had paid. When Fleet later credited over-accrued interest erroneously charged to the customers, the offsetting accounting operated to reduce the value of the assets on Fleet's books. Whether the asset reduction was from a cash account, a receivable account or an unbilled accrual account does not matter because under any of these scenarios Fleet suffered the same economic harm.

Thus, Advanta's contention that the excess interest component of the damage claim can only be proved by amounts actually billed to, then paid by, and then refunded to, Advanta customers lacks merit. Of the total dollar amount of excess interest Fleet actually refunded, it was proper for Fleet to seek to recover that portion that had accrued up to February 28,1998.

It is undisputed that Fleet refunded $41,820,842 to Advanta's former customers. After that process was completed, Fleet asked David Mietlicki, a Fleet employee responsible for financial planning, forecasting, and financial analysis, to calculate that portion of the almost $42 million Fleet had paid on Advanta's behalf, which had accrued as of February 28, 1998. Mietlicki performed a series of analyses, as a result of which he concluded that between approximately $4.2 million and $8.7 million of excess interest had accrued to Advanta's benefit, up to February 28, 1998.[52] Fleet selected the lowest point in that range—$4.2 million—which represented only 10% of the total excess interest Fleet actually refunded, and only $5 million more than the $3.7 million Advanta's own accounting firm, Andersen, had calculated. Fleet has shown to the Court's satisfaction that $4.2 million represents Fleet's excess interest damages with the "reasonable certainty" required by Pennsylvania law.

Similarly deficient are Advanta's criticisms of Fleet's claim for $3.3 million of incremental costs that Fleet incurred to rectify the miscoding

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[52]Trial Tr. at 859-878; PX 360, PX 361.

problem. Most of that amount represents additional labor costs associated with handling the increased call and mail volume and the associated incremental telephone charges and mailing expense.[53] Also included in that amount was $226,512.50 that Fleet paid to FDR for FDR's services during the recovery effort.

Advanta contends that except for the $226,512.50, which was an identifiable incremental cost,[54] the balance of Fleet's claimed damage figure is not recoverable because it does not represent true incremental costs. Stated differently, Advanta argues that Fleet incurred no other incremental costs (including telephone costs) because it hired no extra persons nor added any new facilities to deal with the miscoding problem but, rather, kept the same staff levels (at the same salaries) and the same infrastructure.

Fleet's response is that, except for $131,000 of "QA/Support and Management" expense, the balance of its $3.3 million claim represents actual incremental costs. In particular, Fleet's claim for $1.45 million of telephone expense was an incremental cost based solely on the number of calls related specifically to the miscoding problem, the average duration of such calls, and the variable costs (6 cents per minute) that the telephone company actually charged Fleet for those calls.[55] Because those calls would not have been made but for Advanta's miscoding errors, and because they caused Fleet to pay actual out-of-pocket dollars, the Court agrees that the telephone expense was incremental.

As for the balance of the $3.3 million claim, Advanta has added no credible evidence which persuades the Court that those amounts do not represent incremental, out-of-pocket costs actually incurred to remedy the miscoding problem.

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In summary, Fleet has proved to the Court's satisfaction that it

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[53]Trial Tr. at 969-78, 987-89.

[54]Advanta also contests the $226,000 on the ground that it was paid after the Closing. The argument is frivolous because the issue is when the liability arose, not when it was paid, and in this case, the liability would have arisen before the Closing because the miscoding resulted from Advanta's operation of the Business before the Closing.

[55]Trial Tr. at 969-77. The evidence shows that the miscoding issue drastically increased the call volume in Fleet's customer service department for months following the Closing. From March to July of 1998, monthly average call volumes increased by approximately 85% from the previous year's monthly averages, and the average time to answer an incoming call increased more than eightfold. Trial Tr. at 947-951; PX 206 at 130212. Once the miscoding issue was resolved in the Fall of 1998, call volumes and related performance measures returned to their normal levels. Trial Tr. at 1036; PX 206 at 130212; PX 477.

incurred actual damages of $7,369,000[56] as a result of the miscoding problem. Therefore, a judgment in that amount will be entered against Advanta on Fleet's miscoding claim.

B. The Introductory Rate Balance Claim

1. The Nature Of The Dispute

At issue on Fleet's second claim is the correct level of Introductory Rate Balances (i.e., customer account balances on which interest accrued at below market or "introductory" rates) that Advanta transferred to Fleet at the February 20, 1998 Closing. This issue is important because the Introductory Rate Balance level affected the Agreed Deficit, which in turn was a critical component of the formula used to compute Fleet's purchase price for the Business.

At the Closing, Advanta presented an estimated Introductory Rate Balance level of $1.7 billion. It is now established, and Advanta concedes, that its initial estimate was too low by at least 25% because Advanta now contends that the true level was $2.14 billion. Fleet claims, however, that the correct Introductory Rate Balance level was $2.67 billion. Thus, on this issue the parties remain approximately one-half billion dollars apart.

Each party's position is supported by analyses prepared by witnesses who testified at the trial. The parties reach different conclusions, not because of their respective choices of methodology, but, rather, because of each party's approach to implementing its methodology. That is, although neither side quarrels with the other side's approach as a matter of theory, both sides criticizes each other's application of that theory to the data at hand.

Both sides agree that the resolution of the Introductory Rate Balance issue boils down to the question of which party's implementation is more reasonable. The starting point for analyzing that question is to summarize each side's methodology. That is done in Part B 2, *infra*. In Part B 3 the Court addresses Advanta's objections to the implementation of Fleet's approach, and in Part B 4 the Court considers and resolves Fleet's objections to the implementation of Advanta's approach. The starting point for both sides' analyses is the Contribution Agreement's definition of "Introductory Rate Balances," which is:

> consumer credit card receivables [I] accruing finance charges

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[56] $7,500,000 less the $131,000 of non-incremental "opportunity costs."

> at a special introductory annual percentage rate [2] offered to new credit card customers only at the time of the opening of a credit card account [3] for a limited period, referred to as an "introductory rate;" it [being] understood that the term Introductory Rate Balances does not include any portion of a credit card holder's balances (i) resulting from a cash advance and accruing interest at a cash advance rate; (ii) that no longer carry a special introductory rate as a result of a delinquency; or (iii) resulting from any other promotional campaign or relationship management activities.[57]

The definition thus contains three elements (reflected by the inserted bracketed numbers) and three exclusions (reflected by the lowercase Roman numerals in parentheses).

2. Summary Of The Parties' Methodologies For Determining The Introductory Rate Balance Level As Of February 20, 1998

a. *Fleet's Analytical Approach*

The analysis performed by Fleet's trial witness, John Matthewson, involved two steps. In Step 1, Matthewson determined the level of Introductory Rate Balance, as of February 20,1998, from the Advanta database. In Step 2, he determined (from the "miscoded BT file") the Introductory Rate Balances that were erroneously excluded from the February 20,1998 database because they had been miscoded. Under Matthewson's approach, the sum of the balances arrived at in Steps 1 and 2 equals the Introductory Rate Balances as of February 20, 1998.

(i) Step 1

To capture the three elements of the definition of Introductory Rate Balances as accurately as possible, Mattewson limited his analysis to balances that were "accruing finance charges at a special introductory percentage rate," by including only those balances that were accruing interest at an annual percentage rate (APR) below 10%.[58] To ensure that

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[57]PX 1 at A-0312, § 2.1 (tt) (bracketed numbers added).

[58]This limitation effectively excluded all balances accruing at the interest rate that would apply when the promotional period expired-the so-called "go to" rate-because there were no "go to" rates below 9.99% in the relevant marketing campaigns. Trial Tr. at 78.

the special introductory rate was one offered to "new credit card customers only at the time of the opening of a credit card account," Mathewson included only those accounts that had been opened during the twelve months immediately preceding February 20, 1998. To verify that the analysis covered only special introductory rates offered "for a limited period," Matthewson included only those accounts that had a promotional expiration date that had not expired by February 20, 1998.

Matthewson's analysis also gave effect to the three exclusions. First, to exclude balances "resulting from a cash advance and accruing interest at a cash advance rate," he subtracted out the cash balances of all relevant accounts. Second, by limiting his analysis to balances accruing interest below 10%, Matthewson eliminated those accounts that "no longer carr[ied] a special introductory rate as a result of delinquency," since delinquent accounts were charged a "penalty" interest rate of 21.9%.[59] Third, to avoid capturing balances "resulting from any other promotional campaign or relationship management activities," Matthewson included only those balances that had been transferred to an account within 90 days of the date the account was opened. According to Matthewson, that 90-day limitation excluded relationship management activity because no relationship management offers were made during that 90-day period.[60]

As shown by PX 434, a Powerpoint presentation of Fleet's analysis, Matthewson's Step 1 analysis reveals that as of February 20, 1998, $1.862 billion in balances (i) were accruing interest below 10%, (ii) for a limited period that would expire in the future, (iii) for accounts that were opened between February 1997 and February 20, 1998, (iv) after excluding balances transferred more than 90 days after the date the accounts were opened.[61]

That $1.862 billion figure did not, however, capture the entirety of the Introductory Rate Balances as of February 20, 1998 because Fleet's Step 1 analysis did not reflect the balance transfers that had been miscoded. To that extent, Fleet's Step 1 computation understated the correct level of Introductory Rate Balances. To account properly for the (nonincluded) miscoded balance transfers, Fleet performed a second step that is next described.

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[59]PX 434 at 27; *see also* Trial Tr. at 1090. PX 434 refers to a penalty-price rate of 21.99%, while the trial testimony refers to a 21.9% penalty-price rate. The difference here is unimportant to the point being made.

[60]Trial Tr. at 1091. Tellingly, Fleet's $1.8 billion figure is in the same ballpark as Advanta's original $1.7 billion estimate derived from the methodology Advanta employed at the Closing, but later abandoned during this litigation. PX 434 at 11; Trial Tr. at 1097-98; *compare* PX 71 *with* PX 434 at 11.

[61]Trial Tr. at 1097-98; PX 434 at 11.

(ii) Step 2

To determine the correct amount of miscoded Introductory Rate Balances, Fleet started with the miscoded BT file provided by FDR. From that file, Matthewson was able to identify some—but not all—of the miscoded Introductory Rate Balances as of February 20, 1998. Missing were two key information items that would have to come from other sources.

The first missing information item was a determination of whether an initially miscoded balance transfer had been "fixed." In other words, there was no acknowledgment of whether the interest rate had been reduced to the proper (introductory) level by the time of the Closing. If the balance transfer had been fixed, then that fixed balance had already been captured in Step 1 of Fleet's analysis. To avoid double counting, therefore, Fleet identified and then eliminated the fixed balance transfers from the miscoded BT file.

Second, although the miscoded BT file reflected the amount of the initial Balance transfer at the time the transfer was made, it did not reflect the amounts that the customer had "paid down" on that initial balance between the date of the balance transfer and the February 20, 1998 Closing. To avoid overstating the level of Introductory Rate Balances as of the Closing, it was necessary for Fleet to determine the level of pay-downs and make the appropriate adjustment.

Fleet corrected these potential overstatements of miscoded Introductory Rate Balance transfers as follows: First, Fleet subtracted from the miscoded BT file all balance transfers made after February 20, 1998. All told, Fleet identified approximately $208 million of post-February 20, 1998 balance transfers in the miscoded BT file.[62]

To determine what portion of the remaining $1.134 billion of miscoded BTs had been "fixed," Fleet then matched up the account numbers in the miscoded BT file to the account numbers in the analytical database. That enabled Fleet to determine what portion of the miscoded BTs (erroneously) resided in the Merchandise Balances and what portion was (erroneously) contained in the Promotional Balances.[63] Fleet

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[62]PX 434 at 14; Trial Tr. at 1102.

[63]A credit cardholder's account balances contain three separate components: (1) a Merchandise Balance, representing the amount of purchases made with the credit card; (2) a Cash Balance, representing the amount of "cash advances" made through the credit card; and (3) a Promotional Balance, representing the amount of balances transferred as a result of a promotional campaign. Each component has its own separate interest rate. Merchandise and Promotional Balances may, depending upon the circumstances, accrue interest at an introductory rate.

determined the interest rate at which the balances were accruing in the analytical database and discarded from the miscoded BT analysis all balances that the database showed were accruing interest at rates below 10%. By that process, Fleet eliminated $253 million of fixed miscoded BTs from the miscoded BT analysis.

Next, Fleet calculated the pay-down rate on the remaining balances. For Promotional Balances the process was simple, because the analytical database showed the exact remaining balance; specifically, that of the $620 million remaining in the Promotional Balances, $24 million had been paid down by February 20,1998. Fleet eliminated that $24 million from the miscoded BT analysis. For the Merchandise Balances, the process was more difficult because the miscoding problem had caused those balance transfers to be commingled erroneously with balances resulting from the cardholders' purchases. Because there was no way to separate out the account activity on the balance transfers from the other account activity, Fleet had to estimate the pay-down on the Merchandise Balances. Based on industry experience and other data, Fleet applied a 5% estimated monthly pay-down rate, yielding an estimated $21 million paid down on the miscoded BTs in the Merchandise Balances.

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As a result of its analysis in Step 2, Fleet computed a total of $835 million of miscoded Introductory Rate Balances as of the Closing. Adding that figure to the $1.832 billion of Introductory Rate Balances derived from the analysis in Step 1, Fleet arrived at a $2.668 billion total of Introductory Rate Balances as of the Closing. According to Fleet, that approximate $2.7 billion figure translates to damages of $21,199,200 resulting from Advanta's underestimate of the Introductory Rate Balances.[64]

b. *Advanta 's Analytical Approach*

Advanta contends that Fleet's methodology is flawed because it

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[64]Damages are calculated by plugging the correct figure into the Yield Adjustment formula in the Contribution Agreement. Based on that formula, the Yield Adjustment should have been ($2.668B - $2.1925B) x .0438 x .5, which equals $10,413,450 in Fleet's favor. But,because the parties closed their deal based on Advanta's $1.7 billion estimate of Introductory Rate Balances, the result was a Yield Adjustment of ($1.7B - $2.195B) x .0438 x .5, which equals $10,785,750 in Advanta's favor. Fleet's damages are the difference between what the Yield Adjustment should have been ($10,413,450 in Fleet's favor) and the Yield Adjustment figure upon which the parties closed ($10,785,750 in Advanta's favor). The difference is $21,199,200.

overstates the level of Introductory Rate Balances by approximately $500 million as of the Closing. Advanta claims that the correct level of Introductory Rate Balances was $2.14 billion. Advanta's methodology used to arrive at that figure (which it presented through the testimony of its witness, John Derham) differs in key respects from the methodology employed by Fleet.

In simplest terms, Advanta's approach starts with the "total pie" of balances to be classified, and then subtracts from that "total pie" the balances that cannot be Introductory Rate Balances. The amount remaining is equal to the total amount of Introductory Rate Balances. Specifically, Advanta started with a total receivables balance of $11.838 billion on February 20,1998 and then subtracted those portions that did not qualify as Introductory Rate Balances. The process of identifying the balances that were *not* Introductory Rate Balances required ten separate steps, which are next described.

(i) Steps 1 and 2

Steps 1 and 2 involved eliminating $7.378 billion in balances for accounts that were too old to have Introductory Rate Balances on February 20, 1998, and eliminating another $3 million in balances for accounts that were too new to have Introductory Rate Balances on that date.

(ii) Steps 3 and 4

In steps 3 and 4, Advanta eliminated all balances having introductory rates that expired before February 20, 1998 because beginning on February 20, those balances would be accruing interest at their non-introductory "go to" rate. To determine when the balances went "off intro," Advanta first looked for introductory expiration dates in the database, where available. Excluded were balances on the database having introductory rates that would expire before February 20, 1998. The problem was that of the approximately 900,000 accounts on the database, roughly half showed no expiration dates. For those balances that showed no expiration date, Advanta identified the "job number," the "system code," or both numbers for those accounts, to determine if they showed introductory rates expiring before February 20, 1998. If they did, those balances were excluded. Steps 3 and 4 resulted in the elimination of $1.766 billion of balances from contention as Introductory Rate Balances.