such third party." These holdings have read the plain words of the Assumability Exceptions as representing a congressional intent to respect the contract rights of parties when applicable law provides that the parties do not have to accept substitute performance from a third-party without their consent. Notably, the United States Court of Appeals for the Third Circuit and the federal Bankruptcy Court in Delaware adhere to this literal approach.

A law professor could fruitfully spend the next year or so examining the implications that the Bankruptcy Code has on ipso facto clauses in alternative entity agreements. As a state trial judge with many cases to decide, I do not have all year to peer through the muck in search of what will at most be a debatable answer. Rather, I must decide promptly whether the clear law of my state is preempted by federal law.

Although state trial judges are duty-bound to respect the supremacy of federal law within its expansive sphere and to respect congressional decisions to preempt our law, we are not duty-bound to go out of our way to look for reasons to preempt our own state's law. Nonetheless, the question of whether the Bankruptcy Code preempts the application of the Ipso Facto Clause in the LLC Agreement requires this court to apply with fidelity the preemption principles articulated by the federal courts. Fortunately, the federal courts have been restrained about finding that the Bankruptcy Code's terms preempt state law provisions generally governing the property rights of bankrupt debtors. Although Congress clearly has the power to establish uniform bankruptcy laws throughout the United States, "Congress has [also] generally left the determination of property rights in the assets of a bankrupt's estate to state law." Therefore, in examining whether the Bankruptcy Code preempts state law, the United States Court of Appeals for the Third Circuit has held that the "usual rule is that congressional intent to pre-empt will not be inferred lightly. Pre-emption must be either explicit, or compelled due to an unavoidable conflict between the state law and the federal law."

45In re Sunterra Corp., 361 F.3d 257, 262 n. 8 (4th Cir. 2004) (quoting In re Access Beyond Techs., Inc., 237 B.R. 32, 48 (Bankr. D. Del. 1999)). See also, In re James Cable Partners, 27 F.3d 534, 537 (11th Cir. 1994); Matter of West Electronics Inc., 852 F.2d 79, 83 (3d Cir. 1988); In re Catron, 158 B.R. 629, 633-638 (E.D. Va. 1993); In re Catapult Entertainment, Inc., 165 F.3d 747, 750 (9th Cir. 1999). I use some license here so as not to confuse the opinion even more through a separate consideration of cases dealing with § 365(e)(2) as opposed to § 365(c)(1). The debate about their respective meanings is essentially identical in substance.


In keeping with that teaching, I apply a restrained preemption analysis in this case and do not reach out to imagine or exaggerate conflicts between Delaware law and the Bankruptcy Code. On the other hand, I am also duty-bound not to ignore an "explicit" congressional preemption of state law or an "unavoidable conflict" between the Bankruptcy Code and Delaware law.49

Cutting to the chase, I do perceive § 18-304 of the Delaware LLC Act (and therefore the Ipso Facto Clause in the Milford Power LLC Agreement) to be preempted to some limited extent. In so ruling, I acknowledge that under the reasoning of *Chrysler Financial Corporation*, the Superior Court found that §§ 365 and 541 of the Bankruptcy Code only operate to defang ipso facto clauses while the debtor is actually in Bankruptcy Court and that the federal government has no interest in protecting debtors whose bankruptcy filings are dismissed without a Bankruptcy Court order protecting their interest in executory contracts containing ipso facto clauses.

The problem with that argument, from my perspective, is that it slight the obvious purpose of the Bankruptcy Code in precluding ipso facto clauses from working forfeitures of important economic assets of debtors. Section 349 of the Bankruptcy Code has been construed as extending that protection to a debtor whose case is dismissed. In *First Sec. Bank v. Creech*, the Utah Supreme Court held that, irrespective of a default under an ipso facto clause, debtors whose bankruptcy filing had been dismissed had their interests in the relevant contract restored under § 349 as if the bankruptcy filing had never occurred.50 In keeping with *Creech*, Professor Erlich has expressed the view that:

If the case is dismissed, the debtor's interest in any property that had passed to the estate prior to the commencement of the case revests in the debtor the instant before commencement of the case. Thus, the default under the ipso facto clause entailed by the filing of the bankruptcy petition is, by force of law, neutralized.51

(3d Cir. 1997) (quoting *In re Roach*, 824 F.2d 1370, 1373 (3d Cir. 1987)).

49 *Id.*

50 858 P.2d 958 (Ut. 1993).

The plaintiffs argue that § 349 simply means that the debtor gets back the property interest it possessed immediately before the bankruptcy filing but does not mean that the effect of the bankruptcy filing under state law is preempted. Although Congress gave debtors in the Bankruptcy Courts protection against ipso facto clauses, they noted that § 349 does not explicitly indicate that the anti-ipso facto clause provisions of the Bankruptcy Code continue to preclude enforcement of an ipso facto clause after a dismissal and that there is legislative history that suggests that those provisions only stay enforcement of the ipso facto clause until the Bankruptcy case concludes or unless the Bankruptcy Court expressly overrides the ipso facto clause and vests the property in the estate or a transferee of the estate, free and clear of the clause's operation.52

The problem I have with the plaintiffs' argument is that it suggests that Congress's antipathy towards ipso facto clauses was capriciously implemented. So long as a debtor remains in bankruptcy, the Bankruptcy Code neutralizes the effect of an ipso facto clause, thereby enabling the debtor's estate to use the asset subject to forfeiture to satisfy creditor claims. But if a debtor's bankruptcy case is dismissed, the debtor may be stripped of an important economic asset by virtue of the mere fact of filing for bankruptcy without restriction by the combined operation of §§ 365, 541, and 349—a stripping that might in turn lead to the actual insolvency of the debtor. Although the plaintiffs contend that Congress was implicitly exacting a toll on improvident bankruptcy filings by permitting ipso facto clauses to be enforced after a dismissal, they cite no legislative history suggesting such an intent and there are other aspects of bankruptcy law that serve that purpose expressly.53 In view of the evident hostility towards ipso facto clauses in §§ 365 and 541, and the language of § 349, I conclude that Congress intended that a debtor whose bankruptcy filing was dismissed should not, when its property interests vest under § 349, be subject to any greater consequences from the operation of an ipso facto clause than it would have been had the relevant contract at issue been addressed within the context of a plan approved by the Bankruptcy Court itself.

As a consequence, I reach a result in this case that is different from either that advocated by PDC or by the plaintiffs. For PDC's part, it wishes me to conclude that the Bankruptcy Code entirely preempts the application of the Ipso Facto Clause and § 18-304 of the Delaware LLC Act. For the plaintiffs' part, they wish me to conclude that the Bankruptcy Code has no preemptive effect at all on the Ipso Facto Clause or § 18-304.

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53See, e.g., Fed. R. Bankr. P. 9011(c) (permitting imposition of sanctions for bringing frivolous or unwarranted actions in bankruptcy court).
I reach the more nuanced conclusion that an ipso facto clause in an LLC contract retains the same potency after a § 349 dismissal that it would have during the course of a bankruptcy proceeding. In so holding, I reject in an important measure the argument made by PDC. Under PDC's view, a debtor receiving a § 349 dismissal would be in a better position to avoid the effects of an ipso facto clause than a debtor whose bankruptcy filing was not dismissed. To understand what I mean, it is critical to consider the effect of the Assumability Exceptions. Read literally, the Assumability Exceptions expressly state that a bankruptcy estate may not assume an executory contract over the non-debtor's objection if state law would bar assignment of that contract to a hypothetical third party. Being under no duty to search for reasons to conclude that Congress has preempted Delaware law, I approach the relevance of the Assumability Exceptions by accepting the literal interpretation of that section adopted by the United States Court of Appeals for the Third Circuit and several other federal courts of appeal.54 Under that interpretation, the Assumability Exceptions preclude even a debtor in possession in bankruptcy from accepting an executory contract if state law would preclude assignment of that contract to a hypothetical third party.

Applying this literal approach, the question then becomes whether the Delaware LLC Act excuses the members of Milford Power from accepting performance from an assignee of PDC's membership interest. Put more broadly, does the Delaware LLC Act excuse members of a limited liability company from accepting performance of an LLC agreement from an assignee of another member? Although one would not know it from reading the parties' briefs, this precise question was recently addressed by Judge Farnan of the United States District Court for the District of Delaware in the case of In re: IT Group, Inc.55 In that case, two debtor-members of a Delaware LLC attempted to assign their membership interests to a third party. Another member of the LLC, Northrop, objected to the attempted assignment. It argued that the Delaware LLC Act did not require Northrop to accept performance from the debtor-members' assignee and that the ipso facto clause in the relevant LLC agreement was enforceable. In the alternative, Northrop argued that the Delaware LLC Act precluded the debtor-members from assigning anything other than the rights specified in § 18-702(b)(2) of the Delaware LLC Act, which accords an assignee the right to participate in profits and losses of a limited liability company. Moreover, Northrop contended that a provision of the LLC

54See cases cited supra notes 45-56.
agreement giving members a right of first refusal as to the transfer of any other member's interest was enforceable.

On appeal from the Bankruptcy Court, Judge Faman held that the Bankruptcy Court was correct in rejecting Northrop's primary argument and embracing its alternative argument.

The Bankruptcy Court held that the debtor-members were barred from transferring their full membership interests because Delaware law excused Northrop from accepting substitute performance. In other words, the Assumability Exceptions operated to exempt the ipso facto clause's force from § 365(e)(1) and to permit the ipso facto clause to deprive the debtor-members of their non-economic rights as members. By contrast, however, the Bankruptcy Court held that the debtor-members could assign their economic interests in the profits and losses of the limited liability company because Delaware law did not excuse Northrop from accepting assignment of these "bare economic rights." To that extent, the ipso facto clause was invalidated by § 365(e)(1) and the debtor-members retained their ongoing right to profits and losses, and could transfer that interest. In so holding, the Bankruptcy Court rejected Northrop's argument that the debtors were "either in default . . . or [were] not" under the ipso facto clause and that there was no reason to treat the economic rights of the debtor differently from the rights of the debtor to participate as a full member.56

On appeal, Judge Faman affirmed, stating:

Under 6 Del. C. § 18-702(b)(2), the members of an LLC are permitted to assign their bare economic interests to another entity. In pertinent part, Section § 18-702(b)(2) provides that an assignee is "entitled to share in such profits and losses, to receive such distribution or distributions, and to receive such allocation of income, gain, loss, deduction or credit or similar item to which the [debtor] was entitled." Because the applicable law does not excuse the Members from rendering economic performance to an assignee, the Court concludes that Section 365(e)(2)(A) does not apply and the default provision is unenforceable as an ipso facto provision.57

56302 B.R. at 487. Essentially, Judge Faman affirmed the Bankruptcy Court's separation of the LLC Agreement into its executory and non-executory components, treating the bare economic interest more like a property right subject to § 541, or so it appears to this non-bankruptcy judge.

57302 B.R. at 487.
Judge Farnan also upheld the Bankruptcy Court's determination that the debtor-members' right to transfer their bare economic rights was subject to Northrop's right of first refusal. Because the right of refusal existed as to any transfer, whether the transferor was in bankruptcy or not, that property right was to be respected within the bankruptcy process and would not, he reasoned, injure the debtor-members' ability to recoup the full value of their bare economic rights.58

Applying the reasoning of Judge Farnan here leads to the conclusion that the Ipso Facto Clause in the Milford Power LLC Agreement is effective to the extent that it deprived PDC of its ability to participate as a member in the governance of Milford Power. Under the Delaware LLC Act, other members of Milford Power are—as a matter of default law—excused from accepting substitute performance of governance rights and duties and therefore the participatory rights of PDC fall outside the reach of § 365(e)(1)'s invalidation of ipso facto clauses. By contrast, under the Delaware LLC Act, the other members of Milford Power are not excused—again, as a matter of default law—from accepting an assignment of PDC's bare economic rights as an equity owner. Thus, after the dismissal of its bankruptcy filing, PDC possessed the same rights as an assignee under § 18-702(b)(2).59

Judge Farnan's reasoning balances the competing policy interests at stake. In keeping with § 18-702(b)(3) (and even § 18-304) of the Delaware LLC Act, his ruling respects the default law of this state by refusing to permit a debtor to transfer its right to participate "in the management of the business and affairs" and "exercise any [governance] rights or power of a

58302 B.R. at 488-489.

59In federal cases other than In re: IT Group, Inc., courts have also treated the governance and economic interests attached to ownership stakes in alternative entities differently for purposes of determining whether the Trustee could assume the debtor's rights. See, e.g., In re: O'Connor, 258 F.3d 392 (5th Cir. 2001) (holding that a debtor's partnership interest was subject to Assumability Exceptions but suggesting that his economic interests in the partnership could be transferred under applicable state law and would have been assumable by Trustee if the Trustee had sought to assume that interest); In re Sunset Developers, 69 B.R. 710 (Bankr. D. Idaho 1987) (finding management and voting rights in a general partnership unassignable, and thus subject to a contractual ipso facto clause terminating these rights upon bankruptcy filing, but finding economic rights assignable, and exempt from termination through the operation of a contractual ipso facto clause); In re DeLuca, 194 B.R. 65 (Bankr. E.D. Va. 1996) (holding that provisions of a limited liability company operating agreement providing for dissolution of the company upon a member's bankruptcy filing but permitting the remaining members to continue business and to elect a new manager are not invalid ipso facto provisions, but that loss of debtor's right to participate in management of an entity did not deprive the debtor of the economic interest in the entity). See also Norton on Bankruptcy § 39: 86 at 39-153 (noting that the economic rights of a partner may be generally assigned by a debtor in possession but that assignment of "management rights" is much more "problematic").
member" in an LLC absent specific contractual authorization. At the same time, however, he noted that the General Assembly had concluded that the economic rights of a member in an LLC were, as a general matter, freely assignable. In other words, he concluded that Delaware's default law specifically distinguished between those aspects of an LLC Agreement that should not be freely transferable because substitute performance should not be imposed on the other members absent their express consent (i.e., the managerial powers and duties) and those aspects that should be freely transferable (i.e., the passive right to share in profits and losses). This distinction, like those made by federal law, recognizes that it is far more tolerable to have to suffer a new passive co-investor one did not choose than to endure a new co-manager without consent. The same logic applies when a member of an LLC must remain in a relationship with a member that has filed for bankruptcy. By terminating the bankrupt filer's status as a member with governance rights, the solvent members only have to live with the bankrupt filer as an assignee with a passive economic interest.

Notably, this distinction is also reflected in the Milford Power LLC Agreement itself. In Article 9.5, the LLC Agreement recognizes that there might be circumstances when the company is required to recognize a transfer that has been accomplished in violation of the procedures of the LLC Agreement itself, e.g., in violation of the first refusal rights granted to other members by Article 9.2. In the circumstance when "the Company is required to recognize such disposition or transfer, the Units so transferred shall be strictly limited to the transferor's rights to allocations and distributions as provided by this Agreement with respect to the transferred Units . . . ." Furthermore, as a general matter, the Milford Power LLC Agreement recognizes that members may have a need to transfer their units, and provides procedures by which transfers may be accomplished. Although the other members must in most situations provide "prior written consent" to a transfer, that consent "cannot be reasonably withheld, conditioned, or delayed."

Of course, I recognize that a reasonable mind could conclude that the outcome I reach is neither incontestably required by the applicable law nor economically optimal. One can argue, as Professor Ribstein, does that state courts should treat the Bankruptcy Code as non-preemptive of ipso facto clauses in non-bankruptcy cases involving limited partnerships and limited liability companies until Congress makes its intent to preempt indisputable. By vindicating the contractual expectations of venturers, he would say, we best promote responsible wealth creation. I respect that view, as it accords

60 18 Del. C. § 18-702(b)(3).
61 LLC Agreement Art. 9.1.
with the public policy of my state as expressed in § 18-304 of the Delaware LLC Act. His view, which was that adopted in Chrysler Financial, also has the virtue of being clear: outside of bankruptcy, ipso facto clauses are always enforceable absent a prior federal court order to the contrary.

On the other hand, the position of PDC also has the same virtue of simplicity. If the Bankruptcy Code is read as erasing the effect of a bankruptcy filing upon a § 349 dismissal, then members of limited partnership or LLCs simply have to live with having as a fellow member a person or entity that filed for bankruptcy and had their case dismissed. If the evident intent of Congress is to avoid having the simple fact of a bankruptcy filing work a forfeiture on a debtor's property interests, then state courts should respect that intent and not penalize a debtor whose bankruptcy case is dismissed by subjecting them to a loss of property that they would not have suffered at the hands of a bankruptcy court had their case not been dismissed.

By adhering to the reasoning of Judge Farnan in the In re: IT case, I leave the parties with a more complex outcome. By enforcing the Ipso Facto Clause so as to deprive PDC (or a transferee from it) of the ability to exercise the strong participatory rights given to PDC by the LLC Agreement, I recognize the legitimate business justification for § 18-304 and ipso facto clauses modeled on it, a justification well-explained by Professor Ribstein's article on the subject. At the very least, my approach alleviates the concern that members will, because of solvency concerns, interfere with the ability of a limited liability company to pursue risky business strategies that hold the promise for large profits.

But, by recognizing what I perceive to be the preemptive force of the Bankruptcy Code on ipso facto clauses to the extent that they deprive an LLC member of the economic rights set forth in § 18-702(b)(2), I also respect Congress's desire to avoid having property interests of debtors divested simply because the debtors filed for bankruptcy. This desire is not entirely alien to our law, as our courts have often noted that Delaware law does not favor interpretations that result in forfeitures. 62

That is, the practical effect of my ruling leaves § 18-304 with continued vitality. Essentially, as I have read it, § 18-304 means that a member who files for bankruptcy still ceases to be a member, but becomes an assignee with the economic rights specified in § 18-702(b).

Because I have concluded that the Ipso Facto Clause cannot be

62 Cf. Garrett v. Brown, 1986 WL 6708, at *8 (Del. Ch. Jun 13, 1986) ("Forfeitures are not favored and contracts will be construed to avoid such a result."); Clements v. Castle Mortg. Service Co., 382 A.2d 1367, 1370 (Del. Ch. 1977) ("Forfeiture as such is highly disfavored by the courts, including those of Delaware.")
applied to deprive PDC of the economic rights of an assignee,\(^{63}\) I need not determine whether, as the plaintiffs contend, PDC—as a withdrawn member—would have been deprived entirely of its interest in the profits and losses of Milford Power. Although that appears to be the only sensible reading of the LLC Agreement,\(^{64}\) I need not and do not rest my conclusion on that ground.

Notably, because I have held that PDC continues to possess the economic rights of an assignee in Milford Power, its argument that the doctrine of unclean hands should bar the plaintiffs' claim is further enervated, as nothing in this ruling will deprive PDC of the right to share in the proceeds of any sale of the power plant. Rather, PDC will be deprived of that opportunity only if the Lenders are successful in their foreclosure action or for other circumstances that would not flow directly from this decision.

VI. Conclusion

For all these reasons, the plaintiffs' motion for summary judgment is granted in part. PDC has been divested of its right to participate in the management of Milford Power and only retains the economic rights of a transferee under § 18-702(b)(2). The plaintiffs shall prepare a conforming final order and submit it to me, upon notice to PDC as to form, within twenty days. Each side shall bear its own costs.

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\(^{63}\)Because PDC argued that relevant provisions of the Bankruptcy Code preempted giving any effect at all to the Ipso Facto Clause, I could not avoid the preemption question. Trust me, I explored how I might accomplish that sidestep.

\(^{64}\)Article 11.9 is difficult to interpret as leaving a Withdrawing Member any right to participate in profit allocations after the event of withdrawal. By its plain terms, a Withdrawing Member has the duty to pay any obligation to the LLC owed by it as of the time of withdrawal, but was, by withdrawing, assigning "all its rights and interests in the Company" to the other members.
UNREPORTED CASES

OFFICIAL COMMITTEE OF UNSECURED CREDITORS OF INTEGRATED HEALTH SERVICES, INC. v. ELKINS

No. 20,228-NC

Court of Chancery of the State of Delaware, New Castle

August 24, 2004

Joanne B. Wills, Esquire, and David S. Eagle, Esquire of Klehr, Harrison, Harvey, Branzburg & Ellers LLP, Wilmington, Delaware; and Max W. Berger, Esquire, Daniel L. Berger, Esquire, Jeffrey N. Leibell, Esquire and Beata Gocyk-Farber, Esquire, of Bernstein Litowitz Berger & Grossmann LLP, New York, New York, of counsel, for plaintiff.


Sherry Ruggiero Fallon, Esquire, of Tybout, Redfearn & Pell, Wilmington, Delaware; and Paul R. DeFilippo, Esquire of Woolmuth, Maher & Deutsch LLP, New York, New York, of counsel, for defendant Robert N. Elkins.

NOBLE, Vice Chancellor

This case arises from various compensation arrangements approved by the Directors of Integrated Health Services, Inc. ("IHS"). Plaintiff, the Official Committee of Unsecured Creditors (the "Committee" or "Plaintiff") of IHS, initiated a suit against Defendants Lawrence P. Cirka, Edwin M. Crawford, Kenneth M. Mazik, Robert A. Mitchell, Charles W. Newhall III, Timothy F. Nicholson, John L. Silverman, George H. Strong (collectively, the "non-Elkins Defendants"), and Robert N. Elkins (together, with the non-Elkins Defendants, the "Defendants"), all current or former members of the IHS Board of Directors (the "Board"), in the United States Bankruptcy Court for the District of Delaware (the "Bankruptcy Court"). The Bankruptcy Court abstained from hearing this fiduciary duty dispute under Delaware law, and the Plaintiff, accordingly, brought suit in this
Court.

In its Complaint, the Plaintiff alleges that Elkins breached his fiduciary duties of loyalty and good faith to IHS by obtaining certain compensation arrangements without regard to the best interests of IHS; by using his various positions at IHS to exert improper influence over other members of the Board and the Board's compensation consultant, Joseph Bachelder, in connection with his compensation arrangements; by causing IHS to loan him money prior to approval by the IHS Board's Compensation and Stock Option Committee (the "Compensation Committee"); and by entrenching himself in office by insisting on unconscionable compensation arrangements.

The Plaintiff also alleges that the non-Elkins Defendants breached their duties of loyalty and good faith by subordinating the best interests of IHS to their allegiance to Elkins; by failing to exercise independent judgment with respect to certain compensation arrangements, by failing to select an independent compensation consultant to address Elkins's compensation arrangements on behalf of IHS; by failing to rely on the advice of Bachelder; and by participating in Elkins's breaches of fiduciary duty by approving or ratifying his actions.

Furthermore, the Plaintiff alleges that each of the Defendants breached their fiduciary duty of due care by approving or ratifying certain compensation arrangements without adequate information, consideration, or deliberation; by failing to exercise reasonable care in selecting, and in overseeing the work of, Bachelder (and thus, at times, relying on a conflicted compensation consultant's advice); by not acting in accordance with the advice of Bachelder in regard to certain compensation agreements; and by failing to monitor how the proceeds of company loans were utilized.

The Plaintiff alleges that these actions were performed in bad faith.¹

Finally, the Plaintiff asserts that the Defendants wasted corporate assets by approving certain compensation agreements and by failing to assure that proceeds from loans to executive officers for the purchase of stock in IHS were, in fact, used to purchase stock of IHS.

The non-Elkins Defendants have moved to dismiss this action pursuant to Court of Chancery Rule 12(b)(6).² They contend that the Plaintiff has failed to plead facts demonstrating that the challenged

¹As will be discussed more fully below, the Plaintiff's principal duty of loyalty claim and its duty of care claim depend upon the same factual allegations.

²Because the filing of this action was approved by the Bankruptcy Court, there is no motion to dismiss for failure to comply with Court of Chancery Rule 23.1's demand requirement. Thus, the Plaintiff's allegations are not subject to the more exacting standard imposed by Court of Chancery Rule 23.1 for derivative actions. See In re Walt Disney Co. Deriv. Litig., 825 A.2d 275, 285 (Del. Ch. 2003).
compensation arrangements were not approved by an independent and disinterested majority of the directors of IHS at the time of the approval of any compensation agreement, that they are entitled to the protections of the exculpatory clause incorporated into IHS's charter in accordance with 8 Del. C. § 102(b)(7), that no facts in the Complaint allege that they were grossly negligent in making compensation decisions, and that the Complaint does not set forth facts that would sustain a waste claim. Furthermore, they argue that claims based on any compensation matters arising before January 31, 1997, are barred by the applicable statute of limitations. Elkins has adopted the non-Elkins Defendants' motion to dismiss and, additionally, has submitted a supplemental motion to dismiss (together, the "Motions to Dismiss"). Elkins's supplemental motion argues that to the extent that duty of loyalty claims are asserted against him, as opposed to the non-Elkins Defendants, such claims should be dismissed because all of the challenged transactions were approved by a majority of disinterested, independent members of IHS's Board or Compensation Committee. He also argues that an agreement which he reached with IHS and which was approved by an order of the Bankruptcy Court on January 3, 2001, (the "Agreement"), bars the Plaintiff from prosecuting claims not arising from "wrongful" acts. To the extent that claims within the Complaint are for "wrongful" acts, Elkins seeks a determination that the Agreement limits his liability exposure to claims paid by IHS's directors' and officers' liability insurance policy (the "D&O Policy").

As set forth below, I conclude that the Plaintiff has failed to raise any doubt that a majority of the directors approving the transactions questioned by the Plaintiff were independent and disinterested. I also conclude that the Plaintiff's duty of care and duty of loyalty claims against the Board—based on allegations that the non-Elkins Defendants exercised no business judgment—ought to be analyzed together and, from that analysis, I am persuaded that certain of the Plaintiff's pleadings allege sufficient facts to maintain an action alleging breach of fiduciary duty. In addition, I conclude that the Plaintiff has alleged, in a manner sufficient to withstand a motion to dismiss, that Elkins breached his fiduciary duties to IHS. The Plaintiff, however, has not alleged sufficient facts to support a waste claim.³

³Also before the Court is the Plaintiff's motion to strike certain exhibits presented by the non-Elkins Defendants in support of their motion to dismiss. To the extent I do not rely on the contested exhibits, I need not reach decision on the motion to strike.
I. PROCEDURAL BACKGROUND AND STANDARD OF REVIEW

The Bankruptcy Court granted the Plaintiff's motion to commence and prosecute certain actions on behalf of the estates of debtor IHS. Following an investigation, on January 31, 2002, the Plaintiff filed a complaint in Bankruptcy Court. The Defendants successfully moved for permissive abstention in favor of this Court.

As a result, the Plaintiff filed its Complaint in this Court on April 2, 2003. In response, the non-Elkins Defendants filed a motion to dismiss pursuant to Rule 12(b)(6). Elkins adopted that motion and added his supplemental motion. This memorandum opinion addresses those motions.

In addressing a motion to dismiss, the Court must accept all of a plaintiff's well-pleaded factual allegations as true, must view those facts in the light most favorable to the plaintiff, and must draw all reasonable inferences from those facts in favor of the plaintiff. This does not, however, extend to conclusory allegations that may be contained in the complaint. With this in mind, the facts recited in this memorandum opinion are derived from the well-pleaded allegations of the Complaint unless otherwise noted.

II. FACTUAL BACKGROUND

A. The Parties

1. The Company, its Bankruptcy, and the Formation of the Committee

IHS was founded by Elkins in the mid-1980s as a small private company. It operated a national chain of nursing homes and provided subacute care to patients typically following discharge from hospitals. Between its founding and 1997, IHS experienced much success. At its peak, IHS was listed on the New York Stock Exchange, employed over 80,000 people and generated $3 billion in annual revenue. In 1997,

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5 Orman, 794 A.2d at 15; Gelfman v. Weeden Investors, L.P., 792 A.2d 977, 984 (Del. Ch. 2001).
6 Oral Argument onDefs.' Mot. to Dismiss and Pl.'s Mot. to Strike, Tr. ("Hearing Tr.") at 6.
7 Id.
Congress passed the Balanced Budget Act of 1997.\textsuperscript{8} This act changed the Medicare reimbursement formula in the subacute care industry and negatively affected IHS's cash flow, which, in turn, had an adverse impact on IHS's financial prospects and stock price. On July 14, 1998, IHS's stock price reached $37.18; by September 30, 1998, the stock had lost more than half its value, trading at only $16.81 per share.

On February 2, 2000, IHS commenced a voluntary proceeding in the Bankruptcy Court.\textsuperscript{9} The Committee was formed by the United States Trustee on February 15, 2000. It consists of eight members, including two representatives of the trade vendor community, three representatives of IHS's public debt, and three representatives of IHS's bank debt.

2. The Non-Elkins Defendants

a. Cirka

Defendant Cirka was a member of the Board from 1994 to March 1998. He served as President of IHS from July 1994 to March 1998 and Senior Vice President and Chief Operating Officer from October 1987 through April 1997.

b. Crawford

Defendant Crawford was a member of the Board from 1995 to October 9, 1999. He was a member of the Compensation Committee until April 1997.

c. Mazik

Defendant Mazik joined the Board in 1995. From that time, he has been a member of the Board and of the Compensation Committee.

d. Mitchell

Defendant Mitchell has been a member of the Board since 1995. Mitchell is a founding partner of the Law Offices of Robert A. Mitchell, which has provided legal services to IHS.

\textsuperscript{8}Pub. L. No. 105-33, 111 Stat. 251.

\textsuperscript{9}While IHS continues to be run pursuant to Sections 1107(a) and 1108 of the Bankruptcy Code, it is not named in the Complaint as a nominal defendant.
Defendant Newhall was a member of the Board from 1986 to November 19, 1999. He also became a member of the Compensation Committee in May of 1997.\(^\text{10}\)

**Defendant Nicholson**

Defendant Nicholson has been a member of the Board since 1986. He served as Executive Vice President of IHS from March 1986 to May 1993. Since February 1998, Nicholson has been the Managing Director of Lyric Health Care LLC. Defendant Elkins held a financial interest in Lyric Health Care LLC at all times relevant to the Complaint.

**Defendant Silverman**

Defendant Silverman has been a member of the Board since 1986, and from June 1995 to December 1997, he served as CEO of a subsidiary of IHS, Asia Care, Inc.

**Defendant Strong**

Defendant Strong was a member of IHS's Board from 1994 until October 8, 1999.

3. **Elkins**

Defendant Elkins served as Chairman of the Board and Chief Executive Officer of IHS from 1986 to July 27, 2000. He served as President of IHS from March 1986 to July 1994, and from March 1998 to January 3, 2001. He was the primary beneficiary of the compensation awards attacked by the Plaintiff.

4. **Bachelder**

While not a party to the litigation, Bachelder plays a central role in

\(^{10}\)Paragraph 2(f) of the Complaint alleges that Newhall was a member of the Compensation Committee beginning in November 1997. However, paragraph 29 places him on the Compensation Committee on May 27, 1997. Viewing the facts in the light most favorable to the Plaintiff, I will view Newhall as having been a member of the Compensation Committee as of May 1997.
the events at issue. The Complaint alleges that Elkins selected Bachelder as a compensation consultant for IHS and negotiated the terms for Bachelder's services. The Complaint describes Bachelder as "an attorney known for representing key executive officers in their negotiations with corporate employers."\textsuperscript{11}

B. The Original Elkins Employment Agreement and Compensation

Under the terms of a five-year employment agreement, effective January 1, 1994 (and, as amended, January 1, 1995), between Elkins and IHS (the "Employment Agreement"), Elkins was to be employed as President and Chief Executive Officer of IHS. Elkins's compensation was to include salary, a performance-based bonus, stock and stock options, and contributions to the IHS employee benefit and retirement plans. Elkins's salary under the Employment Agreement was $750,000 for 1996; $752,277 for 1997; and $809,935 for 1998. In 1996, he received a $5 million bonus, and in 1997, a bonus of $750,000. No bonus was awarded in 1998 because IHS did not meet specified performance targets. IHS made a contribution of $1.2 million to the Key Employee Supplemental Executive Retirement Plan in 1997 for Elkins's benefit. A similar contribution of $14.2 million was made in 1997. Additionally, IHS paid $2 million in life insurance premiums and provided him access to IHS's airplanes.

C. The Challenged Transactions\textsuperscript{12}

1. 1996 Bonus

Elkins's Employment Agreement included a performance-based bonus. On July 16, 1996, Elkins sent a letter to the Compensation Committee\textsuperscript{13} (at this time comprised of Mazik and Crawford) which instructed them to "determine" the amount of bonuses for 1996. The Plaintiff claims that Elkins was present at a July 24, 1996, Board meeting, and discussed with the Board bonuses both for himself and for Cirka. At this meeting, the Board considered two studies prepared by outside consultants (which were sent to them by Elkins), and awarded bonuses of $5,000,000 to Elkins and $1,666,667 to Cirka. These awards were made

\textsuperscript{11}Compl. ¶ 32.

\textsuperscript{12}Throughout this memorandum opinion, I will refer to the transactions criticized by the Plaintiff as the "Challenged Transactions."

\textsuperscript{13}Unless otherwise noted, the Compensation Committee consisted of Mazik and Newhall.
despite the fact that IHS had not met the objectives prescribed for a bonus under the Employment Agreement. The Complaint alleges that before the Board meeting, Elkins approached each of the voting directors individually to discuss his bonus.

2. **1996 Loans**

At some time in 1996, Elkins and Cirka (both officers at this time) caused IHS to disburse $705,527 and $880,630 to each of them respectively. At the time, these disbursements had not been authorized by the Board, and neither Elkins nor Cirka provided a note or other loan documentation to IHS.

At an April 29, 1997, meeting, the Compensation Committee approved the loan *ex post*. This approval was ratified by the full Board the next day.

3. **1997 Option Grant**

On May 27, 1997, Elkins sent a letter to the Compensation Committee, which requested signatures on unanimous written consents to grant Elkins an option to purchase 700,000 shares of IHS stock. This action was taken by the Compensation Committee, and ratified within a few days. Subsequently, Bachelder presented a report supporting the grant of these options.

4. **1997 Loan Program**

In July 1997, Bachelder was asked to analyze IHS's option ratio.\(^{14}\) Bachelder compiled a report ("Bachelder's September Report"), which was presented to the Compensation Committee at its September 29, 1997, meeting. Bachelder did not attend the meeting; his report was sponsored by Taylor Pickett, IHS's Chief Financial Officer.

Bachelder's September Report recommended that certain employees' options be accelerated and that IHS institute a loan program (including a convertible debenture for Elkins) in order to allow those employees to exercise their now-accelerated options. The convertible debenture included a loan forgiveness component, which was tied to a "Change-in-Control" event (defined in the Employment Agreement).\(^{15}\)

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\(^{14}\) An option ratio is a measure of the relationship between employee stock options and the outstanding stock of a company.

\(^{15}\) Such a forgiveness term will be referred to throughout the Opinion as a "Change-in-
At its September 29, 1997 meeting, the Compensation Committee instituted a loan program. This program authorized loans of up to $16 million to "enable the officers of [IHS] to acquire or to hold the common stock of [IHS]." but did not set up any mechanism to monitor how the proceeds of the loans would be spent. At the same meeting, the Compensation Committee granted Elkins a loan of up to $14 million to exercise previously awarded options, as well as additional options to purchase up to 400,000 shares of IHS stock.

That same day, Elkins executed a Promissory Note to IHS for $13,447,000 (the "$13.5 Million Loan"). The terms of this note provided loan forgiveness under three circumstances: (1) a "Change-in-Control" (as defined in the Employment Agreement); (2) termination of Elkins without "Cause" (as defined in the Employment Agreement); or (3) Elkins's departure from IHS for "Good Cause" (as defined in the Employment Agreement).

Other officers borrowed the remaining $2.5 million authorized under the program.

5. 1997 Compensation Revisions

a. July Revision

In early 1997, the Compensation Committee, at the request of Elkins, conducted a review of the compensation arrangements of Elkins and other officers of IHS. Bachelder was retained as a compensation consultant. On July 24, 1997, Bachelder made recommendations relating to Elkins's compensation, including amending Elkins's Key Employee Supplemental Deferred Compensation Plan, granting options to purchase 1.7 million shares of IHS stock, and amending Elkins's employment agreement. After a 15-minute presentation by Bachelder and a short discussion, the Compensation Committee approved all of Bachelder's recommendations. The Board approved these recommendations the same day. Bachelder was not present at the Board meeting and the Board was not given copies of Bachelder's report.

Control Forgiveness Term."

Compl. ¶ 44.

The Complaint, in reviewing certain Challenged Transactions, including the 1997 Loan Program, only alleges approval by the Compensation Committee, and not the full Board. Because the Plaintiff does not allege irregular conduct by the Compensation Committee in the sense of its having taken action beyond its charge, it is reasonable to conclude that the necessary powers were delegated to it. See 8 Del. C. § 141(c)(1).
b. November Revision and the Bonus Forgiveness Term

At an October 19, 1997, meeting among Bachelder, Elkins, and IHS's General Counsel, Marshall Elkins (Elkins's brother), additional changes to the Employment Agreement were discussed. Elkins desired to add another forgiveness term to both the $13.5 Million Loan and a previous $4.7 million loan (the "$4.7 Million Loan"). The forgiveness term (a "Bonus Forgiveness Term") would establish an annual bonus program, under which Elkins would be entitled to receive bonuses once a year beginning in 1998, and ending in 2002. These bonuses would be in an amount that would enable Elkins to repay the principal and interest on each loan covered by the Bonus Forgiveness Term, reduced by the amount his total salary and bonus for the previous calendar year exceeded $500,000.

Although Elkins wanted this Bonus Forgiveness Term to apply both to the $13.5 Million Loan and the $4.7 Million Loan, Bachelder would only recommend the Bonus Forgiveness Term with respect to the larger loan. If the forgiveness terms were to apply to both loans, Bachelder reported, the total forgiveness amount would be too large.

The Compensation Committee approved amendments to Elkins's Employment Agreement, including the Bonus Forgiveness Term for the $13.5 Million Loan, on November 18, 1997. The $4.7 Million Loan was subject only to a Change-in-Control Forgiveness Term. Board approval was obtained the same day.

An amended employment agreement, which included the new loan forgiveness terms and the recommendations approved in July, was signed on November 18, 1997.

6. Forgiveness for Amount Due on $4.7 Million Loan

Elkins did not pay the amount due on his $4.7 Million Loan for 1997. On March 19, 1998, he sent backdated unanimous written consents to the Compensation Committee, which would ex post approve a 1997 forgiveness bonus to cover the amount due on the loan ($281,482). This had the effect of essentially applying a one-time Bonus Forgiveness Term to the $4.7 Million Loan.

The consents were signed and sent to Elkins. The Board subsequently ratified the Compensation Committee's actions.

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18It is unclear from the Complaint when this loan was approved. The validity of this loan, however, is not contested in the Complaint.
7. **$2.088 Million Loan**

On January 28, 1998, Elkins caused IHS to provide to him $2.088 million in the form of a loan (the "$2.088 Million Loan"). This disbursement of funds was initially undertaken without approval from the Compensation Committee or the Board.\(^{19}\)

In a letter dated March 19, 1998, Elkins sent to the Compensation Committee loan documents and backdated unanimous written consents approving the loan *ex post*, which the Compensation Committee duly signed.

8. **$4.2 Million Loan and Extension of the Bonus Forgiveness Term to the $2.088 Million Loan**

On September 30, 1998, Leslie Glew, then associate corporate counsel of IHS and assistant secretary to the Board, sent unanimous written consents to the Compensation Committee on behalf of Elkins. These consents would consolidate the $13.5 Million and $2.088 Million Loans, extend the Bonus Forgiveness Term to cover the $2.088 Million Loan, and provide a new $4 million loan to Elkins. This new loan would be issued to allow Elkins to pay taxes on profits he realized through exercising options.

The Compensation Committee executed the unanimous written consents that same day, and this action was later ratified by the Board. Although Bachelder was never consulted by the Compensation Committee regarding these requests, Glew's cover letter included a reference to Bachelder's previous reports.

As a result of this, Elkins executed two promissory notes. The first, in the amount of $15,535,000, represented the consolidated $13.5 and $2.088 million loans (combined, the "$15.5 Million Loan"). The second stemmed from the authorization of the new $4 million loan. The total proceeds from this loan, however, exceeded the authorized $4,000,000 by $250,000; therefore, Elkins executed a $4.3 million note (the "$4.3 Million Loan") to IHS on October 12, 1998.\(^{20}\)

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\(^{19}\)Newhall, who, along with Mazik, constituted the Compensation Committee at the time of this loan, testified that he knew that the proceeds of the loan were provided to Elkins prior to the Compensation Committee's approval.

\(^{20}\)The Plaintiff emphasizes that many of the Challenged Transactions occurred while IHS was suffering severe financial consequences from the legislative changes to Medicare reimbursement.
9. **$4.5 Million Loan**

In November 1998, Elkins received funds from a $4.5 million loan (the "$4.5 Million Loan"). As with the $2.088 Million Loan, this disbursement of funds was not authorized when taken. The loan was approved and ratified by the Compensation Committee on November 19, 1998. That action was ratified by the Board hours later. Elkins then executed a promissory note to IHS reflecting this loan.

10. **1999 Loan Program**

By 1999, the effects of the Balanced Budget Act of 1997 were beginning to be felt. As of March 19, 1999, IHS's stock was trading at only $6.81 per share. In light of this, Elkins and Pickett, the Plaintiff claims, believed that Citibank21 would seek to amend IHS's credit agreement so as to eliminate IHS's ability to use the credit agreement for loans to employees.

On March 18, 1999, the Board22 was sent unanimous written consents. These consents would establish a $25 million loan program for officers of IHS. Under this program, each beneficiary would execute a promissory note to IHS. The note would contain both a Change-in-Control Forgiveness Term and a Five-Year Forgiveness Term. The Five-Year Forgiveness Term provided that 20% of the amount of the loan, and any interest, would automatically be forgiven on each anniversary of the loan if the beneficiary was still employed at IHS. The Board approved this program on March 19, 1999 without consultation with Bachelder. As of March 31, 1999, IHS had loaned $11.5 million to Elkins (the "$11.5 Million Loan"), and $12.9 million to other IHS officers.

11. **Extension of the Five-Year Forgiveness Term**

By mid-1999, Elkins had several loans outstanding: The $15.5 Million Loan, which was subject to the Bonus Forgiveness Term; the $4.7 Million Loan, which was subject only to the Change-in-Control Forgiveness Term, but for which the Board had approved a bonus-forgiveness-type award in 1998; the $4.3 Million and $4.5 Million Loans, which were subject only to the Change-in-Control Forgiveness Term; and the $11.5 Million Loan, which was subject to the Five-Year Forgiveness Term.

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21It is not clear from the Complaint if Citibank was IHS's primary lender.
22In contrast to other Challenged Transactions, in this case, the Board, not the Compensation Committee, was requested to take initial action.
Term. These loans totaled over $40 million, almost thirty million of which were not subject to the Five-Year Forgiveness Provisions.

On July 8, 1999, in a meeting attended by Elkins, the Compensation Committee extended the application of the Five-Year Forgiveness Provisions to all of Elkins's loans. Further, it extended the time for repayment of the $4.7 Million Loan by five years, removed selling restrictions on the IHS stock Elkins purchased in connection with the $15.5 Million Loan, and consolidated the $4.3 Million and $4.5 Million Loans into one loan totaling $8,750,000. The Board approved this action that same day.

12. The Elkins "Poison Pill"

In a move the Plaintiff calls the creation of a "Poison Pill," IHS, in January 2000, amended the employment agreements of officers having outstanding loans from IHS to allow for forgiveness of those loans (totaling approximately $16 million) if Elkins were to depart from IHS.

When Elkins left IHS in January 2000, IHS forgave $16 million in loans to other IHS officers, as well as $40 million in loans to Elkins.

III. ANALYSIS

A. The Statute of Limitations and the 1996 Bonus

The Defendants argue that the Plaintiff's claims arising out of conduct prior to January 31, 1997, should be barred by the statute of limitations applicable to breach of fiduciary duty claims. The Plaintiff counters, citing Kahn v. Seaboard Corp., that the statute of limitations should be tolled because this is a case involving wrongful self-dealing and

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23 The status of the 1996 Loan is uncertain, based on facts alleged in the Complaint.

24 The only transaction affected by this is the 1996 Bonus. Although funds involved in the 1996 Loans were disbursed in 1996, Board approval of these loans occurred in April of 1997, inside the statute of limitations period.

25 Opening Br. ofDefs. Lawrence P. Cirka, Edwin M. Crawford, Kenneth M. Mazik, Robert A. Mitchell, Charles W. Newhall, III, Timothy F. Nicholson, John L. Silverman and George H. Strong in Support of Their Mot. to Dismiss on Grounds of Failure to State a Claim ("Defs.' Opening Br.") at 44. The applicable statute of limitations is 10 Del. C. § 8106: "No action to recover damages caused by an injury unaccompanied with force or resulting indirectly from the act of the defendant shall be brought after the expiration of 3 years from the accruing of the cause of such action." The Plaintiff filed its petition for relief in the Bankruptcy Court on February 2, 2000.

While a statute of limitations defense is generally raised in a defendant's answer, it may be raised in a motion to dismiss if the complaint alleges facts showing that the complaint was in fact filed too late. Brooks v. Savitch, 576 A.2d 1329, 1330 (Del. 1989).
that in such a case, the statute of limitations is tolled until stockholders knew or had reason to know of the facts constituting the alleged wrong.\(^\text{26}\) Although Kahn does not require any affirmative act of concealment by the defendant in order for this tolling principle to apply, it notes that the statute of limitations will not be tolled if the plaintiff had reason to know of the facts constituting the alleged wrong. Further, Kahn leaves it to the plaintiff to plead and prove facts that would support the tolling principle.\(^\text{27}\) The Plaintiff acknowledges that the 1996 Bonus was disclosed in IHS’s proxy statement.\(^\text{28}\) This filing was enough to alert stockholders reasonably to a possible infringement of their rights. Although the Plaintiff claims this filing did not actually alert any responsible outside stockholder to the process the Board undertook, the standard only requires it reasonably to alert the stockholders as to that alleged process.\(^\text{29}\) As such, all claims associated with the 1996 Bonus are dismissed.

**B. Liability Post-Resignation**

The Complaint, as drafted, alleges that the members of the Board breached their fiduciary duties with respect to the Challenged Transactions. It does not designate which transactions any Defendant is liable for. The Defendants have argued that once a director has resigned, that director may no longer be held liable for the subsequent actions of the Board.\(^\text{30}\) To the extent that the Plaintiff is suing the non-Elkins Defendants solely based on their positions as board members, this is a correct statement of law.

Cirka left the Board in March 1998. He cannot be held liable for any harm caused by the Board’s decisions concerning the $4.2 Million Loan, Extension of the Bonus Forgiveness Term to the $2.088 Million Loan, the $4.5 Million Loan, the 1999 Loan Program, the Extension of the Five-Year Forgiveness Term to all of Elkins’s Loans, or the Elkins "Poison Pill." As to Cirka only, claims arising out of those Challenged Transactions are dismissed with prejudice.

Crawford and Strong both left the Board on October 8, 1999, and Newhall left on November 19, 1999. As such, they do not have any potential liability with regard to the Elkins "Poison Pill." As to Crawford, Strong, and Newhall, any claim arising out of the Elkins "Poison Pill" is dismissed with prejudice.

\(^{26}\) Kahn v. Seaboard Corp, 625 A.2d 269, 276 (Del. Ch. 1993).
\(^{27}\) Id. at 277.
\(^{28}\) Br. of Pl., Official Committee of Unsecured Creditors of Integrated Health Services, Inc., in Opp’n to Defs.’ Mot. to Dismiss ("Pl.’s Brief") at 41.
\(^{29}\) Of course, the Committee did not exist during the events at issue.
\(^{30}\) Hearing Tr. at 12-13.
C.  **Fiduciary Duty Violation—Board Action**

1.  **Characterization of the Plaintiff's Claims**

The Complaint contains two Counts premised on breach of a corporate director's fiduciary duties. One alleges breach of the fiduciary duty of loyalty and the second alleges breach of the fiduciary duty of care.

The alleged conduct that forms the basis of both counts is substantially similar. The Defendants attempt to defend against the loyalty count by arguing that a board consisting of a majority of disinterested, independent directors approved all compensation arrangements. The Defendants respond to Plaintiff's care claims with three separate arguments: (1) to the extent the Defendants relied on Bachelder's opinions in approving the challenged transactions, they are insulated from liability by 8 Del. C. § 141(e);31 (2) to the extent 8 Del. C. § 141(e) does not insulate the Defendants from liability, IHS's § 102(b)(7) exculpation provision does so;32 and (3) regardless of the above, the Plaintiff has failed to plead facts that show gross negligence, a necessary minimum foundation for a due care claim on behalf of the Board.

There was much confusion, both in the parties' briefs, and at oral argument, as to whether the Plaintiff's claims stem from the Defendants' duty of care or duty of loyalty.33 In *In re the Walt Disney Co. Derivative*
Litigation, the Chancellor found that the facts alleged in the complaint, if true, would imply that disinterested, independent directors "knew that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss." The Chancellor held that if they did indeed act in such a way, they "consciously and intentionally disregarded their responsibilities," and that the defendants, therefore, could be in violation of their fiduciary duties to the corporation.

The Court, therefore, must determine whether the Plaintiff's well-pleaded allegations, taken as true, amount to a violation of the fiduciary duty of loyalty or the fiduciary duty of care. Then, the Court will evaluate if the fiduciary duty claims surviving that inquiry are barred by the § 102(b)(7) provision in IHS's charter.

duty of loyalty or not. For this argument, I don't care, okay, frankly. The tests are there. We should apply the test. Prior to the Disney decision, the cases lined up in saying "Bad faith is a subset of the duty of loyalty and here's the test." After the recent Disney decision, we have a bad-faith claim under a duty-of-care theory. I'm prepared on this complaint to apply either standard. It doesn't matter; okay?

Hearing Tr. at 18.

34 In re Walt Disney Co. Deriv. Litig., 825 A.2d at 289.
35 Id. (emphasis in original).
36 As observed in Guttman v. Huang, 823 A.2d 492, 506 (Del. Ch. 2003), "[a] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest." One cannot act in conformity with her duty of loyalty to a company if she acts in bad faith. Disney, in its discussion of the benefitted corporate officer's actions in negotiating with the company after he became a fiduciary of it, points this out. It is on this notion that an actionable fiduciary duty violation, based on the fiduciary duty of loyalty, can be read from Disney.

37 The duty of care requires that 'in making business decisions, directors must consider all material information reasonably available, and the directors' process is actionably only if grossly negligent.' In re Nat'l Auto Credit, Inc. S'holders Litig., 2003 WL 139768, at *12 (Del. Ch. Jan. 10, 2003) (quoting Brehm v. Eisner, 746 A.2d 244, 259 (Del. 2000)). 8 Del. C. § 102(b)(7) begins by protecting from monetary damages any violations of fiduciary duty. It then provides four types of actions, including a breach of the duty loyalty or acts or omissions not in good faith, that would not be shielded from monetary damage. Not among these are violations of the duty of care. Thus, actions taken that are even grossly negligent, so long as not falling within one of the exceptions contained in § 102(b)(7), will be shielded by a § 102(b)(7) provision. One may alternatively conceptualize the holding in Disney as a duty of care claim that is so egregious—that essentially alleges the Board abdicated its responsibility to make any business decision—that it falls within the second exception to the general exculpating power of § 102(b)(7). See 8 Del. C. § 102(b)(7)(ii) (preventing exculpation from monetary liability "for acts or omissions not in good faith . . .").

38 A defense under § 102(b)(7) may be considered in the context of a motion to dismiss. Emerald Partners v. Berlin, 787 A.2d 85, 91-93 (Del. 2001) (emphasizing that the § 102(b)(7) defense applies to due care claims for monetary damages); Malpiede v. Townsend, 780 A.2d 1075 (Del. 2001).
Specifically, the Court undertakes two separate analyses. Initially, the Court will inquire as to whether the Board that approved each Challenged Transaction consisted of a majority of members not interested in the Challenged Transaction or not beholden to one who was interested in the Challenged Transaction.

Because the Court concludes that a majority of the Board members who approved the Challenged Transactions were disinterested and independent, the Court will move on to the next inquiry. The question will become one of whether the facts alleged in the Complaint reasonably support the inference that these disinterested, independent directors "knew that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss."\(^{39}\) If they did indeed act in such a way, they have acted in a manner that cannot be said to be the product of sound business judgment and so cannot be protected by the presumption of the business judgment rule. Or put another way, if they "consciously and intentionally disregarded their responsibilities,"\(^{40}\) they could not have acted in such a way so as to be shielded by a § 102(b)(7) provision from monetary damages resulting from violations of fiduciary duty.

2. **A Board Consisting of a Majority of Disinterested and Independent Directors Approved the Challenged Transactions**

A director is "interested" if she "will receive a personal financial benefit from a transaction that is not equally shared by the stockholders."\(^{41}\) Director independence is a separate concept from director interestedness. In order to claim a lack of independence, a plaintiff must allege facts that raise sufficient doubt that a director's decision was based on extraneous considerations or influences, and not on the corporate merits of the transaction.\(^{42}\) The inquiry into a director's independence is fact-specific, and the Court is called upon to apply a subjective "actual person" standard, instead of an objective "reasonable director" standard in making its determination.\(^{43}\) Furthermore, the Court will not deem a director lacking independence unless the plaintiff alleges, in addition to control, "such facts as would demonstrate that through personal or other relationships the

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\(^{39}\) *In re Walt Disney Co. Deriv. Litig.*, 825 A.2d at 289.

\(^{40}\) *Id.* (emphasis in original).


\(^{42}\) *Id.* (quoting *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1989)).

\(^{43}\) *Orman*, 794 A.2d at 24; *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1167 (Del. 1995).
directors are beholden to the controlling person." 44

The Plaintiff argues that Elkins dominated and controlled the Board as a whole, and that, as such, the Board itself was not independent. Since the Complaint pleads a pattern of Board deferral to Elkins, the Plaintiff argues, the Board can be said to lack independence from Elkins. General allegations of domination over a Board are simply not sufficient under Delaware law to state a traditional duty of loyalty claim. 45 "Our cases have determined that personal friendships, without more; outside business relationships, without more; and approving of or acquiescing in the challenged transactions, without more, are each insufficient to raise a reasonable doubt of a director's ability to exercise independent business judgment." 46 And while domination and control are not tested merely by economics, 47 a plaintiff must allege some facts showing a director is beholden to an interested director in order to show a lack of independence. 48 "The critical issue . . . is whether the director was conflicted in his loyalties with respect to the challenged board actions." 49

a. Interested Directors

It is not in dispute that Elkins was interested in the outcome of all Challenged Transactions. Cirka was interested in the 1996 Loan (and 1997 ex post approval of that loan). Giving the Plaintiff the benefit of the doubt, I will assume Cirka was one of the officers who benefited from the 1997 Loan Program as well. Cirka, however, was not interested in any other Challenged Transaction. No allegations in the Complaint indicate any other Board member was ever interested in any of the Challenged Transactions.

44Aronson, 473 A.2d at 815.
45A lack of independence may arise from a "close personal or familial relationship or through force of will." Orman, 794 A.2d at 25 n.50 (emphasis added). A conclusory allegation that an executive exercised his "force of will," does not, by itself, raise sufficient doubt about a director's independence.
48Id. at 938-939; Orman, 794 A.2d at 24.
b. Independence of Directors

i. Independence of Crawford, Mazik, Newhall, and Strong

The Complaint raises no allegations of a lack of independence of Crawford, Mazik, Newhall, or Strong. It contains no factual allegations that any of these directors were beholden to the interested directors. These four directors are disinterested and independent.\(^5\)

ii. Mitchell

The Complaint alleges that Mitchell is a "founding partner of the Law Offices of Robert A. Mitchell, which provided legal services to IHS at relevant times."\(^5\) The Complaint, however, makes no allegations as to the amount of fees the law firm obtained from IHS, and whether those fees constituted such a large part of the firm's income so as to be material to either the firm or Mitchell. Simply because Mitchell is the founding partner of a law firm which provided legal services to IHS, without more, is not enough to establish Mitchell was "beholden to" Elkins or Cirka.\(^5\)

iii. Nicholson

Nicholson was an officer of IHS from March 1986 to May 1993.\(^5\) That Nicholson was an officer of IHS three years before the first of the Challenged Transactions makes him neither interested nor dependent. From February 1998 on, Nicholson has been the Managing Director of Lyric Health Care LLC ("Lyric"), a company in which Elkins held a financial interest.\(^5\) Here, again, the Complaint fails to allege any facts indicating that because of these circumstances, Nicholson was in any way beholden to Elkins. Specifically, the Complaint fails to allege that Elkins's interest was sufficiently material to Nicholson to warrant a determination

\(^5\)McMillan v. Intercargo Corp., 768 A.2d 492, 496 (Del. Ch. 2000) ("In sum, the complaint alleges no facts from which a reasonable inference can be drawn that any conflicting self-interest or bad faith motive caused the defendant directors to fail to meet their obligations.").
\(^5\)Compl. ¶ 2(e).
\(^5\)Compl. ¶ 2(g).
\(^5\)There is disagreement over whether it was Elkins or IHS that had an interest in Lyric. Defs.' Opening Br. at 19. For purposes of the Motions to Dismiss, I will assume Elkins did have a stake in Lyric.
that by way of this interest, Elkins controlled or dominated Nicholson. No other allegations as to Nicholson have been made. As such, Nicholson, at all relevant times, was disinterested and independent.

iv. Silverman

Finally, the Complaint alleges that from June 1995 to December 1997, Silverman served as CEO of Asia Care, Inc., a subsidiary of IHS.55 Although the Complaint does not allege that Silverman's position was material to his financial well-being or that Silverman served at Elkins's pleasure, I will assume, without deciding, that he lacked independence from Elkins.

c. All Transactions Were Approved by a Majority of Disinterested, Independent Directors

From 1996 through 1998, the Board consisted of Elkins, Cirka, Crawford, Mazik, Mitchell, Newhall, Nicholson, Silverman, and Strong. Of these nine directors, only Elkins and Cirka, and possibly Silverman, could be deemed interested or not independent with respect to the 1996 Loans and 1997 Loan Program. Only Elkins could be deemed interested (and possibly Silverman could be deemed not independent) with respect to the 1997 Option Grant, the Compensation Revisions, the $2.088 Million Loan, or the forgiveness of the amount due on the $4.7 Million Loan. Thus, all of these transactions were approved by a board consisting of a majority of independent, disinterested directors.

The Board approving the $4.2 and $4.5 Million Loan, the Extension of the Bonus Forgiveness Term to the $2.088 Million Loan, the 1999 Loan Program, and the Extension of the Five-Year Forgiveness Term consisted of Elkins, Crawford, Mazik, Mitchell, Newhall, Nicholson, Silverman and Strong. Here, at least six of eight Board Members were disinterested and independent, and all of these directors approved the Challenged Transactions.

Finally, when the Board approved the Elkins Poison Pill, it consisted of Elkins, Mazik, Mitchell, Nicholson, and Silverman. Here, at least three of the five directors approving this "poison pill" were disinterested and independent.

Since all Challenged Transactions were approved by the majority of a board consisting of a majority of disinterested, independent directors, I

55Compl. ¶ 2(h).
must now turn to whether any of the Challenged Transactions was authorized with the form of intentional and conscious disregard to a director's duties that sustains fiduciary duty claims and avoids the § 102(b)(7) exculpatory provision.

3. Did the Directors "Consciously and Intentionally Disregard Their Responsibilities"?

a. The Disney Standard

This Court's May 2003 Disney decision is the most recent in a series of decisions arising out of the hiring and termination of Michael Ovitz as the president of Disney. In that decision, the Court came to the conclusion that the complaint's allegations, if true, showed that the defendant directors did more than act in a negligent or even grossly negligent fashion in approving Ovitz's hiring and termination. As stated above, the Chancellor determined that the complaint adequately alleged that the defendants "consciously and intentionally disregarded their responsibilities."56

Before pursuing this fact-specific inquiry, I pause to make two observations. First, both Disney and this case involve Board approval of compensation packages for corporate officers and directors. While there may be instances in which a board may act with deference to corporate officers' judgments, executive compensation is not one of those instances. The board must exercise its own business judgment in approving an executive compensation transaction.57

Second, it is important to highlight yet again that the standard moves beyond gross negligence. To survive a motion to dismiss based on this standard, where the charter contains a § 102(b)(7) provision, a plaintiff must plead facts that, if true, would imply that a Board "consciously and intentionally disregarded [its] responsibilities." While a high bar, the Plaintiff has pleaded such facts here.

b. The 1996 Loans

The Complaint alleges the Compensation Committee approved the 1996 Loans ex post and Board ratification followed shortly thereafter. The

56 In re Walt Disney Co. Deriv. Litig, 825 A.2d at 289.
57 In a sense, this is a variation of the Plaintiff's "force of will" argument. While such an argument would not suffice to show that a group of directors lacked independence in the traditional duty of loyalty analysis, in the realm of executive compensation, this Court will not dismiss claims that properly allege that a board was dominated and controlled by its executives to the extent that it could not even exercise any form of its own business judgment.
Complaint further alleges that the Compensation Committee gave such approval even though the Compensation Committee was given no explanation as to why the loans were made and the Board, without "any additional investigation, deliberation, consultation with an expert, or determination as to what the Compensation Committee's decision process was," provided such ratification. These allegations, if true, would imply knowing and deliberate indifference to the Board's duties to act "faithfully and with appropriate care," and thus I cannot dismiss the Plaintiff's fiduciary duty claim arising out of this Challenged Transaction.

c. The 1997 Option Grant

The Complaint discusses a letter Elkins sent to the Compensation Committee, urging them to sign consents for the 1997 Option Grant. The letter, the Complaint alleges, opened with the phrase "as we discussed and

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58Compl. ¶ 27. There has been much discussion as to whether the allegations in the Complaint are either false or mischaracterizations. Hearing Tr. at 25-27;Defs.' Opening Br. at 31-38; Reply Br. ofDefs. Lawrence F. Cirka, Edwin M. Crawford, Kenneth M. Mazik, Robert A. Mitchell, Charles W. Newhall, III, Timothy F. Nicholson, John L. Silverman and George H. Strong in Support of Their Mot. to Dismiss on Grounds of Failure to State a Claim ("Defs.' Reply Br.") at Ex. B;Pl.'s Brief at 31-33. In support of their claim that such allegations are either false or mischaracterizations, the Defendants offered numerous exhibits to their Opening Brief. As discussed above, the Plaintiff initially moved to either strike such exhibits or, alternatively, to convert the Motions to Dismiss to motions for summary judgment.

At oral argument, the Defendants conceded that, instead of converting Defendants' Motions to Dismiss into motions for summary judgment, the Defendants would prefer that the Court not rely on the documents identified in the Motion to Strike, and proceed with the Motions to Dismiss. Hearing Tr. at 28.

In its brief in opposition to the Motions to Dismiss, the Plaintiff attempts to refute assertions of mischaracterization and does address the challenged exhibits. In addressing such exhibits, the Plaintiff may be seen to alter its allegations. The Plaintiff implies that it is alleging a lack of "meaningful" deliberation, as opposed to a total lack of deliberation. Pl.'s Brief at 31-33.

The facts in this case are different from those in Disney. Elkins founded IHS and had been an executive of the company for over 10 years at the time of the first Challenged Transaction. Ovitz was at Disney for one year. No expert was retained by Disney, while Bachelder (regardless of questions over the method of his selection) was retained by IHS. Thus, a change in characterization from a total lack of deliberation (and for that matter, a difference between the meaning of discussion and deliberation, if there is one), to even a short conversation may change the outcome of a Disney analysis. Allegations of nondeliberation are different from allegations of not enough deliberation.

Nevertheless, these are motions to dismiss, governed by Court of Chancery Rule 12(b)(6). On a motion to dismiss, I may only consider the Complaint and documents that the Complaint incorporates or that are integral to it. Orman, 794 A.2d at 15. As a practical matter, therefore, I do not consider the disputed exhibits, or even the Plaintiff's seeming alteration of allegations. The future course of this proceeding, obviously, will depend upon whether the facts which the Plaintiff can prove match its allegations.

59In re Walt Disney Co. Deriv. Litig., 825 A.2d at 289.
60Compl. ¶29-30.
approved."61 Because the approval cited by the letter was only approval as to a grant "in the amount and price to be determined at a later date," and because no later discussion was ever taken, the Complaint concludes that "Elkins unilaterally determined the amount of his own option grant."62 This is a conclusory allegation of the type I need not take as true for purposes of a motion to dismiss.63 Here, the Complaint states that the Compensation Committee previously discussed and approved an option grant. While the Complaint alleges that Bachelder was asked to provide an after-the-fact supporting report, it does not allege that this previous discussion was defective. I cannot find, based on the nonconclusory allegations of fact in the Complaint, that the Defendants intentionally disregarded their responsibilities with regard to this option grant. IHS's § 102(b)(7) provision thus insulates the non-Elkins Defendants from liability in regard to this Challenged Transaction, assuming for these purposes that these facts otherwise would describe a breach of fiduciary duty.

d. The 1997 Loan Program

I can find no sufficient allegation of knowing and deliberate indifference to the duty to act faithfully and with appropriate care with regard to the 1997 Loan Program. The Compensation Committee and the Board received Bachelder's September Report relating to IHS's option ratio.64 Even accepting as true that IHS never contacted Bachelder to question him on this report, the report was presented to the Compensation Committee by Pickett, IHS's Chief Financial Officer. The Complaint alleges that the Compensation Committee did engage in a discussion in regard to the report. While failure to consult a tax expert on the tax consequences of the report, and even the failure to set up a monitoring mechanism with regard to the loan program may or may not have been negligent (or even grossly negligent), no inference can be drawn that this decision was made without good faith. Defendants commissioned a compensation consultant report, discussed his report, and implemented a program based on that report. While the Board may not have acted with the degree of care the Plaintiff would have preferred, IHS's § 102(b)(7) provision, as pertinent here, prevents the imposition of monetary liability for all but those actions undertaken disloyally or without good faith. The

61Id. ¶ 30.
62Id.
63Orman, 794 A.2d at 15.
64Because I find IHS's § 102(b)(7) provision shields Defendants from liability regarding the 1997 Loan Program, I do not reach arguments regarding 8 Del. C. § 141(e).
Plaintiff's allegations do not meet that standard.

e. The 1997 Compensation Revisions

With regard to the 1997 Compensation Revisions, the Plaintiff alleges that the Compensation Committee "completely abdicated [its] fiduciary duties with respect to review and approval of [Bachelder's] Compensation Review." Specifically, the Complaint alleges the Compensation Committee did not meet with Bachelder, or discuss the progress of his work, and did not ask any questions or make requests or recommendations. The Complaint does, however, note that Bachelder did make a 15-minute presentation to the Compensation Committee, at which he provided the Committee with a 32-page report. Further, the Complaint concedes that following this presentation, a discussion ensued. As to the implementation of the Bonus Forgiveness Term, the Compensation Committee actually denied extension of the Bonus Forgiveness Term to the $4.7 Million Loan. And while the Board did not engage in discussion following the Committee's approval, it is clear the Committee took enough action that I cannot conclude it acted in more than a grossly negligent manner, if that.

Counsel for the Plaintiff, at oral argument on the Motions to Dismiss, discussed what would be a reasonable length of time for board discussion before approving, in that case, the 1997 Loan Program, or what would be an unreasonable length of time for the Board to consider such decisions. Counsel took the following position: "Now we're not saying if it was 20 minutes, it would have been okay or if it was 5 minutes, it wouldn't have been okay. Perhaps 5 or 10 minutes would have been sufficient if there had been some other involvement or discussion with the expert other than that very brief meeting." The type of inquiry counsel may be suggesting is not particularly helpful in evaluating a fiduciary claim. As long as the Board engaged in action that can lead the Court to conclude it did not act in knowing and deliberate indifference to its fiduciary duties, the inquiry of this nature ends. The Court does not look at the reasonableness of a Board's actions in this context, as long as the Board exercised some business judgment.

The Compensation Committee did rely on Elkins to identify the appropriate compensation consulting firm to advise it with respect to his compensation. By selecting a consultant under his influence, Elkins may

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65Compl. ¶ 33.
66For the same reason discussed above, I do not reach 8 Del. C. § 141(e).
67Hearing Tr. at 42.
UNREPORTED CASES

have violated his fiduciary duties. To the extent the Board should have been more diligent in the selection process, the lack of diligence alleged, by itself and especially in light of Elkins's long history with the Company, is simply not enough to demonstrate a lack of loyalty or good faith on the part of the members of the Compensation Committee.

f. Forgiveness for Amount Due Under the $4.7 Million Loan

Accepting that the facts alleged regarding the extension of the Bonus Forgiveness Term to the $4.7 Million Loan are true, the Compensation Committee acted based on a misleading letter from Elkins. Nevertheless, the Compensation Committee, if acting in conformity with even the Disney standard, should have at least been cognizant of its own refusal to extend a Bonus Forgiveness Term to the $4.7 Million Loan at one of its meetings held less than five months before. Elkins's letter should have at least prompted some discussion. The Compensation Committee's signing of the unanimous written consents in this case raises a concern as to whether it acted with knowing and deliberate indifference. Moreover, since the Complaint alleges the Board ratified the Compensation Committee's action without any review whatsoever, claims as to this Challenged Transaction survive the Motions to Dismiss.

g. $2.088 Million Loan

The $2.088 Million Loan was the smallest of the loans and obviously begs the question: how does one compare a board's blessing of such a loan with the $145 million transactions involved in Disney? The question, again in this context, is whether a board exercises some business judgment in making a compensation decision. As the Chancellor wrote in the first incarnation of Disney,

Just as the 85,000-ton cruise ships Disney Magic and Disney Wonder are forced by science to obey the same laws of buoyancy as Disneyland's significantly smaller Jungle Cruise ships, so is a corporate board's extraordinary decision to award a $140 million severance package governed by the same corporate law principles as its everyday decision to authorize a loan. Legal rules that govern corporate boards, as well as the managers of day-to-day operations, are resilient,
irrespective of context.\textsuperscript{68}

While this loan, by itself, is much smaller than the package under scrutiny in Disney, the same principles apply—when a board acts with knowing and deliberate indifference to its duties to act faithfully and with appropriate care, it acts in such a way as to be denied the protection of a § 102(b)(7) provision.

Here, Newhall testified to his knowledge that Elkins was receiving the proceeds of the $2.088 Million Loan prior to the Compensation Committee's approval. In justifying the signing of the unanimous consent without deliberation, Newhall simply stated he knew Elkins would never "'pull anything behind anyone's back.'"\textsuperscript{69} Even for an officer who founded a company and had been with that company for over 10 years, and even for a transaction as proportionately small as this, directors of a public corporation must exercise more than blind faith in approving loans. Claims against Mazik and Newhall\textsuperscript{70} arising out of the ex post approval of this loan survive the Motions to Dismiss.

h. $4.2 Million Loan and Extension of the Bonus Forgiveness Term to the $2.088 Loan

Again, the Complaint alleges Compensation Committee approval and Board ratification of an Elkins request without any "consideration, deliberation, or advice from any expert."\textsuperscript{71} Because I must accept this allegation as true on a motion to dismiss, I deny the Motions to Dismiss as to this claim.

i. $4.5 Million Loan

The Complaint alleges that the Compensation Committee approved this $4.5 Million Loan "without any deliberation as to the appropriateness of granting a new loan to Elkins or whether IHS received any consideration for this 'loan'"\textsuperscript{72} and that subsequent Board approval was "without consideration, deliberation or advice from any exert [sic]."\textsuperscript{73} As such, I cannot dismiss claims regarding the approval of this loan.

\textsuperscript{69}Compl. ¶ 58.
\textsuperscript{70}The Complaint does not allege Board ratification of this transaction.
\textsuperscript{71}Compl. ¶ 60.
\textsuperscript{72}Id. ¶ 64.
\textsuperscript{73}Id. ¶ 65.
j. 1999 Loan Program

The entire Board approved the 1999 Loan Program without Compensation Committee approval. While Glew sent a letter to the Board stating that the Compensation Committee "discussed and recommended" the loan program, the Complaint alleges it in fact did not. Instead, the Complaint alleges that the Board approved the program "without any consideration, deliberation, or advice from any expert." Such an allegation, if true, would imply the type of knowing and intentional indifference that would imply a breach of fiduciary duty not insulated from liability by a § 102(b)(7) clause. The Motions to Dismiss the claims with regard to this Challenged Transaction are denied.

k. Extension of the Five-Year Forgiveness Term to all of Elkins's Loans

The Complaint alleges that Bachelder was opposed to extending the Five-Year Forgiveness Provision to all of Elkins's loans, but it stops short of alleging the Compensation Committee knew of his opposition. While not alleging a total lack of deliberation on behalf of the Compensation Committee, it does allege such a lack in the Board's ratification of Compensation Committee action. Moreover, the Complaint, at paragraph 78, may be read to allege that, although the Compensation Committee deliberated at a July 8, 1999, meeting, it did not consult with any experts with respect to the extension of the term, and did not consider its costs to IHS or whether IHS would receive any consideration from it. Once again, given the procedural posture of this matter, the Motions to Dismiss as to this Challenged Transaction are denied.

l. The Elkins "Poison Pill"

The Plaintiff alleges that it was "unable to identify any corporate authorizations for the January 2000 Amendments, or any analysis of the January 2000 Amendments, their cost to IHS or the corporate reason for this performed either by the Compensation Committee or by other members of the Board." On a motion to dismiss pursuant to Court of Chancery Rule 12(b)(6), the Court must take all reasonable inferences from the

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74Id. ¶ 73.
75Id. ¶ 68.
76Id. ¶¶ 76-77; Hearing Tr. at 45-46.
77Compl. ¶ 80.
allegations in the favor of the nonmoving party. A reasonable inference one can take from an inability to find such information, after a reasonable inspection, is that no such action was taken.\(^7\) Thus allegations regarding the Elkins "Poison Pill" are sufficient, at this stage of litigation, to sustain the Plaintiff's breach of fiduciary duty claims.

D. Duty of Loyalty—Elkins

In general, employees negotiating employment agreements with their employers have the right to seek an agreement containing the best terms possible for themselves. However, once an employee becomes a fiduciary of an entity, he has a duty to negotiate further compensation agreements "honestly and in good faith so as not to advantage himself at the expense of the [entity's] shareholders."\(^7\) This requirement does not prevent fiduciaries from negotiating their own employment agreements so long as such negotiations are "performed in an adversarial and arms-length manner."\(^8\)

The Complaint contains numerous allegations that Elkins failed to fulfill this duty. At oral argument, counsel for the non-Elkins Defendants, discussed some of the Plaintiff's allegations of Elkins's control of the Board.\(^8\) That Elkins set out agendas for Board and Compensation Committee meetings; that Elkins attended meetings; that he spoke with directors outside of the meetings; that he negotiated his compensation packages with the Board and Compensation Committee; or even that he spoke with the Board's compensation consultant are all, individually, not enough to show a breach of Elkins's duty of loyalty. But these, taken together, and coupled with the Complaint's allegations that Elkins reviewed and revised every draft of Bachelder's reports before they were submitted to the Board,\(^2\) that Elkins exerted pressure on Bachelder to justify Elkins's

\(^7\) Without more, a plaintiff's allegation that it did not find a certain corporate document may mean little. It is significant, however, that the Committee, through proceedings in the Bankruptcy Court, was able to conduct an investigation to develop and to support its allegations. E.g., Compl. ¶¶ 17, 20 & 58. This investigation allowed for substantially broader inquiry than would have been available under, for example, 8 Del. C. § 220. It included not only obtaining documents but also deposing directors and former in-house counsel. Thus, the alleged absence of approvals, in this unique circumstance, supports the inference, at least in the context of a motion under Court of Chancery Rule 12(b)(6), that there was none. Again, the facts, when fully developed, may turn out to be quite different.

\(^7\) In re Walt Disney Co. Deriv. Litig., 825 A.2d at 290.

\(^8\) Id.

\(^9\) Hearing Tr. at 23-24. While this discussion dealt with whether the Board was "behind" to Elkins, it is useful in this context as well. The allegations are listed in Compl. ¶¶ 17-19.

\(^2\) Id. ¶ 34.
compensation;\textsuperscript{83} that Elkins's March 19, 1998 letter to the Board stated inaccurate facts as to what the Compensation Committee had previously approved in regard to forgiveness of previous loans;\textsuperscript{84} that Elkins caused IHS to disburse funds to him without corporate authority;\textsuperscript{85} that Elkins insisted on the 1999 Loan Program solely because he thought Citibank would seek to eliminate IHS's use of its credit agreement to provide loans to employees;\textsuperscript{86} and that Elkins insisted on extending a Five-Year Forgiveness Term to all of his loans, notwithstanding opposition by Bachelder;\textsuperscript{87} suggest Elkins "may have breached his fiduciary duties by engaging in a self-interested transaction."\textsuperscript{88}

Elkins argues that either Compensation Committee or Board approval cleanses any duty of loyalty violation he may have committed. The Plaintiff is not alleging here that Elkins breached his fiduciary duty of loyalty because of the end result of achieving the Challenged Transactions. The Plaintiff is arguing that Elkins, in bad faith, manipulated the process of Compensation Committee or Board approval itself. If he manipulated the process, he cannot benefit from the decisions reached through that process.

Elkins is correct that this case is not identical to \textit{Telxon Corp. v. Meyerson}.\textsuperscript{89} Telxon addressed an entire board's approval of board member compensation. There, the board was self-determining its compensation. Here, however, the Plaintiff is alleging that Elkins engaged in a pattern of behavior, in bad faith, to self-determine his benefits, notwithstanding the necessity of board approval. To the extent the Complaint argues facts that, if true, would show Elkins acted in bad faith and in conflict with his fiduciary duty of loyalty to IHS, such a claim cannot be dismissed at this stage.

\textbf{E. Waste}

Count III of the Complaint claims that each of the Defendants wasted corporate assets by approving the Challenged Transactions and by failing to assure the proceeds of the loans from IHS to executive officers were used for the stated corporate purpose.

Waste is a standard rarely satisfied in Delaware courts. Indeed,

\textsuperscript{83}Id. ¶ 38
\textsuperscript{84}Id. ¶ 57.
\textsuperscript{85}Id. ¶ 26, 27, 58, 64.
\textsuperscript{86}Id. ¶ 66.
\textsuperscript{87}Id. ¶ 75.
\textsuperscript{88}\textit{In re Walt Disney Co. Deriv. Litig.}, 825 A.2d at 290.
\textsuperscript{89}802 A.2d 257 (Del. 2000).
waste is "an extreme test, very rarely satisfied by a . . . plaintiff."90 In *Brehm v. Eisner*, the Supreme Court described the plaintiffs' allegations as that the board not only committed a procedural due care violation in approving an employment agreement, "but also that the Board committed a 'substantive due care' violation constituting waste."91 The Court went on to dismiss the characterization of waste in this manner, equating due care with *process*. In evaluating a waste claim, courts look to the exchange *itself*. The exchange must be *irrational*.92

To succeed in proving waste, a plaintiff must plead facts showing ""an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.""93 Further, when dealing with a board's decision on executive compensation, its substantive decision is entitled to great deference. "It is the essence of business judgment for a board to determine if "'a "particular individual warrant[s] large amount[s] of money, whether in the form of current salary or severance payments."'"94

The Plaintiff's brief acknowledges that there are only two ways for a waste claim to survive a motion to dismiss: the Complaint alleges facts showing the corporation received no consideration, or that a transfer of corporate assets served no corporate purpose.95 As written in IHS's 1999

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92*Id.* at 264. This is an important distinction. Rarely, if ever, will a plaintiff have direct evidence of a board's intent. Yet the *Disney* standard is scienter-based. Thus, the Court will generally be required to look to the Board's actions as circumstantial evidence of state of mind. The Court, in analyzing whether an action was taken with intentional and conscious disregard of a board's duties, must determine that the action is beyond unreasonable; it must determine that the action was irrational.

In *Brehm*, the Supreme Court noted this distinction. In rejecting the "substantive due care" argument made by the plaintiffs, the court noted

Due care in the decisionmaking context is *process* due care only. Irrationality is the outer limit of the business judgment rule. Irrationality may be the functional equivalent of the waste test or it may tend to show that the decision is not made in good faith, which is a key ingredient of the business judgment rule.

*Id.* at 264. In the case of an alleged breach of fiduciary duty for intentionally and consciously disregarding one's duties of faithfulness and care, the Court will focus on whether the Board's *process* is *irrational*. In executive compensation cases, the Court will look to see whether the Board engaged in any form of review or deliberation. While a board's action might be found to violate both the standard framed in *Disney* and the waste standard, this is not one of those cases.

93*Id.* at 263 (quoting *In re Walt Disney Co. Deriv. Litig.*, 731 A.2d at 362 (quoting *Glazer v. Zapata*, 658 A.2d 176, 183 (Del. Ch. 1993))).
94*Id.* (quoting *In re Walt Disney Co. Deriv. Litig.*, 731 A.2d at 362 (quoting *Grimes v. Donald*, 673 A.2d 1207, 1215 (Del. 1996))).
95Pl.'s Brief at 38 (citations omitted).
Proxy Statement:\textsuperscript{96} One of the Company's strengths contributing to its success is a strong management team, many of whom have been with the Company for a large number of years. The Committee believes that low executive turnover has been instrumental to the Company's success, and that the Company's compensation program has played a major role in limiting executive turnover. The compensation program is designed to enable the Company to attract, retain and reward capable employees who can contribute to the continued success of the Company, principally by linking compensation with the attainment of key business objectives.\textsuperscript{97}

This stated corporate purpose, to retain key employees, is repeated in IHS's 1998 and 1997 Proxy Statements.

The Plaintiff challenges this stated purpose, claiming it to be a sham, because of the Board's failure to monitor how the loans were spent. While challenging a failure to monitor may be a proper breach of duty of care claim, I cannot conclude that an alleged failure to monitor proceeds of compensation, \textit{ex post}, without more, is enough to conclude that a Company's articulated purpose is a sham.

The Plaintiff's brief argues that, regardless of corporate purpose, a motion to dismiss a waste claim must fail if the corporation received no valid consideration for its exchange of assets. Delaware law recognizes that retention of key employees may itself be a benefit to the corporation.\textsuperscript{98} The Plaintiff argues that, with regard to the Extension of the Five-Year Forgiveness Term, Bachelder believed that such extension could not be supported by consideration to be obtained by IHS. However, Plaintiff does not claim that the Board knew of Bachelder's determination.\textsuperscript{99} The Five-

\textsuperscript{96}IHS's 1997-1999 Proxy Statements are included in the Appendix to the non-Elkins Defendants' Motion to Dismiss, and were not among the documents included in the Plaintiff's motion to strike. The Court considers them incorporated by reference to the Complaint.

\textsuperscript{97}1999 Proxy Statement.

\textsuperscript{98}Beard \textit{v.} Elster, 160 A.2d 731, 738 (Del. 1960). See also Zupnick \textit{v.} Goizueta, 698 A.2d 384, 387-88 (Del. Ch. 1997). The Plaintiff challenges the Defendants' reliance on Zupnick. Although Zupnick dealt with the awarding of options for past consideration, instead of the awarding of compensation to retain services, the basic argument that additional compensation is waste because an officer was already contractually obligated to perform services to the company and had been compensated for doing so is present in both Zupnick and this case, and was rejected in Zupnick.

\textsuperscript{99}At oral argument, the Plaintiff conceded that the Complaint, while alleging that Elkins sought out Bachelder to justify the extension of the forgiveness provisions, does not allege that the Board relied on Bachelder, or knew of Elkins's consultation with him. Hearing
Year Forgiveness provisions were designed to forgive 20% of a loan so long as an officer was in the continuous employ of IHS.\(^{100}\) It is not irrational to conclude that the extension of these provisions induced Elkins to stay with IHS in the face of troubling financial times.\(^{101}\) In sum, I conclude that this is not an "unconscionable case [] where [the] directors irrationally squander[ed] or g[a]ve away corporate assets."\(^{102}\)

\(F.\) The Elkins Waiver Agreement

The Agreement\(^{103}\) provides:

The Debtors shall have, and shall be deemed to have fully, finally and forever released, relinquished and discharged all Elkins Released Parties from all Released Claims that they individually or collectively, whether directly, representatively, derivatively, or in any other capacity, ever had, now have, or hereafter can, shall or may have[].\(^{104}\)

Released Claims are defined generally to include:

[A]ll Claims, rights, causes of action (including Avoidance Power Causes of Action), notes, debts, accounts payable, rights of reimbursement or contribution, demands, judgments, suits, matters and issues, known or unknown, whether individual, class, derivative, representative, legal, equitable, or any other type, or in any other capacity, of the Debtors, in each case against an Elkins Released Party.\(^{105}\)

Excluded from this general definition are claims giving right to a loss arising from Wrongful Acts.\(^{106}\) That term, defined for purposes of the Agreement as defined in directors' and officers' insurance policies procured by IHS (the "D&O Policies"), includes alleged breaches of fiduciary duty.

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\(^{100}\) Compl. ¶ 78.

\(^{101}\) Brehm, 746 A.2d at 264 (2000) ("Irrationality is the outer limit of the business judgment rule.").

\(^{102}\) Id. at 263.

\(^{103}\) The parties have not questioned that the Court may consider the Agreement.

\(^{104}\) Agreement at § 7.1(ii).

\(^{105}\) Id. § 1.24.

\(^{106}\) Id. § 1.24(i).
Moreover, the Agreement limits the source of recovery for Non-Released (i.e., Wrongful Acts for these purposes) claims to those covered by the D&O Policies:

[I]t [is] the express intent of the parties to this Agreement that the insurance available, if any, pursuant to the D&O Policies shall be the sole source of recovery for any Claims of the Debtors which do not constitute Released Claims; provided, however, a Claim against Elkins giving rise to a Loss arising from a Wrongful Act shall constitute a Released Claim if the Loss incurred by Elkins with respect thereto exceeds the amount actually paid by the Insurer under any D&O Policy (but shall constitute a Released Claim only for the amount of such excess)[.]

It is not in dispute that the breach of fiduciary duty claims are Wrongful Acts, as the Agreement (by way of the D&O Policies) defines them. The Plaintiff has admitted that the D&O Policies are the sole source of recovery. I see no reason, especially in light of this concession, that the Plaintiff's claims against Elkins should be dismissed. To the extent any damages, if found, exceed coverage under the D&O Policies, they will be deemed to constitute Released Claims.

IV. CONCLUSION

For the foregoing reasons, the non-Elkins Defendants' motion to dismiss the Plaintiff's waste claim is granted. Similarly, the non-Elkins Defendants' motion to dismiss the Plaintiff's fiduciary duty claims, with regard to the 1996 Bonus, 1997 Option Grant, 1997 Loan Program, and 1997 Compensation Revisions is granted. The non-Elkins Defendants' motion to dismiss the Plaintiff's fiduciary duty claim in regard to the $2.088 Million Loan is dismissed as to all non-Elkins defendants except for Mazik and Newhall. The non-Elkins Defendants' motion to dismiss is granted for Cirka as to the $4.2 Million Loan, the Extension of the Bonus Forgiveness Term to the $2.088 Million Loan, the $4.5 Million Loan, the 1999 Loan Program, the Extension of the Five-Year Forgiveness Term, and the Elkin

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107Id.
108Pl.'s Opening Br. at 44 ("Plaintiff acknowledges that the Release limits any recovery against Elkins to amounts actually paid by the insurers, and acknowledges further than, as a result, Plaintiff may not recover from Elkins or from any Elkins Released Party any amount in excess of amounts actually paid by the insurers.").
"Poison Pill." The non-Elkins Defendants' motion to dismiss is granted for Crawford and Strong as to the Elkins "Poison Pill." In all other respects, the non-Elkins Defendants' motion to dismiss is denied.

Elkins's motion to dismiss the Plaintiff's waste claim is granted. To the extent the Plaintiff's claims reach Elkins as a Board member, Elkins's motion to dismiss those claims is granted to the same extent as the non-Elkins Defendants' motion to dismiss. Elkins's motion to dismiss the Plaintiff's breach of fiduciary duty claims made against him individually and in a capacity apart from his role as a director is denied.

Counsel shall confer and submit a conforming order within 10 days.

IN RE ORACLE CORP. DERIVATIVE LITIGATION

No. 18,751 (Consolidated)

Court of Chancery of the State of Delaware, New Castle

November 24, 2004
Revised December 2, 2004


Kenneth J. Nachbar, Esquire, of Morris, Nichols, Arst & Tunnell, Wilmington, Delaware; Alan N. Salpeter, Esquire, Javier H. Rubinstein, Esquire, and Sheri L. Drucker, Esquire, of Mayer, Brown, Rowe & Maw, LLP, Chicago, Illinois, of counsel; and Donald M. Falk, Esquire, John Nadolenco, Esquire, Christopher P. Murphy, Esquire, and Shirish Gupta,
Esquire, of Mayer, Brown, Rowe & Maw, LLP, Palo Alto, California, of counsel, for defendants Lawrence J. Ellison and Jeffrey O. Henley.

Allen M. Terrell, Jr., Esquire, and Brock Czeschin, Esquire, of Richards, Layton & Finger, Wilmington, Delaware; and Jordan Eth, Esquire, of Morrison & Foerster, San Francisco, California, of counsel, for Oracle Corporation.

David C. McBride, Esquire, Christian Wright, Esquire, and Adam Poff, Esquire, of Young Conaway Stargatt & Taylor, LLP, Wilmington, Delaware; and James G. Kreissman, Esquire, of Simpson, Thacher & Bartlett, Palo Alto, California, of counsel, for the Special Litigation Committee of Nominal Defendant Oracle Corporation.

STRINE, Vice Chancellor

This derivative action involves a claim that two of the top officers at Oracle Corporation breached their fiduciary duty of loyalty to the company by selling stock in the company at a time when they possessed material, adverse, nonpublic information about the company. The plaintiffs thus raise a claim under the venerable case of Brophy v. Cities Service Co.\(^1\) Defendant Lawrence J. Ellison is Oracle's largest stockholder and was its Chairman of the Board and Chief Executive Officer at the time of the events relevant to this case. Defendant Jeffrey O. Henley was Oracle's Chief Financial Officer and director at the time of the complaint.

Ellison and Henley are alleged to have sold large amounts of Oracle stock in 2001—albeit amounts that were only a small percentage of their total Oracle holdings—while in possession of information that, according to the plaintiffs, suggested that Oracle would be unlikely to meet its publicly-announced revenue and earnings projections for that quarter, which was to end on February 28, 2001. Those projections—the "Market Estimates"—had indicated that Oracle would increase its FY 2001 third quarter "3Q 01" license revenues "about 25%" over the comparable quarter in the previous year, "3Q 00," and would earn 12 cents per share.\(^2\) As it turned out, Oracle fell far short of those projections, delivering license revenue growth of only 5% and earnings of only 10 cents per

\(^{1}\)70 A.2d 5 (Del. Ch. 1949).
\(^{2}\)DX 83. Both parties have submitted extensive evidence. For ease of reference, Plaintiffs' and Defendants' exhibits will be referred to as "PX ___" and "DX ___." respectively. Similarly, the charts summarizing the evidence that both parties submitted will be referred to as "PC ___" and "DC ___."
share—results that moved Oracle's stock price sharply downward. According to the plaintiffs, Ellison and Henley both possessed material financial information before their January 2001 trades that should have led them to recognize that Oracle would not meet the Market Estimates. Having sold shares at prices materially in excess of Oracle's market price after Oracle disclosed that it would not meet the Market Estimates, Ellison and Henley allegedly reaped ill-gotten gains that the plaintiffs say should be returned to Oracle.

The case is now before the court on a summary judgment motion. After a review of the massive record, I conclude that Ellison and Henley are entitled to summary judgment. In keeping with prior Delaware precedent, I conclude that Ellison and Henley can only be held liable if they acted with scienter, by trading, in whole or in part, because they possessed adverse, nonpublic information that made it likely that Oracle would fall materially short of the Market Estimates. Contrary to the plaintiffs, I conclude that no rational trier of fact could find that: 1) Ellison or Henley possessed material, nonpublic financial information as of the time of their trades; or 2) Ellison or Henley acted with scienter, by consummating trades in part because they believed, on the basis of the nonpublic information they had received, that Oracle would materially fall short of the Market Estimates. As a result, I find that even if Brophy v. Cities Service Co. remains good law, this case should be dismissed.

The grounds for this decision are fully set forth in the later pages of this opinion but can be summarized as follows:

- The conservative bias of Oracle's financial projection system, which resulted in estimates of earnings and license revenue growth that were more likely to be low than high. There is no evidence to cast doubt on the integrity of Oracle's estimation process. Within this process, the estimates of Oracle executive Jennifer Minton were historically the most accurate and given the most weight;
- Oracle's best estimates of its 3Q 01 results at the time of Henley's and Ellison's trades, which continued to predict that the company would either exceed or meet the Market Estimates;
- The lack of any record evidence that Henley or Ellison had been informed as of the time of their trades by any

3DX 87.
subordinate in the company that the company was not in a position to meet or even exceed the Market Estimates;

- The reality that well over a majority of Oracle's quarterly income is generated within the last month of the quarter, and that most of the last month's revenue is generated in the last week of the quarter.
- The undisputed evidence that Oracle's 3Q 01 prospects weakened substantially in the last month of the quarter (February 2001), the month following the completion of trading by Henley and Ellison, largely due to customers refusing to close deals in the final days of the quarter;
- The evidence that even with that weakening, Oracle's internal estimates indicated that it could possibly meet or almost meet the 12 cents estimate in the Market Estimates as late as February 12, 2001;
- The uncontradicted evidence that lower level Oracle executives were surprised and dismayed at the rapid deterioration in their units' results in the last few days of February 2001;
- The absence of any apparent exigency or rational motive that would have led Ellison or Henley—who owned huge amounts of Oracle stock—to sell small portions of their Oracle holdings because they thought Oracle's performance was declining, and the presence of other legitimate, unsuspicious reasons that explain the timing of their sales.

Taken together, the record simply will not support a rational inference of wrongdoing, even given the plaintiff-friendly standard that applies on a motion for summary judgment. At best, the plaintiffs have pointed to the existence of financial information that might have led a rational insider at Oracle at various points in January 2001 to believe that Oracle might not meet the Market Estimates, if they had thought about the information in the manner that the plaintiffs now do (which there is no evidence that Ellison or Henley did) and had the benefit of hindsight (which Ellison and Henley did not). Of course, the reality is that public companies often possess intraquarter information that suggests that meeting quarterly projections is not certain or may even be doubtful. That is inherent in the nature of projections, which are not warranted guarantees. In fact, the record indicates that Oracle had previously succeeded in
meeting quarterly estimates in quarters when the company's information, as of the second month of the quarter, was bleaker than that possessed in January 2001 as to the likely results of 3Q 01.

Most important, the undisputed evidence is that Ellison and Henley were presented with their subordinates' best estimates of 3Q 01 performance throughout January 2001 and that every projection until January 29, 2001—when Henley was long done trading and Ellison was nearly done—predicted that Oracle would exceed the Market Estimates. Even the January 29, 2001 projections showed Oracle earning 11.58 cents per share and having license revenue growth of 24%, which given Oracle's practice of rounding up and its revenue estimate of "about 25%" growth, were projections that, if achieved, still would have met the Market Estimates exactly. Put bluntly, although Ellison and Henley had less reason to be confident that the company would meet the Market Estimates as of the end of January 2001, there is no rational basis to question their stated belief that they thought they would because that belief was based on the best advice of their subordinates, which indicated that the company was positioned to do so. In other words, there simply existed no nonpublic information as of the relevant dates that reliably predicted that Oracle would fall materially short of the Market Estimates.

In sum, after receiving huge amounts of documentary evidence and taking several depositions, the plaintiffs have failed to turn up evidence that supports a rational inference that Ellison or Henley abused their positions of trust at Oracle by exploiting material, adverse financial information in order to sell their stock at artificially inflated prices. Absent such evidence, the plaintiffs have no triable claim under *Brophy*.

I. Factual Background

A. A Comment On The Record

The evidentiary record developed in this case is massive. The current motion practice followed previous motion practice regarding whether the recommendation of an Oracle special litigation committee ("SLC") that this case should be dismissed was entitled to deference under the *Zapata* standard.\(^{4}\) In an opinion that did not reach the merits of that recommendation, this court held that the exacting standards of independence that apply in the special litigation context were not met.\(^{5}\)

The reality is that the SLC Report was highly influential to the way

\(^{4}\) *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003).

\(^{5}\) *Id.* at 947.
this case later proceeded. For one thing, the plaintiffs have substantially changed their earlier arguments, popping up new ones to replace the ones whacked by the SLC.\(^6\) For another, the plaintiffs reduced the focus of their attack by dropping their claims against certain other Oracle directors who sold during 3Q 01 and targeting Ellison and Henley exclusively.

Having started with a ponderous record of evidence compiled with the SLC, the parties then expanded it further. Although given extra pages to write their brief, the plaintiffs' lawyers granted themselves even more pages by filing an affidavit of one of their number, which was simply a brief by another name containing additional arguments that did not fit within their 80 page answering brief. I struck the submission as an affidavit but permitted it to be treated as an additional brief and gave the defendants a corresponding additional brief. More onerously, the plaintiffs submitted an unwieldy array of appendices, broken down into four varieties, totaling over forty volumes.

The defendants, by modest contrast, confined themselves to submitting a smaller, but still very substantial, number of pages to support their motion for summary judgment. Taken together, the plaintiffs' and defendants' submissions come close to an all-evidence dump of discovery.

In approaching this record, my focus is where I told the plaintiffs it would and must be: on what information Ellison and Henley possessed at the relevant times. That focus is designed to illuminate whether there is evidence from which a rational fact-finder could conclude: 1) that Ellison or Henley possessed material, nonpublic information at the time of their trades in 3Q 01; or 2) that their possession of material, nonpublic information motivated, in whole or part, their trades in 3Q 01. As I will explain again later, I am focused on the evidence that exists regarding what Ellison and Henley knew, believed, and did before their trades in 3Q 01 and not on what the plaintiffs, in litigation-inspired hindsight, argue that Ellison and Henley should have done, but did not do, to analyze the information they received before their trades.

\(^6\)A reading of my prior opinion is suggestive of the differences. See In re Oracle Corp. Derivative Litig, 824 A.2d 917 (Del. Ch. 2003). The defendants have abandoned those theories that did not pan out after the SLC developed an extensive factual record and additional discovery was taken. Oddly, as this case was being argued at the summary judgment stage, a federal complaint relying upon theories more like the original complaint in this case was reinstated by the United States Court of Appeals for the Ninth Circuit. Nursing Home Pension Fund, Local 144 v. Oracle Corp., et al., 380 F.3d 1266 (9th Cir. 2004). This opinion, of course, addresses only the arguments made in this case in the summary judgment briefs.
B. Overview of Oracle Corporation

Oracle is the second largest software company on Earth. It specializes in developing, making, selling, distributing, and servicing computer software that helps businesses, government agencies, and other complex organizations manage themselves.

The company was co-founded in 1977 by defendant Larry Ellison who continued to be its CEO during the events giving rise to this lawsuit. By the end of its FY 2000 (which ended on May 31, 2000), Ellison and Oracle could look back on the company's first year with revenues in excess of $10 billion and operating income of over $3 billion. That achievement topped off an impressive period of growth, with Oracle's FY 00 results showing strong growth over the revenue and operating income of $5.7 billion and $1.26 billion it achieved in FY 97.

This strong performance enabled Oracle to effect a two-for-one stock split in FY 00 and to see the value of its common stock increase sharply in the market, such that the mean of its low and high price for the last quarter of FY 00 had reached $37.74. As Oracle's largest stockholder, holding over 1.39 billion shares—let's underscore that—1.39 billion shares!—or 24% of Oracle's common stock, Ellison was one of the world's wealthiest persons. By FY 00, Ellison was taking most of his annual compensation in options, having given up most of his salary and bonus income.

By this time period, Defendant Henley had also amassed considerable personal wealth as Oracle's CFO and Executive Vice President. In FY 00, Henley received total cash compensation of over $2.1 million plus options for a million Oracle shares. Perhaps more pertinently, Henley also owned a large amount of Oracle stock—over 15 million shares on a split-adjusted basis. Although this is insubstantial compared to Ellison, it is substantial relative to most millionaires, as those shares then had a value between $400 and $500 million.

As of the end of FY 00, therefore, Oracle—as well as Ellison and Henley—were riding high. The company was thriving and its key executives were benefiting from that success.

On the horizon, however, Oracle faced the challenge of continuing to increase its revenues and operating income in the face of a slowing economy in 2000 and the bursting of the dot.com bubble. Because many

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7See DX 77 at 10.
8Id.
9DX 81 at 9 of 54.
10See DX 79 at 9568. Oracle effected a two for one stock split on October 12, 2000. Thus, the 696,356,050 shares shown in DX 79 as of August 21, 2000 became 1.39 billion shares soon thereafter.
of its products are expensive, Oracle had to prove that it could continue to sell in a market when procurement budgets at both businesses and government agencies might narrow substantially in the short-term. And because many dot.coms had gone bust, that sector was not positioned to continue as a growth vehicle for Oracle sales or even as a consistent source of on-going revenues.

C. Oracle's Sources Of Revenue

The most important driver of Oracle's profitability is its software licensing business. In FY 00, licensing was responsible for 44% of the company's total revenues.\(^{11}\)

The reason that licensing is important is that Oracle's other revenues are largely derivative of a customer's original decision to buy a license to use Oracle software. Thus, in FY 00, Oracle derived 29% of its revenues from support services it provided to users of its software, 22% from training personnel who consult with users of its software, and 5% from providing education about the use of its software.\(^{12}\)

Because licensing is so important to Oracle's business, it is the focal point of the plaintiffs' claims. Therefore, it has also occupied the bulk of the defendants' response and will be a major focus of this opinion.

D. Oracle's License Revenues

The decision to invest in a major software system made by Oracle (its database product and/or its enterprise software) is no small matter for businesses and government. These systems are expensive and will be used during a multi-year period (or so it is hoped).

These realities resulted in a pattern of revenue receipt by Oracle that is important to understand. First of all, Oracle's license revenues tend to be lowest in the first quarter of any fiscal year, increase in the second and third quarters, and peak in the last quarter.

Second and most important, Oracle's license revenues tend to come in within the last month of each quarter, a so-called "hockey stick effect." The analyst community is well aware of this phenomenon, and the words of one analyst well capture the writings of many who covered Oracle: "[E]asily 50% of license revenues historically have been done in the final month of the quarter, with much of that coming in the final week of the

\(^{11}\) DX 81 at 11 of 54.
\(^{12}\) DX 81 at 5 of 54.
quarter. In point of fact, that analyst statement underestimated the extent of the hockey-stick effect for Oracle. That effect was, as I will next portray, even more pronounced.

The reason for the effect is well-understood. Purchasers of software harbor a belief, perhaps borne of experience or superstition, that sellers will cut the best deal near the end of a quarter because they are counting on the sale to make their quarterly projections. As a result, purchasers hold out until the end, trying to extract the last concessions before signing a binding deal. This leads to the last-minute booking of many sales when times are good, and the potential that many deals might fall through right before quarter's end or slip into later quarters if buyers are experiencing budget pressure. To the extent that the negative scenario is the one that pans out, there is the obvious risk that Oracle will fail to meet its quarterly earnings projection.

To highlight the importance of this effect and to make later references clearer, it is useful to describe Oracle's primary license generating units. As of FY 00, Oracle's license sales force in North America was divided into three divisions. Oracle Service Industries ("OSI") handled sales to government agencies, educational institutions, and companies in the financial services, telecommunications, utilities, and health care industries. Oracle Product Industries ("OPI") sold to businesses that make products. Northern American Sales ("NAS") sold to customers not within OPI's and OSI's domain, including customers with revenues of less than $500 million annually, which included most of Oracle's dot.com clients. Taken together, OSI, OPI and NAS generated most of Oracle's license revenue, with other sources of revenues coming from Oracle sales abroad.

Now that OPI, OSI and NAS have some meaning, I return to the hockey-stick effect's importance at Oracle. Illustrative of that phenomenon is the following chart, which shows the extent to which the last month of a quarter's revenues dominate Oracle's quarterly revenues. The units other than OSI, OPI, and NAS all reflect license sales units for areas other than North America:

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13DX 144 at 1110-11; see also DX 142, DX 143, DX 147 (reflecting analysts' awareness of the fact that Oracle's revenues tended to come in very near the end of quarters and that the ultimate numbers for any quarter were heavily dependent on that end-period).
Percentage of Oracle Quarterly Revenue by Month for Major Business Units (FY 01)\textsuperscript{14}

<table>
<thead>
<tr>
<th>Business Unit</th>
<th>Month 1</th>
<th>Month 2</th>
<th>Month 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>OSI</td>
<td>7%</td>
<td>10%</td>
<td>83%</td>
</tr>
<tr>
<td>NAS</td>
<td>11%</td>
<td>11%</td>
<td>78%</td>
</tr>
<tr>
<td>OPI</td>
<td>17%</td>
<td>7%</td>
<td>76%</td>
</tr>
<tr>
<td>Latin America</td>
<td>17%</td>
<td>29%</td>
<td>53%</td>
</tr>
<tr>
<td>EMEA</td>
<td>19%</td>
<td>21%</td>
<td>60%</td>
</tr>
<tr>
<td>Japan</td>
<td>25%</td>
<td>27%</td>
<td>48%</td>
</tr>
<tr>
<td>APAC</td>
<td>15%</td>
<td>17%</td>
<td>68%</td>
</tr>
</tbody>
</table>

The third month of each quarter was also the month that delivered the most revenue for Oracle's other major revenue generating units, support and consulting, though the effect is less pronounced. Given all divisions' dependence on third month revenues, over 50% of Oracle's total revenues came in within the third month of a quarter during FY 01, as the following chart shows:

Average Percentage of Oracle Quarterly Revenue by Business Unit and Month (FY01)\textsuperscript{15}

<table>
<thead>
<tr>
<th>Business Unit</th>
<th>Month 1</th>
<th>Month 2</th>
<th>Month 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>License</td>
<td>15%</td>
<td>16%</td>
<td>69%</td>
</tr>
<tr>
<td>Support</td>
<td>32%</td>
<td>31%</td>
<td>37%</td>
</tr>
<tr>
<td>Consulting</td>
<td>33%</td>
<td>27%</td>
<td>40%</td>
</tr>
<tr>
<td>Total</td>
<td>24%</td>
<td>24%</td>
<td>52%</td>
</tr>
</tbody>
</table>

This depiction is not atypical and reflects the continuation and deepening of a pattern that had persisted at Oracle for several years.

License revenue was typically even more compressed, with most coming in within the last week of the quarter, not just the last month, as this chart addressing FY 01 shows:

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\textsuperscript{14}DC 4.
\textsuperscript{15}DC 2.