Tuesday, October 26
2:30pm-4:00pm

705 - View from the Delaware Bench: Corporate Outlook, Reform, Revelations and Innovations

Michael A. Barlow
Legal Counsel
Office of Governor Jack A. Markell

Jeffrey Bullock
Secretary of State
State of Delaware Department of State

Christopher Butner
Assistant Secretary and Managing Counsel, Securities/Corporate Governance
Chevron Corporation

Jack Jacobs
Justice
Delaware Supreme Court

Donald Parsons
Vice Chancellor
Delaware Court of Chancery

Andrea Unterberger
Associate General Counsel
Corporation Service Company

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Session 705

Faculty Biographies

Michael A. Barlow

Michael A. Barlow is chief legal counsel to Delaware Governor Jack A. Markell. In that capacity, Mr. Barlow is responsible for providing legal advice to the Governor on legislation, litigation, appointments, and policy matters.

Prior to entering public service, Mr. Barlow practiced corporate litigation with Skadden, Arps, Slate, Meagher & Flom LLP in Wilmington. His practice included litigation in the Delaware Court of Chancery, as well as multi-state and multi-district matters arising under the Delaware General Corporation Law, federal securities laws, and state and local tax laws. Mr. Barlow served as a law clerk to the Honorable Thomas L. Ambro of the U.S. Court of Appeals for the Third Circuit and the Honorable Roderick R. McKelvie of the District of Delaware.

Kevin Brady
Connolly Bove Lodge & Hutz

Jeffrey Bullock

Jeffrey W. Bullock is currently Delaware's 80th Secretary of State. Secretary Bullock oversees nearly twenty different agencies, including the Division of Corporations, the Division of Historical and Cultural Affairs, the Division of the Arts, and the Division of Professional Regulation. He also has a number of constitutional responsibilities, including serving on the Board of Pardons. In his first year as Secretary of State, he has been a transformational leader in advancing Governor Markell's priorities in the areas of education, job creation and smaller, more efficient government. Under his direction, the Department of State continues to raise significant revenue for the State of Delaware, and the Division of Corporations unveiled a 30-minute expedited service offering for filings to further enhance service and revenue. Secretary Bullock orchestrated the move that brought the International Trade and Development Group (ITG) into the Secretary of State's Office from the Office of Management and Budget. The ITG has worked to develop business and incorporating opportunities by visiting with professionals in Canada, Spain, Sweden, Korea and Israel and has endeavored to bring significant green industry to Delaware in the form of wind turbine production.

Secretary Bullock has dedicated most of his professional career to public service. He brings to the Department of State a wide range of executive public sector experience, including prominent roles in leading Delaware's two largest governments. He served as the chief of staff to Governor Thomas R. Carper. More recently, Bullock was the Chief Administrative Officer for New Castle County, Delaware's largest county.

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Christopher Butner

Christopher A. Butner is assistant secretary and managing counsel, securities/corporate governance, of Chevron Corporation. He provides advice and counsel to the board, the Board Nominating and Governance Committee and senior management in the areas of governance, the securities laws, and the NYSE listing standards.

Prior to joining Chevron, Mr. Butner was in private practice working on a variety of governance and securities law matters as an associate at Dewey Ballantine in New York. Prior to that, he served as associate at Jones Day in Dallas. He began his legal career with Law, Snakard & Gambill, P.C. in Fort Worth.

Mr. Butner received his LLM from Georgetown University, his JD from Oklahoma City University School of Law, summa cum laude, and his BS from Texas Christian University.

Jack Jacobs

Justice Jack B. Jacobs was appointed to the Delaware Supreme Court in 2003. He is also an adjunct professor of law at the law schools of New York University, Widener University, and Columbia University. He is a member of the American Law Institute (serving as advisor on the Restatement (Third) of Restitution), and of the Delaware and American Bar Associations (where he served on the ABA Business Law Section Committee on Corporate Laws). He also is a fellow of the American Bar Foundation, and an advisory board member of the Rand Center for Corporate Ethics and Governance. Justice Jacobs has participated in academic symposia programs related to corporate and securities law at various law schools and continuing legal education organizations. He has served as Distinguished Jurist Lecturer at the University of Pennsylvania Law School; Regent's Lecturer in Residence at the UCLA School of Law; Morrison & Foerster Lecturer at Stanford Law School; Distinguished Visiting Jurist at the Harvard Law School Corporate Governance Program and William J. Brennan Lecturer at NYU School of Law.

Before his appointment to the Delaware Supreme Court, Justice Jacobs was vice chancellor of the Delaware Court of Chancery. Prior to that, he practiced law in Wilmington, Delaware.

Besides authorizing numerous law review articles addressing various aspects of corporation law, mergers and acquisitions and corporate governance, Justice Jacobs has been an invited guest speaker at corporate law conferences throughout the world.

Justice Jacobs graduated from the University of Chicago (BA, Phi Beta Kappa) and from Harvard University (LLB).

William Lafferty
Morris, Nichols, Arsht & Tunnell

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Donald Parsons

Donald F. Parsons, Jr. is a vice chancellor of the Court of Chancery of the State of Delaware. As a member of the Court of Chancery, one of the world's preeminent business courts, Vice Chancellor Parsons regularly handles cases dealing with important issues affecting corporate governance under the Delaware General Corporation Law and various alternative entity statutes.

Before joining the Court of Chancery, he spent over twenty-four years at the firm of Morris, Nichols, Arsht & Tunnell LLP in Wilmington, Delaware, where he was a senior partner. While in private practice, he specialized in intellectual property litigation, participated in numerous jury and nonjury patent trials, and wrote several papers relating to intellectual property law. Before joining Morris, Nichols, Vice Chancellor Parsons clerked for the Honorable James L. Latchum of the United States District Court for the District of Delaware.

Currently, Vice Chancellor Parsons is the president of the American College of Business Court Judges or ACBCJ. The ACBCJ consists of judges from commercial, business, and technology courts in over 25 states from all over the United States. Vice Chancellor Parsons also serves as a business court representative to the Business Law Section of the American Bar Association. He also is a Past President of the Delaware State Bar Association.

He received a BS degree from Lehigh University and is a graduate of the Georgetown University Law Center.

Andrea Unterberger

Andrea B. Unterberger is assistant general counsel of Corporation Service Company (CSC), a leading provider of independent director, registered agent, transaction and corporate identity protection services, based in Wilmington, Delaware. Ms. Unterberger's responsibilities include diverse aspects of in-house practice, including litigation management, risk management, business development, human resources, and intellectual property, among others. Ms. Unterberger directs the company's media business, which includes book publishing and related web-based services. Additionally, Ms. Unterberger serves as a legal advisor to the company's independent director service and serves as an independent director for companies in financial distress.

Prior to joining CSC, Ms. Unterberger was a litigation attorney in the Wilmington office of Pepper Hamilton LLP, and a law clerk to the Hon. William B. Chandler III, of the Delaware Court of Chancery. Prior to attending law school, Ms. Unterberger served as a marketing director for Thomson Financial Services.

Ms. Unterberger is an active member of the Delaware State Bar Association and is on the board of ACC's Delaware Valley Area Chapter (DELVACCA). Ms. Unterberger has been a guardian ad litem for the Office of the Child Advocate since 2002.

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Ms. Unterberger graduated magna cum laude from Widener University School of Law, where she was an editor of the Delaware Journal of Corporate Law, and a Wolcott law clerk to the Hon. Randy Holland of the Delaware Supreme Court. Ms. Unterberger received her undergraduate degree from Brown University.

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- The Metropolitan Corporate Counsel® – Special Report, "CCLD: Another Great Delaware Business Court, June 2010, Editor Interview of Hon. Myron T. Steele, Chief Justice, Supreme Court of Delaware
- Superior Court of the State of Delaware Administrative Directive No. 2010-3, Complex Commercial Litigation Division

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Select articles from the Harvard Law Blog on Dodd-Frank Legislation

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SELECT ARTICLES FROM THE HARVARD LAW BLOG ON DODD-FRANK LEGISLATION

Finally, Governance Becomes Possible

Posted by Ira Millstein, Well Gotshal & Manges LLP, and Stephen Davis, Yale School of Management, on Monday August 30, 2010 at 12:33 pm on the Harvard Law Blog at the following web address: http://blogs.law.harvard.edu/corpgov/2010/08/30/finally-governance-becomes-possible/#more-12609. Editor's Note: Ira Millstein is a partner at Well Gotshal & Manges LLP and Senior Associate Dean for Corporate Governance of the Yale School of Management. Stephen Davis is executive director of Yale's Millstein Center for Corporate Governance and Performance.

Thirty years late, the new Dodd-Frank Act hands shareholders power to influence the composition of boards and shape CEO pay. But will these institutional investors, on whom Americans depend for their financial security, use their authority responsibly? Will corporate boards welcome and accept good faith dialogue with their shareholders? Will both sides forego short term financial engineering and align for the long term performance the country badly needs?

For decades, investors, anxious about a company gone awry, have had little choice but to complain from the sidelines, petitioning finger-wagging resolutions directors could easily ignore. Shareholders tried that to no avail at AIG before its epic collapse. Defenses fortified under-performing boards from pressure they should have faced to better control risks and tie CEO pay to measurable actual performance over time. But resolutions and defenses did not stop short-term funds that piled disabling debt on companies. Aggressive investors could cherry-pick firms for proxy fights or use stock techniques to harass. Long term institutional investors were shackled; the short term prevailed. One result: Too many boards tolerated management excesses and failures that ushered in the financial crisis.

Now comes Dodd-Frank. The hardest-fought governance provision in the Act is one that affirms the US Securities and Exchange Commission's authority to make it easier for investors to nominate candidates to corporate boards. Code named "access," such rules promise to put pressure on troubled companies to give investors reasons to stay loyal-or risk rebellion. The market won't collapse once access is part of the governance furniture. Similar rules exist around the world without causing anarchy. Under new SEC rules, challengers holding stock for at least three years would have to meet a 3% ownership threshold to petition a candidate – and then muster a majority vote to get him or her elected. That's tough unless a company is floundering or a board deeply out of touch. Still, just the existence of access is a powerful signal that alters the balance of power.

As a concession to business, lawmakers purged an equally sweeping reform from Dodd-Frank. That provision would have required board elections by majority vote. But 73% of S&P 500 companies have already switched to majority vote, and the rest will be under intense pressure to do so quickly. Moreover, Congress approved a step that makes majority voting more potent once installed. Dodd-Frank prohibits arcane 'broker non-votes' which routinely added to 'yes' totals. That crutch is no more.

All this amounts to a quiet upheaval in the way US corporations will operate. Sarbanes-Oxley, passed in the wake of Enron/Worldcom scandals, was a crackdown on fraud using a battery of government controls and enforcement. Dodd-Frank, by contrast, hands unprecedented rights to investors in the expectation that they will serve as a "neighborhood watch" against corporate mismanagement. We're not alone in this.

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Britain's Financial Reporting Council just launched a 'stewardship code' to rouse investor monitoring of corporate boards.

Boards and Investors, both, will need to rethink their respective responsibilities, new or expanded, under Dodd-Frank. The most critical step boards can take is to open dialogue with shareholders. Today, few directors do outreach. They leave it to management. But Dodd-Frank changes imperatives. Boards should invite investor input on nominations, risk and executive compensation policies, while preserving director authority. Some firms (e.g., Pfizer, Coca Cola, Prudential Financial) already pioneer working formats. What dividend do they get in return? The potential for more loyal, long-term investors- especially when firms must take risks to grow.

As to investors, Dodd-Frank places a colossal bet that shareholders will patrol the market. Up to now many, including major mutual funds, have simply voted shares on autopilot. That may have been rational when ballots carried little weight. But investors just paid a brutal price for inattention that runs to the trillions. Funds can tap new Dodd-Frank rights to assist, and hopefully ensure, that corporate boards drive the kind of long-term performance that benefits American savers.

Institutional investors will rightly face rising pressure to assume responsibility for mindful ownership practices which appreciate the uniqueness of each company. Shareholders will need to embrace the transparency and accountability they have long asked of corporate America.

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Governance Changes Under Dodd-Frank

Posted by Andrew R. Brownstein, Wachtell, Lipton, Rosen & Katz, on Friday September 24, 2010 at 9:33 am on the Harvard Law Blog at the following web address: http://blogs.law.harvard.edu/corpgov/2010/09/24/governance-changes-under-dodd-frank/#more-13074. This post is based on a Wachtell Lipton firm memorandum by Mr. Brownstein, Steven A. Rosenblum, Eric S. Robinson, Adam O. Emmerich, Trevor S. Norwitz, and Jenna E. Levine.

The Dodd-Frank Act mandates a variety of changes to the governance, disclosure and compensation practices of all public companies. Many of the provisions of the Act require further SEC rulemaking and interpretation before definitive responses can be implemented, but companies should become familiar with the pending changes and take preparatory steps where possible. The purpose of this memo, which we will periodically update, is to provide a framework for our recommendations by highlighting certain actions companies should consider taking immediately, as well as certain key provisions of the Act which will require responses in the longer term. (Links to our earlier memos are embedded throughout and in the attached index.)

Immediate Action Items

Prepare for Proxy Access and the Upcoming Proxy Season. As a result of their publication in the Federal Register today, the new proxy access rules will become effective on November 15, 2010, and will apply to the 2011 proxy season for companies (other than small reporting companies) that mailed their 2010 proxy statements on or after March 15, 2010. In our recent memo (available on the Forum here, we outlined certain steps that companies should consider now in light of the adoption by the SEC of the new regime. These include enhancing investor relations and shareholder communications programs, monitoring the company's investor base and shareholder filings, updating changes to advance notice and director qualification by-laws and corporate governance policies, and reviewing the size and makeup of the board. Issuers should monitor the application of the new rules, and keep directors apprised of any significant developments. As limitations on broker discretionary voting continue to put pressure on obtaining quorums and passage of important mandates, companies may wish to consider the need for more aggressive proxy solicitation efforts and selective investor outreach.

Review Board Agendas in Light of Regulatory Changes. The coming year will necessarily bring a large number of governance changes, and advance planning for implementation of those changes will be hampered by the current lack of clarity around the new rules. In order to enable timely reactions when needed, it is important that directors be kept apprised of new information about the rules as it becomes available. To this end, companies are advised to consider periodic board update sessions on rulemaking as it continues.

Review (or Consider Adopting) Hedging Policies. Disclosure of whether employees or directors are allowed to hedge company stock will soon be required (and will cover certain transactions which are not addressed by many companies' existing anti-hedging policies). Companies should review their anti-hedging policy with an eye to bringing it in line with the transactions and persons covered by the new disclosure requirement. Companies that do not have a policy on hedging may want to adopt one.

Participate in the SEC Rulemaking Process for Whistleblower Bounties. The Act creates a system of cash incentives to encourage and reward whistleblowers who come forward to the SEC. As we noted in a recent memo (available on the Forum here), the new rules unfortunately create a major financial incentive

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for employees with knowledge of wrongdoing to bypass corporate compliance systems and ethics mechanisms. Substantial SEC rulemaking is required to implement the changes. We recommend that companies urge the SEC to implement the new whistleblower regime in a way that will support rather than undermine corporate compliance systems. The enactment of the Act is also an occasion for a company to review the overall structure of its compliance and ethics policies and procedures, with an eye to finding more effective ways to embed a compliance component in day-to-day operations. There is a need to think creatively about the most effective ways to communicate to employees the importance of surfacing their concerns internally. Management should seek to develop meaningful incentives for employees to make use of corporate compliance and ethics reporting mechanisms. Maintaining a corporate culture in which all personnel understand that conducting business ethically is a shared and important value will be a cornerstone of this effort.

Establish a Board Review Process for Derivatives Transactions. Companies intending to rely on the "end-user exemption" to the new swap clearing requirements must have their actions in reliance on the exemption reviewed and approved by an "appropriate committee" of the board. Companies should undertake an assessment of their current and expected derivatives activity, including a planned review of the new requirements with the board which includes a discussion of the appropriateness of relying on the clearing exemption. If it is determined that the exemption may be used, a board review process should be implemented. While the audit committee may initially appear to be the appropriate body to assume this responsibility, alternatives should be carefully considered in light of the already substantial workloads borne by audit committee members. Once a committee has been selected, its charter should be revised to reflect this new function.

Longer Term Considerations

Many of the initiatives of the Act take the form of sweeping pronouncements that will only come into effect after the SEC has adopted implementing regulations. Others are automatically effective but nevertheless require SEC interpretation or rulemaking as a practical matter.

Compensation Related Matters

The Act introduces an extensive new regime of requirements related to compensation practices and disclosure. We have discussed certain of the new requirements in detail in a previous memo (available on there Forum here), including the requirement to hold shareholder votes on executive compensation, both periodically and in connection with extraordinary corporate transactions, heightened independence requirements for compensation committee members and advisors, and clawback policy requirements. In addition, the SEC must adopt rules requiring disclosure of the relationship between executive compensation and corporate financial performance, and of the ratio of the median annual total compensation of a company's employees (excluding its chief executive officer) to the total annual compensation of its chief executive officer. As we have previously stated, we anticipate that this disclosure requirement may present significant challenges for issuers without any corresponding benefit to investors, and advise companies to pay particular attention to development of the specific rules in this area.

General Corporate Governance Matters

Broker Discretionary Voting and Advance Voting Instructions. As noted above, the Act further curbs broker discretionary voting. In connection with its examination of "proxy plumbing" matters, the SEC has

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requested comment on the advisability of permitting advance voting instructions by shareholders to their brokers (for example, whether brokers should be permitted to vote shares based on an advance shareholder instruction always to vote either for or against management unless otherwise specified). We recommend that companies consider engaging with the SEC regarding the advisability of this concept, and whether it might prevent further erosion of the voting power of retail shareholders.

Conflict Minerals. The Act includes a direction to the SEC to promulgate regulations requiring new disclosures from issuers that manufacture products using "conflict minerals" (which includes specified minerals like gold and columbite-tantalite as well as anything else the Secretary of State determines from time to time to be financing conflict in central Africa). Because tiny amounts of these minerals are often used in electronic components like capacitors, which are found in a wide variety of products, including computers, mobile phones and automobiles, these new rules will increase the due diligence and disclosure burden on a wide range of companies, compelling them to carefully review their supply chain to identify the use and source of any such minerals. We hope that the SEC will adopt a practical approach towards this requirement as well.

* * *

Many provisions of the Act may have as yet unforeseen consequences. Furthermore, a number of provisions of the Act which currently appear duplicative of existing rules (for example, the required disclosure regarding the separation of the Chairman and CEO roles) may in fact turn out to expand or modify disclosure or compliance requirements as rulemaking and interpretation continues. We will continue to monitor developments and will provide updates as warranted.

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Dodd-Frank Provisions Affecting Executive Pay

Posted by Joseph E. Bachelder III, Law Offices of Joseph E. Bachelder, on Tuesday October 5, 2010 at 9:05 am on the Harvard Law Blog at the following web address: http://blogs.law.harvard.edu/corpgov/2010/09/28/delaware-supreme-court-addresses-majority-voting-standards-in-director-elections/#comments. This post is based on an article by Mr. Bachelder that first appeared in the *New York Law Journal*.

Today's column focuses on several of the provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203 (July 21, 2010) affecting executive compensation. These are (i) Say on Pay (including discussion of Proxy Access as it relates to Say on Pay), (ii) the so-called "clawback" provisions and (iii) the new requirement that a ratio of CEO pay to the median of the pay of all other employees be disclosed in the proxy statement. (These are only some of the provisions of Dodd-Frank that will impact on the executive pay process; a longer list of provisions relating to executive pay is noted separately below.)

Taken together, the provisions in Dodd-Frank that affect the executive pay process quite arguably will have the broadest and most significant impact on that pay process of any set of new rules ever contained in one law. The federal government, of course, has impacted for a long time on executive pay through tax and securities laws (and through temporary rulemaking such as that under Pay Controls (1971) and the Troubled Asset Relief Program (TARP) (2008)). But it is unlikely that there has ever been a single law that contains the potential long-term consequences for the process of setting executive pay that are contained in these provisions of Dodd-Frank.

For these reasons, Dodd-Frank may be described as a significant further step in the "federalization" of executive pay. "Federalization" for this purpose is intended to mean the use of federal law as a source of rulemaking and of governance on executive pay issues in contrast to the use of state law in deciding such issues.

Among the consequences of this federalization process will be a shift in the ultimate decision-making on important executive compensation issues from Boards of Directors to other "stakeholders" (or creation of a capacity to influence that decision-making). For example, shareholders (by Say on Pay votes and Proxy Access), regulators in Washington (by regulating on the meaning of excessive compensation at financial institutions) and, in some cases, a combination of federal regulators and SROs (in implementing "clawback" rules) will become more involved in the executive compensation process.

Boards of Directors will become increasingly concerned with compliance with rules and directives of these "stakeholders" (even when nonbinding in the case of Say on Pay votes). Boards' historic role of having primary responsibility, under state law, for making important (often subjective) independent judgments on these significant executive pay issues will now be shared with (in some cases supplanted by) the authority of these other stakeholders under Dodd-Frank.

Dodd-Frank imposes new rules relating to executive compensation in the following areas:

- Shareholder voting (nonbinding) on executive pay (§951),
- Compensation committee independence (§952),
- Disclosures as to (i) executive pay in comparison with financial performance of the issuer and (ii) the ratio of the CEO's pay to the median pay of all other employees of the issuer (§953),

- In the case of certain financial restatements, required recovery by the issuer of amounts paid to its executive officers (so-called "clawbacks") (§954) and
- Standards and limitations on executive pay at financial institutions (§956).

Another provision, Proxy Access (§971), will likely have an impact, in some cases, in conjunction with some of the foregoing provisions (e.g., Say on Pay).

Two other provisions apply to executive pay but are not likely to affect significantly the executive pay process:

- Disclosures regarding employee and director hedging (including hedging as to grants under compensation arrangements) (§955) and
- New requirements as to voting by brokers on, among other matters, executive pay (§957).

All but one of these new Dodd-Frank provisions affects public companies generally. One provision (§956) establishes rules regarding "excessive compensation" at "covered financial institutions." [1]

Corporate Governance Rules

Say on Pay and Proxy Access will impact significantly on actions of Boards of Directors, and particularly Compensation Committees, in their deliberations on executive pay. (Say on Pay and Proxy Access each has separate significance for the executive pay process, but their most significant impact may occur when the two are employed together in connection with a dispute over executive pay at a given issuer.)

1. Say on Pay. Say on Pay has been a part of corporate governance in the United States for a number of years. [2] Section 951 of Dodd-Frank now imposes on public companies generally the requirement of providing a nonbinding Say on Pay vote by share-holders. [3] The requirement to include a Say on Pay resolution in the proxy statement will apply starting with a covered company's first shareholder meeting occurring after Jan. 21, 2011 (the six-month anniversary of the enactment of Dodd-Frank).

The new rule requires that at intervals no greater than three years shareholders must be given the opportunity for a nonbinding vote on the company's executive compensation program. (That proxy statement for the first shareholders' meeting occurring after Jan. 21, 2011, must give shareholders the right to vote on the frequency of the Say on Pay vote: it may be one, two or three years. At least once every six years, shareholders must be provided the opportunity for this separate vote as to the frequency of the Say on Pay vote.)

In addition to the Say on Pay vote, Dodd-Frank also requires that a nonbinding vote opportunity be given to shareholders, by separate resolution, in connection with a vote on a merger, consolidation, sale of assets or similar transaction, to approve so-called "golden parachute compensation" unless the agreements and understandings relating to such compensation have been the subject of prior Say on Pay votes within the meaning of §951. [4]

2. Proxy Access. Section 971 of Dodd-Frank authorized the Securities and Exchange Commission's adoption of rules regarding Proxy Access. In Rule 14a-11 of Regulation 14A under the 1934 Act (as amended by §971 of Dodd-Frank), the SEC adopted a new Proxy Access rule effective Nov. 15, 2010. 75 Fed. Reg. 56668 (Sept. 16, 2010). Before the enactment of Dodd-Frank, the SEC already had been in the process of rulemaking on Proxy Access (See SEC Release No. 33-9046 (June 10, 2009).)

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Under Rule 14a-11, if a shareholder has owned (and continues to own) 3 percent or more of the issuer's voting securities for three or more years, that shareholder is eligible to include in the issuer's proxy statement (at the issuer's expense) a list of candidates (together with a statement of up to 500 words in support of each such candidate), which list may include a number of nominees representing up to 25 percent of the number of board seats. [5] (This means all board seats, not just those up for election in the case of a staggered board.) If more than one eligible shareholder proposes a list of candidates, the shareholder with the largest number of shares (and only that shareholder) will have the right to include a list of candidates. [6]

Comment. The combination of Say on Pay rules and the new SEC proxy access rules will put significant pressure on compensation committees to be sure there is nothing in the issuer's executive compensation program likely to trigger a proxy contest. Not only activist shareholders but also shareholder advocates such as RiskMetrics likely will exploit this combination of new rules. 65433 5

Erroneously Awarded

Section 954 of Dodd-Frank requires the SEC to "direct" national securities exchanges and national securities associations to prohibit "the listing of any security of an issuer" if that issuer fails

"to develop and implement a policy providing—

'(1) for disclosure of the policy of the issuer on incentive-based compensation that is based on financial information required to be reported under the securities laws; and

'(2) that, in the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer of the issuer who received incentivebased compensation (including stock options awarded as compensation) during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement.'"

This provision does not call directly for a clawback from the executive officers receiving the incentive compensation payments. Instead, briefly restated, it requires that (i) the SEC direct (ii) national securities exchanges and national securities associations to require that (iii) listed companies adopt "policies" that include recovery of incentive-based compensation that was based on erroneous financial information that results in financial restatements being required under the securities laws. [7]

Among many questions under §954 needing to be answered are the following:

- If an "accounting restatement" is required under securities laws, what financial "data" must be taken into account in determining the "excess" of the "incentive-based compensation" that the covered executive received over what he or she would have received absent the erroneous data? [8]
- b. If a board or compensation committee is given discretion regarding the payment of an incentive award, does this put the payment outside the application of §954 even if financial criteria underlie the award?
- Once the new rules take effect under §954, will they affect only payments made after the effective date? What about awards that, as of the effective date, are mid-cycle (say, two years into a three-year performance cycle)?

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- What is meant by "recovery" of "incentive-based compensation"? An employer might recover the economic benefit to the executive by offsetting it against compensation that otherwise would be paid to the executive in the future. This might avoid a possible tax issue for the executive. On the other hand, it might not resolve a possible constitutional issue under the Fifth Amendment if, for example, Dodd-Frank were applied so as to require recovery of an award made to an executive (assume the executive to be faultless) prior to the date of enactment. [9]

Comment. Compensation committees will need to address §954 of Dodd- Frank promptly because the present language and design of plans and the awards under those plans may determine whether clawback rules to be adopted under §954 in the future will apply to such awards. For example, introduction of factors other than financial factors (such as company discretion as already noted) may alter, or even eliminate, the applicability of §954. At the same time, it is likely that, in order to protect themselves, more companies will insert language into plans and/or awards that provides for recovery in some form of an incentive payment that was based on financial error.

New Pay Ratio to Be Disclosed

Section 953(b) of Dodd-Frank provides that the SEC shall require each issuer to include in the proxy statement a ratio based on:

"the annual total compensation of the chief executive officer (or any equivalent position) of the issuer"

divided by

"the median of the annual total compensation of all employees of the issuer, except the chief executive officer (or any equivalent position) of the issuer."

There have been vigorous protests over the required disclosure of this ratio in the proxy statement. A troublesome feature of the ratio for many issuers may be the impact on shareholders of such issuers who will see this ratio as to their company for the first time. This information, together with other Dodd-Frank changes including the introduction of Say on Pay and authorization of Proxy Access, may cause some anxious moments at many companies.

Apart from this concern, there are numerous questions regarding calculation of the ratio that will need to be addressed. These include:

- In the case of companies with employees located in numerous countries, how are adjustments to be made based on so many cost-of-living differences and currency differentials?
- If Company A manufactures its own components but Company B imports these same components, it would appear that Company B avoids, in computing the CEO pay ratio, the "down draft" of the lower compensation levels Company A is paying its own employees in its own manufacture of these components.
- To what extent will companies be given guidance by the SEC as to how to obtain actuarially equivalent calculations for large groups of employees (in both foreign countries and in the United States, assuming foreign-based employees are included in determining the ratio) in respect of pensions and deferred compensation arrangements requiring such calculations? What sort of modifications will be made in the standards of accuracy imposed on these calculations where companies are forced to make approximations?

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In view of these and other questions raised by the CEO pay ratio, issuers generally should begin now the process of accumulating data necessary to calculate this ratio. Many of the calculations, however, will depend upon the positions to be taken by the SEC on questions such as those noted above. Dodd-Frank does not specify the date by which the SEC must adopt its rules covering the calculation of the pay ratio. It is not anticipated that rules will be in effect for the 2011 proxy season. The SEC recently indicated that it does not intend to propose rules regarding the CEO pay ratio until some time in the period of April-July 2011 (See http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml).

Endnotes

[1] For this purpose, "covered financial institutions" include, generally, banks, brokerdealers, credit unions and investment advisors and also Fannie Mae and Freddie Mac. See Dodd-Frank §956(e)(2) for the more technical and complete definition of "covered financial institution."

[2] For prior discussions on Say on Pay developments, see this column, June 28, 2010, and June 19, 2009. The first time a U.S. public company provided its shareholders with a nonbinding vote on its executive compensation programs was in 2008 when Aflac offered such a vote to its shareholders (a majority of those voting approved the programs). Nonbinding Say on Pay votes are required at companies with outstanding TARP obligations pursuant to §111(e) of the Emergency Economic Stabilization Act of 2008 (EESA) as added by the American Recovery and Reinvestment Act of 2009 (ARRA). Say on Pay laws also have been enacted in several European countries and have been under active consideration by governments in other countries as well.

[3] The Say on Pay requirements of §951 apply to issuers of securities registered under §12 of the Securities Exchange Act of 1934 ("1934 Act") which are subject to §14 (Proxies) of such act. (An example of an issuer which is not subject to §14 is a "foreign private issuer" as defined in Rule 3b-4 under such act.) The SEC has the authority (under §951 of Dodd-Frank) to exempt certain issuers (or classes of issuers)—small issuers, for example—from the Say on Pay requirements.

[4] Section 951 of Dodd-Frank requires that in any proxy or solicitation for a meeting at which shareholders are asked to approve "an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all the assets of an issuer," the person making the solicitation must disclose "any agreements or understandings" that such person has with any named executive officers of either the company being acquired or the acquiring company concerning compensation relating to the acquisition, merger, consolidation, sale or other such disposition. The shareholders must be given a nonbinding vote to approve such agreements or understandings and compensation unless such agreements or understandings have been the subject of prior Say on Pay votes pursuant to §14A(a) of the 1934 Act, as added by §951 of Dodd-Frank.

[5] The new Proxy Access rules contained in Rule 14a-11 cannot be used by a shareholder trying to gain control of the company. For this purpose, "control" is presumably as defined in Rule 12b-2 of Regulation 12B under the 1934 Act: "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."

[6] Although the shareholder who meets the threshold and holding period requirements with the highest percentage of voting stock is given preference under the new Proxy Access rule, if that shareholder does not propose nominees representing 25 percent of the number of directors, then other shareholders who

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meet the threshold and holding period requirements (in descending order of stock holdings following the shareholder with the highest percentage of voting stock) may include nominees including those proposed by any such larger shareholder until such number of shareholder nominees equals (but does not exceed) 25 percent of all directors.

[7] Section 954 of Dodd-Frank contrasts with §304 of Sarbanes-Oxley (15 U.S.C. §7243 (2002)) which claws back directly from any CEO or CFO subject to its provisions the applicable clawback amounts. See, also, clawback provisions under TARP. EESA §111(b)(3)(B), as amended by ARRA §7001.

[8] Presumably data relating to earnings must be taken into account. What about stock price (for example, in an incentive award tied to Total Shareholder Return)? Are restricted stock and stock unit awards, unless subject to separate performance criteria, covered by §954? The argument against such awards being covered would be (1) they are not "incentive-based compensation" for purposes of §954 (i.e., they are not, as such, performance-based) and (2) a stock or stock unit award based on time vesting only does not itself entail financial criteria to which §954 is directed.

[9] See in this connection *SEC v. Jenkins*, 2919 U.S. Dist. LEXIS 57023 (June 9, 2010). In the *Jenkins* case, the SEC brought an action under Sarbanes-Oxley §304 against an executive not accused of taking part in the misconduct that gave rise to the clawback. The executive moved to dismiss the action. The motion was denied. In his motion, the executive raised an issue as to the constitutionality of Sarbanes-Oxley §304. The possibility remains that constitutional issues will be raised at trial. Any constitutional issue under Dodd-Frank would be distinguishable from the constitutional issue under Sarbanes-Oxley. Dodd-Frank does not apply directly to the executive but rather directs the applicable securities exchanges and associations to adopt listing rules requiring clawback policies and enforcement by exchanges and associations be in the form of delisting the listed company. (To avoid delisting, the company, of course, would have to recover from the executive.) The affected executive presumably would argue that the federal government cannot do by indirection what it cannot do directly (on this particular point, to apply a new rule retroactively to awards previously paid). Whether any constitutional issue might arise on the ground of retroactive application of the statute to existing legal entitlements, including payments of compensation already made, will depend upon the determinations of the SEC in its future rulemaking as to the listing requirements of the exchanges and associations.

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Excerpt from Chevron Corporation Bylaws

As Amended September 29, 2010

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Excerpt from Chevron Corporation Bylaws, As Amended September 29, 2010

ARTICLE II

Forum for Adjudication of Disputes

Unless the Corporation consents in writing to the selection of an alternative forum, the Court of Chancery of the State of Delaware shall be the sole and exclusive forum for (i) any derivative action or proceeding brought on behalf of the Corporation, (ii) any action asserting a claim of breach of a fiduciary duty owed by any director, officer or other employee of the Corporation to the Corporation or the Corporation's stockholders, (iii) any action asserting a claim arising pursuant to any provision of the Delaware General Corporation Law, or (iv) any action asserting a claim governed by the internal affairs doctrine. Any person or entity purchasing or otherwise acquiring any interest in shares of capital stock of the Corporation shall be deemed to have notice of and consented to the provisions of this Article VII.

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Key Delaware Cases (2010) (summaries)

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KEY DELAWARE CASES (2010) (SUMMARIES)

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DELAWARE SUPREME COURT

***City of Westland Police & Fire Retirement Sys. v. Axcelis Techs., Inc.*, 2010 WL 3157143 (Del. Aug. 11, 2010).**

Delaware Supreme Court Addresses Majority Voting Standards in Director Elections

Posted by Steven M. Haas, Esq., Hunton & Williams LLP, on Tuesday September 28, 2010 at 9:13 am on the Harvard Law Blog at the following web address:
http://blogs.law.harvard.edu/corpgov/2010/09/28/delaware-supreme-court-addresses-majority-voting-standards-in-director-elections/#comments

A recent Delaware Supreme Court decision has significant implications for corporations with majority voting standards where incumbent directors fail to receive the required level of support and tender their resignations to the board of directors. The decision, *City of Westland Police & Fire Retirement System v. Axcelis Technologies, Inc.*, provides stockholders with a roadmap for inspecting a corporation's books and records after a board refuses to accept the directors' resignations.

Background
In *Axcelis*, the corporation had a "plurality plus" governance policy in which directors were elected by a plurality of the votes cast but were subject to a board policy that required directors to tender their resignations if the votes cast "withheld" were greater than the number of votes cast "for" such persons. At its 2008 annual meeting, the three directors who sat on the corporation's classified board of directors failed to receive majority support from the stockholders and tendered their resignations. The board, however, refused to accept their resignations, noting that one of the directors was the corporation's lead independent director and each of them sat on key board committees.

Following the annual meeting, the City of Westland Police & Fire & Retirement System, a pension fund and Axcelis stockholder, demanded to inspect the corporation's books and records pursuant to Section 220 of the Delaware General Corporation Law. The purpose of the demand was to investigate, among other things, "the Board members' compliance with their fiduciary duties to the Company and its shareholders as it relates to the Board's refusal to accept the resignations" of the directors who failed to receive majority support. When the demand was refused, the pension fund brought suit in the Delaware Court of Chancery, which held that the pension fund failed to state a "proper purpose" and did not allege any "credible basis from which to infer any possible wrongdoing" that would justify its request.

Delaware Supreme Court's Opinion
The Delaware Supreme Court affirmed the lower court's ruling that the pension fund failed to state a "proper purpose" to inspect the company's books and records, as required by Delaware law. It agreed that the board's refusal to accept the directors' resignations did not raise a credible basis to infer that the directors were acting out of "improper entrenchment motives." The court also agreed that the board's refusal to accept the resignations did not trigger the *Blasius* standard, which requires a board to demonstrate a compelling justification when it interferes with a stockholder vote. The court explained that to do so would improperly shift to the corporation the burden of establishing a "proper purpose."
The Delaware Supreme Court then explained that determining an individual's suitability to serve as a director is a proper purpose. Citing prior case law in *Pershing Square, L.P. v. Ceridian Corp.*, 923

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A.2d 810 (Del. Ch. 2007), the court held that a stockholder can inspect a corporation's books and records under such circumstances if:

- the stockholder establishes a credible basis from which to infer there are legitimate concerns regarding a director's suitability, which can be established by showing that the board refused to accept the resignation of a director who failed to receive majority support from the stockholders under the company's majority voting policy;
- the stockholder's true and primary purpose for inspecting books and records is not improper; and
- the information requested is "necessary and essential to assess[] whether a director is suitable to stand for reelection."

The court explained that "[t]he less-than-majority shareholder vote may be viewed as a judgment by the holders of a voting majority that those director-candidates were no longer suitable to serve (or continue to serve) as directors" and that the board's "decision not to accept those resignations may be viewed as a contrary, overriding judgment by the Board." It continued that "[w]here, as here, the board confers upon itself the power to override an exercised shareholder voting right without prior shareholder approval..., the board should be accountable for its exercise of that unilaterally conferred power. *At stake... is the integrity of the Board decision overriding the determination by a shareholder majority*" (emphasis added). Thus, the court dismissed the plaintiff's complaint because it framed its request the wrong way. **[1]**

Implications

Axcelis has significant implications for companies that have adopted majority voting policies, which include nearly two-thirds of the S&P 500. It almost ensures that a stockholder demand to inspect books and records (as well as related stockholder litigation) will follow a board's decision not to accept director resignations. This is significant because books and records inspections typically are precursors to derivative litigation. In evaluating a demand, *Axcelis* dictates that the pivotal issues will be (1) whether the stockholder has an ulterior motive that is an "improper purpose," (2) whether the documents are necessary and essential to evaluating the director's suitability to serve on the board, **[2]** and (3) the terms of any confidentiality agreement that might be necessary to maintain the confidentiality of the information requested by the stockholder.

As a result, boards that are considering director resignations must carefully consider all relevant factors and document their process. Withhold campaigns already generate significant stockholder and media attention. Boards must now recognize that not just their decision to refuse a resignation, but also the process by which they considered it, will be subject to scrutiny.

One aspect of *Axcelis* that may draw criticism is the court's view that the board had "confer[red] upon itself the power to override" a shareholder vote "without prior shareholder approval (as would be required in the case of a shareholder-adopted by-law or a charter provision)." The stockholders, however, were entitled only to a plurality vote under the corporation's governing documents, so it was the board that had created this conditional policy. In addition, it is not clear whether the court's analysis would change if the stockholders had approved a majority voting standard that permitted the board to refuse a resignation.

Another aspect of *Axcelis* that merits attention is whether the court's focus on how the board "overrode" a stockholder vote will extend to other stockholder proposals. *Axcelis* can be seen as an extension of prior Delaware cases that afford special treatment to director elections. As the Court of Chancery stated in a different context in *Mercier v. Inter-Tel (Delaware), Inc.*, 929 A.2d 786, 811 (Del. Ch. 2007), "[t]he notion that directors know better than the stockholders about who should be on

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the board is no justification at all" for taking coercive defensive actions. Other stockholder proposals, however, such as ratification of a stockholder rights plan or a say-on-pay proposal, relate to key managerial decisions made by directors. In light of the board's statutory mandate to manage the corporation, a good faith disagreement with the stockholders on such issues arguably should not warrant greater judicial scrutiny or open the door to books and record demands.

Editor's Note

Steven Haas is an associate at Hunton & Williams specializing in mergers and acquisitions, securities laws and corporate governance matters. **[*]**

Endnotes

[*] The foregoing does not constitute legal advice or necessarily represent the views of the author's firm or its clients.

[1] The Delaware Supreme Court also rejected the stockholder's request to inspect books and records relating to the board's refusal to accept a takeover proposal, concluding that there was no credible basis to believe the board's decision was anything but a "good faith business decision[]."

[2] On this issue, it remains to be seen whether a withhold campaign reflecting general disagreement with corporate performance or strategy, rather than the merits of an individual's suitability to serve as a director, will influence the types of documents to which the stockholder is entitled.

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***Lambrecht v. O'Neal*, 135,2010, 2010 WL 3397451 (Del. Aug. 27, 2010).**

This case summary is provided by Potter Anderson & Corroon LLP of Wilmington, Delaware (www.potteranderson.com) and can be found at the following web address: http://www.potteranderson.com/news-firm-119.html

Case Summary

In this *en banc* opinion, the Supreme Court of Delaware (the "Supreme Court") answered a certified question of law submitted by a federal district court concerning the nature of double derivative actions. The Supreme Court held that, under Delaware law, plaintiffs suing in a double derivative action who were pre-merger stockholders in the acquired company and who are current stockholders, by virtue of a stock-forstock merger, in the post-merger parent company, are not required to demonstrate for purposes of standing that, at the time of the alleged wrongdoing at the acquired company, (i) plaintiffs owned stock in the acquiring company, or (ii) the acquiring company owned stock in the acquired company.

The certified question of law was submitted to the Supreme Court by the United States District Court for the Southern District of New York (the "Southern District"), and arose out of two double derivative actions pending before the Southern District asserted on behalf of Bank of America ("BofA") and its wholly-owned subsidiary, Merrill Lynch & Co. ("Merrill Lynch" or the "company"). Plaintiffs originally filed "standard" derivative actions on behalf of Merrill Lynch to recover losses suffered as a result of a breach of fiduciary duties by Merrill Lynch officers and directors prior to BofA's acquisition of the company in a stock-for-stock merger. In connection with the merger, the company became a wholly-owned subsidiary of BofA and plaintiffs' Merrill Lynch stock was converted to shares of BofA. After the merger, plaintiffs amended their complaints to take the form of double derivative actions. Defendants then moved to dismiss the double derivative actions for lack of standing, arguing that plaintiffs were required to show that (i) plaintiffs were BofA stockholders both post-merger and at the time of the pre-merger wrongdoing complained of, and (ii) BofA was a Merrill Lynch stockholder at the time of such pre-merger conduct. The Supreme Court assumed, for purposes of its analysis, that at least one plaintiff's ownership of BofA stock was not contemporaneous with the conduct complained of, and that BofA was not a Merrill Lynch stockholder during the time of the wrongdoing alleged by plaintiffs.

In determining whether the procedural requirements proposed by defendants are mandated under Delaware law, the Court first examined defendants' "flawed" conceptual model, whereby a double derivative action represents "two lawsuits in one," consisting of both a standard derivative action by BofA (through plaintiffs), asserting a claim on Merrill Lynch's behalf, and a "superimposed" action asserting the same claim derivatively on BofA's behalf as the new owner. Under such a model, the Court noted, the procedural requirements for bringing each derivative claim independently would need to be satisfied.

The Court then explained four flaws in defendants' proposed conceptual model. First, the procedural requirements posed by defendants would render double derivative lawsuits "virtually impossible" to bring, contradicting Delaware precedent affirming the validity of such actions in cases where standing to bring a derivative claim is lost as the result of an intervening merger. Second, by presuming that BofA was required to proceed derivatively against the Merrill Lynch directors, defendants misinterpreted Delaware case law, which holds that BofA may enforce such a claim directly, by virtue of its 100 percent ownership interest in Merrill Lynch. Third, defendants' argument that plaintiffs were required to own BofA stock at the time of the alleged misconduct at Merrill Lynch misapplied the

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contemporaneous ownership requirement contained in DGCL Section 327, which entitles plaintiffs to "stand in the shoes" of BofA in a double derivative action, and to enforce BofA's post-merger right to pursue Merrill Lynch's pre-merger claim.

Finally, the Court determined that a double derivative action is not a *de facto* continuation of a pre-merger derivative action, but instead represents a "new, distinct action" in which plaintiffs' standing to sue rests upon a failure by the BofA board, post-merger, to prosecute plaintiffs' pre-merger claim against Merrill Lynch. Finally, the Supreme Court dismissed defendants' argument that the Court of Chancery's 2004 decision in *Saito v. McCall*, 2004 WL 3029876 (Del. Ch. Dec. 20, 2004) ("*Saito*"), provided legal support for defendants' proposed procedural requirements, finding that *Saito* addressed the requirements for a double derivative claim in a "conclusory" fashion as a result of the procedural posture of the case. The Supreme Court also concluded that to the extent Saito is inconsistent with the Supreme Court's reasoning and conclusions in the instant case, it is overruled.

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***Crown EMAK Partners, LLC v. Kurz*, 992 A.2d 377 (Del. 2010).**

Delaware Supreme Court Decides Case Regarding "Stockholders of Record", Crown EMAK Partners LLC v. Kurz

Posted by Cooley LLP on April 23, 2010 at the following web address: http://www.cooley.com/63833.

On April 21, the Delaware Supreme Court reversed in part and affirmed in part the much discussed case of Kurz v. Holbrook, in which the Chancery Court had held, among other things, that brokers and banks identified on the Cede breakdown were record holders for purposes of determining stockholders entitled to vote. (See the 2/18/10 news brief posting.) While the Chancery Court did "not foresee any headaches" arising out of its decision, it also acknowledged that the decision would have collateral impact on many other provisions of Delaware law and would "require future cases to work through particular issues." In its decision, however, the Delaware Supreme Court did not even reach the issue of whether banks and brokers are "record owners" for voting purposes. Instead, the Delaware Supreme court decided the case on other grounds, explicitly announcing that the lower court's decision regarding the stock ledger was purely dictum and "without precedential effect." The decision can be found online.

As you may recall, the case involved competing consent solicitations in a contest for control of the board, beginning with an insurgent group that sought to remove and replace several directors to seat a majority. The insurgent group ultimately submitted consents it thought were sufficient, but only after it purchased some additional shares held by an employee. Because the employee shares were subject to certain transfer restrictions, the insurgents devised a work-around in which the employee transferred his future rights to the shares and provided an irrevocable proxy to vote those shares. The incumbent group sought, and submitted sufficient consents, to amend the company's bylaws to reduce the size of the board to eliminate unwanted directors and leave it with a majority (since it had the right to appoint a specified number of directors who would then constitute a majority). Because the company was public, a large proportion of its shares were held in street name. While the incumbents obtained direct signatures from DTC providing proxy authority for the few banks and brokers whose consents they needed, no one obtained the DTC "omnibus proxy" for the consents related to the shares of the banks and brokers held of record by DTC and submitted by the insurgents. (DTC is the depository that is the stockholder of record for all of the participating banks and brokers.) As a result, the transfer agent viewed a large proportion of the consents submitted by the insurgents to be invalid.

The issues involved whether shares necessary to win the consent solicitation were the subject of illegal vote-buying, whether the transfer of the interest in the critical shares was effective in light of transfer restrictions, whether the bylaw that purported to shrink the size of the board below the number of sitting directors was valid, whether failure to obtain an omnibus proxy from DTC was fatal with regard to written consents obtained for the shares held in street name or whether, instead, the banks and brokers who appeared on the Cede breakdown list of participants had the power to vote or act by written consent as record holders.

The Chancery Court had held that the insurgents did not engage in improper vote buying. Although title to the shares was not transferred, the Chancery Court concluded that all of the economic interest in the shares had been transferred, with the result that, under Delaware law, the insurgents were presumed to have the right to vote those shares. The Supreme Court concurred. Because both the economic interests and the voting interests of the shares were transferred, both interests remained aligned and, therefore, there was no improper vote buying.

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The Supreme court also affirmed the Chancery Court's conclusion that the attempt to amend the Bylaws to reduce the number of authorized directors below the number of currently sitting directors was invalid because it conflicted with the DGCL: "Generally, in a contested election, an insurgent first removes the challenged directors, then reduces the number of directorships, and then fills the vacancies. We hold that was the legally proper sequence for accomplishing [the incumbent's] objective in this case."

Where the Supreme Court began to take a different path from the Chancery Court was on the issue of the share transfer restrictions. The Chancery Court held that the insurgents had successfully contracted around the sale and transfer restrictions because the restricted stock grant did not prohibit the employee from agreeing to sell or transfer his shares at a future date. According to the Chancery Court, the effect of the future title transfer was to immediately transfer to the insurgents the economic interest in the shares. However, the Supreme Court held that the purchase and immediate receipt of the full economic interest associated with the shares violated the restricted stock grant agreement because there was, in effect, an actual transfer of the shares in violation of the transfer restrictions. Relying on an academic study, the Supreme Court concluded that, by "reconnecting the voting rights to the economic ownership via the Irrevocable Proxy, the Purchase Agreement immediately conferred upon [the insurgents] the functional equivalent of 'full ownership,'...." There was nothing to transfer in the future, other than the bare legal title. Moreover, this "divestiture of all voting and economic rights in his shares frustrates the purpose of the Restricted Stock Grant Agreement, because bare legal title, alone and without more, does not give [the employee] a stake in the corporation's future." Accordingly, because of the breach of the restrictions, there could be no legally valid sale or transfer of the shares, and the insurgents were not entitled to vote them.

As a result of that decision, the Supreme Court concluded that it need not reach the question of whether the banks and brokers who appeared on the Cede breakdown list of participants should be included as part of the stock ledger and accorded the power to vote or consent as record holders. The Supreme Court emphasized, quoting the Chancery Court itself, that the lower court's interpretation "represents a change in how Delaware practitioners understand the stock ledger for purposes of voting. .. ." and that the DTC system that normally relies on an omnibus proxy from DTC is usually effective. Since the Supreme Court's determination with regard to the restricted stock transfer was dispositive, it was unnecessary for the Supreme Court to decide this issue, "because a decision either way would not alter the result we have reached nor would a gratuitous statutory interpretation resolving this difficult issue be prudent. The human failures that occurred in this case are easily avoidable in the future and may be a one-time anomaly that may not again occur. Moreover, and in any event, a legislative cure is preferable. The DGCL is a comprehensive and carefully crafted statutory scheme that is periodically reviewed by the General Assembly. Indeed, the General Assembly made coordinated amendments to section 219 and section 220 in 2003. Any adjustment to the intricate scheme of which section 219 is but a part should be accomplished by the General Assembly through a coordinated amendment process. Therefore, the Court of Chancery's interpretation of stock ledger in section 219 is obiter dictum and without precedential effect."

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Nemec v. Shrader, **991 A.2d 1120 (Del. 2010).**

The Implied Covenant of Good Faith and Fair Dealing: Nemec v. Shrader

Posted by Richards Laton & Finger on May 3, 2010 at the following web address: http://www.rlf.com/KnowledgeCenter/EAlertsNewsletters?find=14825

In *Nemec v. Shrader*, Nos. 305, 2009 & 309, 2009 (Del. Apr. 6, 2010), the Delaware Supreme Court, in a 3-2 split decision, affirmed the dismissal of a complaint by former officers against Booz, Allen & Hamilton Inc. and its board of directors for failure to state a claim, holding that the directors did not breach either express or implied contractual obligations or fiduciary duties when they redeemed the plaintiffs' stock at a price substantially lower than would have been applicable as the result of a not-yet consummated transaction, because the relevant Officers Stock Rights Plan expressly authorized the timing and price of the redemption and because the contractual obligations established in the Stock Plan superseded the fiduciary duties that might otherwise have applied to the redemption.

Plaintiffs Joseph Nemec and Gerd Wittkemper retired from Booz Allen after collectively spending over 50 years with the company. During their tenure, the plaintiffs were partially compensated with annual grants of stock rights, convertible into common stock of the company, under the Stock Plan. Under the Stock Plan, the plaintiffs had a put right, exercisable for a period of two years from the date of their retirement, to sell their shares back to the company at book value. After the expiration of two years, the company had the right to redeem, at any time, all or part of the plaintiffs' stock at book value. The plaintiffs' put rights expired in March 2008.

In November 2007, The Carlyle Group offered to purchase Booz Allen's government unit for $2.54 billion. The Carlyle transaction, as ultimately agreed upon, generated over $700 per share for the company's stockholders. During this time period, the book value of the plaintiffs' shares was significantly lower than the transaction value. One month after the plaintiffs' put right expired (and four months before the Carlyle transaction closed), the company redeemed the plaintiffs' shares at book value for $162.46 per share. As a result of the redemption, the plaintiffs received nearly $60 million less than they would have under the Carlyle transaction.

The Court of Chancery dismissed the action for failure to state a claim upon which relief can be granted, reasoning that the Stock Plan specifically authorized the company to redeem the plaintiffs' shares at the end of two years following the plaintiffs' retirement. Accordingly, the plaintiffs could not maintain a claim for breach of the implied covenant of good faith and fair dealing because of conduct authorized by the express terms of the contract. The Court also dismissed the plaintiffs' breach of fiduciary duty and unjust enrichment claims.

On appeal, the company argued that the Court of Chancery correctly ruled that the dispute was governed by an express contractual provision which authorized the board to redeem the shares at any time after the two-year period expired. The plaintiffs, on the other hand, asserted that the board exercised its right to redeem the plaintiffs' shares in breach of the implied covenant of good faith and fair dealing. The Supreme Court held that a party asserting a claim for breach of the implied covenant of good faith and fair dealing must establish that the other party acted in an arbitrary or unreasonable manner which frustrated the fruits of the bargain that the asserting party reasonably expected. Absent such a showing, a court will not imply contract terms. A party's reasonable expectations under a

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contract are measured at the time of contracting, and cannot be changed by developments that occur after the contract is executed.

The majority concluded that the plaintiffs did not have a reasonable expectation of participating in the Carlyle transaction at the time they executed the Stock Plan. The implied covenant only applies to later developments that the parties did not anticipate at the time of contracting and not to developments that the parties failed to consider. Here, the Stock Plan expressly authorized the company to redeem the plaintiffs' shares at book value after the expiration of the two-year period. The majority noted that "contractually negotiated put and call rights are intended by both parties to be exercised at the time that is most advantageous to the party invoking the option." The company exercised an express, bargained-for contractual right under the Stock Plan at a time that was most advantageous to the company's existing stockholders. Accordingly, the majority held that the implied covenant of good faith and fair dealing will not imply language that contradicts a party's clear exercise of an express contractual right.

Further, the Court warned that the crafting of a post-contracting equitable amendment that shifts the economic benefits under a contract would vitiate the limited reach of the implied covenant. "Delaware's implied duty of good faith and fair dealing is not an equitable remedy for rebalancing economic interests after events that could have been anticipated, but were not, that later adversely affected one party to a contract. Rather the covenant is a limited and extraordinary remedy."

The Court also affirmed the Court of Chancery's dismissal of the plaintiffs' claims that the company's board of directors breached its duty of loyalty and unjustly enriched itself. The plaintiffs asserted that the board acted to further its own economic interest to the detriment of the plaintiffs, thereby breaching the duty of loyalty. The Court affirmed the dismissal on the ground that the plaintiffs sought to enforce contract rights and therefore the dispute must be adjudicated within the analytical framework of a breach of contract claim. The Court held that a dispute arising out of obligations expressly addressed by contract will be treated as a breach of contract claim, which effectively precludes the assertion of any fiduciary claims arising out of the same facts that underlie the contract claim. Turning to the plaintiffs' unjust enrichment claim, the Court noted that Delaware courts "have consistently refused to permit a claim for unjust enrichment when the alleged wrong arises from a relationship governed by contract." Accordingly, the Court affirmed the Court of Chancery's dismissal of the plaintiffs' final claim for unjust enrichment because the alleged wrong stemmed from a contractual relationship.

Justice Jacobs, joined by Justice Berger, wrote a rare dissent in this case, explaining their belief that "under Delaware case law, a contracting party, even where expressly empowered to act, can breach the implied covenant if it exercises that contractual power arbitrarily or unreasonably." According to the dissent, the company's redemption of the plaintiffs' shares was arbitrary and unreasonable because it prejudiced the plaintiffs while serving no legitimate interests of the company. The dissent concluded that the complaint pled facts from which one can infer that if the parties had specifically addressed the issue at the time of contracting, the parties negotiating the Stock Plan would have agreed that the company could not exercise its right to redeem the plaintiffs' shares immediately before the transaction closed. Relying on the conclusion that the pre-transaction redemption did not serve any legitimate business interest of the company, the dissenting Justices would have reversed the Chancellor's decision to dismiss the complaint with respect to the implied covenant of good faith and fair dealing claim.

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***Parkcentral Global, L.P. v. Brown Inv. Mgmt., L.P.*, 2010 WL 3178430 (Del. Aug 12, 2010).**

Supreme Court Grants Access to List of Hedge Fund's L.P. Members; Rejects Federal Preemption Argument

Written by Francis G.X. Pileggi and posted on August 17, 2010 on the Delaware Corporate and Commercial Litigation Blog at http://www.delawarelitigation.com/2010/08/articles/delaware-supreme-court-updates/supreme-court-grants-access-to-list-of-hedge-funds-lp-members-rejects-federal-preemption-argument/.

Brief Overview
This Delaware Supreme Court decision affirmed a ruling of the Court of Chancery which allowed a limited partner to demand a list of other limited partners in a hedge fund formed as a limited partnership. (*Compare:* Delaware Supreme Court decision issued the day before this decision, *City of Westland Police & Fire Retirement Sys. v. Axcelis Techs., Inc.*, 2010 WL 3157143 (Del. Aug. 11, 2010) which is summarized at [http://www.delawarelitigation.com/2010/08/articles/delaware-supreme-court-updates/delaware-supreme-court-clarifies-section-220-standard-for-shareholder-access-to-books-and-records/], that denied a shareholder's demand for books and records.)

Procedural Background
Within three months of filing a complaint to seek books and records, the Court of Chancery held a trial and determined that pursuant to § 17-305 of the Delaware Revised Uniform Limited Partnership Act (DRULPA), as well as the terms of the partnership agreement, the general partner was required to produce a list of limited partners' names and their last known business, residence or mailing address. The affirmed Chancery decision was highlighted at [http://www.delawarelitigation.com/2010/05/articles/chancery-court-updates/chancery-denies-stay-pending-appeal-of-decision-requiring-disclosure-of-limited-partners-names/]. Although the Court of Chancery refused to grant a stay pending appeal, on May 27, 2010, shortly after the Chancery opinion, the Supreme Court did grant a stay pending an appeal.

Discussion
DRULPA Section 17-305 entitles limited partners to access partner information and records if they make a demand for a purpose reasonably related to their interest as a limited partner. Subsection (a) allows a general partner to establish reasonable standards governing the right to access information. Subsection (f) allows a general partner to restrict the rights of a limited partner to obtain information under Section 17-305.

The stated purpose for which the limited partner sought the data, and which the Supreme Court upheld as a proper purpose, was quoted in the opinion as follows:

> "(a) contact other limited partners in order to investigate claims of the general partner's mismanagement or breaches of fiduciary duty;
> (b) contact other limited partners to investigate the allegations made in [other] pending litigation;
> (c) contact other limited partners to bring their attention to the [other] litigation....;
> (d) contact other limited partners to investigate potential direct and derivative claims against the partnership's auditor;
> (e) contact other limited partners to discuss whether any of them would desire to pursue a derivative and/or a direct claim against the partnership's auditors."

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Parkcentral argued that federal regulations preempted Delaware law and prohibited disclosure of the shareholder list. It referred to the Gramm-Leach-Bliley Financial Modernization Act of 1999, which provided privacy protections for customers of financial institutions. Pursuant to the Act, several federal agencies including the SEC adopted rules designed to protect the privacy interests of individuals.

Although federal agencies, acting within the scope of their Congressionally delegated authority, may preempt state law, the Court determined that the regulations at issue in this case did not preempt Delaware law.

First, the Court reasoned that one may comply with both § 17-305 and the federal regulations. See Arbor Place, L.P. v. Encore Opportunity Fund, L.L.C., 2002 WL 205681 (Del. Ch. January 29, 2002) (reviewing § 18-305 of the Delaware LLC Act, a parallel to § 17-305, the Chancellor ruled that SEC regulations did not preclude disclosure because they contained an exception to the notice and opt-out requirements in order to comply with state law.)

The Court reviewed the regulations involved which allowed for an exception when necessary to comply with state law. See citations to federal regulations at footnote 23.

The Court also rejected the argument that the partnership agreement allowed Parkcentral to keep the list of names and addresses of the other partners from disclosure. First, the Court reasoned that Parkcentral did not demonstrate that it had a good faith belief that providing a list of names and addresses would harm the partnership. See footnote 25. The Supreme Court agreed with the finding of the Vice Chancellor after trial that the general partner did not possess a good faith belief that disclosure would harm the partnership. In addition, the Delaware Supreme Court determined that there was no agreement with a third party that would require Parkcentral to keep the information confidential.

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***Alaska Elec. Pension Fund v. Brown*, 988 A.2d 412 (Del. 2010).**

This case summary is provided by Potter Anderson & Corroon LLP of Wilmington, Delaware (www.potteranderson.com).

Case Summary
In this *en banc* decision written by Justice Ridgely, the Delaware Supreme Court affirmed the Court of Chancery's denial of an application for attorneys' fees and costs by plaintiff intervenor-appellant Alaska Electrical Pension Fund ("Alaska"), as well as the Court of Chancery's determinations with respect to the "at-issue" exception to the attorney-client privilege.

The action arose as a result of a tender offer by General William Lyon ("Lyon"), the CEO and 48% stockholder of Lyon Homes, Inc. ("Lyon Homes"), for the outstanding shares of Lyon Homes that he did not own at a price of $93 per share. Alaska filed a class action suit in the Superior Court of the State of California the same day the tender offer was announced, and two separate class action suits were filed by individual stockholders in the Delaware Court of Chancery two days later. All three suits alleged similar breaches of fiduciary duty and disclosure claims relating to the tender offer. The defendants reached an initial settlement with the Delaware plaintiffs to (i) increase the tender offer to $100 per share, (ii) provide additional disclosures, and (iii) pay $1.2 million in attorneys' fees and costs to the Delaware plaintiffs. Alaska did not join the settlement. Thereafter, Lyon increased his tender offer to a final price of $109 per share after Alaska told Chesapeake Partners Limited Partnership ("Chesapeake"), a major stockholder of Lyon Homes, that a fair price would be between $108 and $126 per share.

After the completion of the tender offer, the parties to the Delaware action filed a stipulation of settlement and the Delaware plaintiffs requested an award of attorneys' fees and costs based on the disclosures obtained and the price increase from $93 to $100. Alaska moved to intervene to present its own fee application for 66% of attorneys' fees, claiming that it was 50% responsible for the price increase to $100 per share, 50% responsible for the additional disclosures, and 100% responsible for the price increase from $100 to $109. Although the Court of Chancery initially held that Alaska was not entitled to a share of attorneys' fees, Alaska appealed that decision arguing that it was entitled to a rebuttable presumption that its litigation contributed to the beneficial outcome achieved for the class. On appeal, the Delaware Supreme Court remanded the case to the Court of Chancery, finding that Alaska was entitled to a rebuttable presumption of causation related to the subsequent increase from $100 per share to $109 per share. On remand, the Court of Chancery again found that Alaska was not entitled to share in the award of attorneys' fees, holding that the presumption of causation had been rebutted. The current appeal to the Delaware Supreme Court followed.

The Delaware Supreme Court reviewed the denial of Alaska's application for attorneys' fees under an abuse of discretion standard, but reviewed *de novo* the legal principles applied by the Court of Chancery in reaching that decision. The Court noted that Delaware law had long-recognized the "common corporate benefit" doctrine as an exception to the American Rule, under which litigants are responsible for their own attorneys' fees. Under the common corporate benefit doctrine, an applicant is entitled to payment of its attorneys' fees upon a showing that: "(i) the suit was meritorious when filed; (ii) the action producing benefit to the corporation was taken by the defendants before a judicial resolution was achieved; and (iii) the resulting corporate benefit was causally related to the lawsuit." Where a defendant takes actions subsequent to the complaint that renders the asserted claims moot, the defendant has the burden of showing that "no causal connection existed between the

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initiation of the suit and any later benefit to the shareholders." The Court held that the Court of Chancery had applied the proper legal principles in finding that Alaska was not entitled to a share of attorneys' fees because Lyon testified that Alaska's lawsuit had no effect on his decision to increase the price of the tender offer to $109 per share. Because the Court of Chancery's factual findings were supported by the record and entitled to deference, the Court of Chancery had not abused its discretion.

In addition, the Delaware Supreme Court held that the Court of Chancery had not abused its discretion in denying discovery of certain privileged emails under the "at issue" exception to the attorney-client privilege. Under the at-issue exception, the attorney-client privilege is deemed waived where a party either: (i) injects a privileged communication into the litigation, or (ii) injects an issue into the litigation, the truthful resolution of which requires an examination of confidential communications. The Court of Chancery held that defendants had not implicated the first prong of the test because they relied exclusively on "objective, non-privileged facts" in rebutting Alaska's presumption of causation. The second prong of the test was also not met because the privileged emails may have been helpful, but were not required to achieve a truthful resolution of the factors motivating Lyon to increase his offer because Alaska had the opportunity to depose Lyon. Accordingly, the judgment of the Chancery Court was affirmed.

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DELAWARE COURT OF CHANCERY

***Yucaipa Am. Alliance Fund II, L.P. v. Riggio*, 2010 WL 3170806 (Del. Ch. Aug. 12, 2010).**

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Delaware Court Upholds Barnes & Noble Shareholder Rights Plan

The Delaware Chancery Court last week upheld a shareholder rights plan adopted by Barnes & Noble's board of directors in the face of a rapid accumulation of stock by investor Ronald Burkle's Yucaipa funds. In a rare post-trial opinion addressing the validity of a shareholder rights plan, Vice Chancellor Strine affirmed that *Unocal* provides the appropriate standard of review for the board's adoption and maintenance of a rights plan with a 20% trigger that "grandfathered" in the existing 30% holding of the company's founder and chairman, Leonard Riggio, while limiting further acquisitions by him.

In *Yucaipa American Alliance Fund II, L.P. v. Riggio*, Vice Chancellor Strine rejected Yucaipa's contention that the board's decision to adopt the rights plan was subject to the stringent "entire fairness" review, reasoning that the grandfathering of Riggio was not the type of self-dealing transaction that invokes entire fairness, and moreover that the decision was approved by an independent board majority. Finding that the Barnes & Noble board's motivation was to protect the company "from the threat of being subject to inordinate influence or even control by a bloc that emerged without paying a fair price for that control," Strine likewise rejected Yucaipa's claim that the board's action must be reviewed under *Blasius*, which requires a "compelling justification" whenever a board acts for the primary purpose of thwarting a stockholder vote.

Applying *Unocal* to the facts at hand, Vice Chancellor Strine concluded that the Barnes & Noble board made a "good faith and reasonable judgment that the company faced a threat to which the Rights Plan was a reasonable, proportionate response."

Strine first analyzed whether the board had a "reasonable basis" for concluding that Yucaipa posed a threat the company. Although at trial Yucaipa emphasized its limited goal of electing three directors (and not a controlling state) to Barnes & Noble board, Strine noted that in its 13D filings Yucaipa reserved the right to make a proposal to acquire all of the company's shares or to propose other M&A transactions involving Barnes & Noble. Strine held that the board had a "reasonable basis" for concluding that Yucaipa—which had rapidly accumulated a nearly 18% stake in the company after Burkle's proposals for changes in corporate strategy were rejected by Riggio —was "potentially planning to acquire a controlling stake in Barnes & Noble or form a governing bloc with another large shareholder."

Strine then went on to find that the rights plan was "a reasonable response to that ongoing threat." In this analysis, Strine focused on the "key issue [of] whether the rights plan inhibit[ed] the ability of Yucaipa to run an effective proxy contest," and concluded that it did not. Strine found that even assuming that management's slate would enter a proxy fight with 37-38% of the expected vote (Riggio's holdings plus those of the directors, officers and employees of the company), Yucaipa was not precluded from running a successful campaign.

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In analyzing the issue of preclusion, Strine expressed skepticism about the recent *Selectica* holding that a rights plan is not preclusive unless it renders a proxy contest "mathematically impossible," observing that "if a defensive measure does not leave a proxy insurgent with a fair chance for victory, the mere fact that the insurgent might have some slight possibility of victory does not render the measure immune from judicial proscription as preclusive."

The Barnes & Noble dispute positions the Court's consideration of the validity of a rights plan within the contemporary scenario of a large, dissident shareholder advocating strategic change and seeking the ability to field a joint proxy slate with like-minded shareholders, rather than the more classic quest for corporate control. However, Vice Chancellor Strine was dismissive of Yucaipa's argument that a rights plan that restricts stockholders that collectively own shares in excess of the triggering threshold from joining together to wage a proxy contest was either novel or untoward. He emphasized that the standard for beneficial ownership incorporated by the Barnes & Noble plan was the well-recognized 13D standard, which has been the subject of many judicial rulings over time, including the seminal 1985 poison pill case of *Moran* itself.

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***Selectica, Inc. v. Versata Enters., Inc.*, 2010 WL 703062 (Del. Ch. Feb. 26, 2010).**
The Supreme Court's *en banc* decision dated Oct. 4, 2010 to affirm the Court of Chancery's decision follows this summary.

This case summary was posted by DLA Piper (www.dlapiper.com) on July 30, 2010 and can be found at the following web address: http://www.dlapiper.com/delaware-chancery-court-upholds-use-of-nol-poison-pills/. The article is authored by Diane Holt Frankle, Esq. and Michael J. Stein, Esq. of DLA Piper.

Delaware Chancery Court upholds use of NOL poison pills

In *Selectica, Inc. v. Versata Enterprises, Inc.,*[1] the Delaware Chancery Court recently upheld the use of what is known as a Section 382 poison pill (or net operating loss, or NOL, pill).

Shareholder rights plans, commonly referred to as poison pills, have historically been utilized by companies as a takeover defense to deter and to mitigate the time pressures of hostile takeover attempts made on unfair terms or at inadequate prices. In essence, shareholder rights plans create cheap stock options in favor of all stockholders except those who have accumulated a threateningly large block, thereby imposing dilution on an acquirer who obtains such a block. Prior to *Selectica*, Delaware courts had only examined the appropriateness of poison pills in the context of hostile change-of-control transactions.

An NOL pill is designed to protect the company's net operating loss carryforwards, which can be used to offset future tax liability to the extent that the company (or an acquiror) has such tax liability in the future. Section 382 of the Internal Revenue Code limits the amount of NOLs that can be used following certain changes in ownership. In summary, a Section 382 ownership change occurs if, on any testing date, the 5 percent stockholders of a company have increased their aggregate percentage ownership of the company by more than 50 percentage points over their respective lowest levels of percentage ownership during the three years prior to the testing date. Therefore, NOL pills generally contain 5 percent thresholds which seek to prevent a person who is not a 5 percent shareholder from becoming one, subject to exemptions, and also place strict limits on acquisition of additional shares by incumbent greater than 5 percent stockholders.

Since its initial public offering, Selectica had lost substantial amounts of money and had generated an estimated $160 million in NOLs. It also had a rights plan which had been in place since February 2003, with a 15 percent threshold. Selectica rejected several proposals from Trilogy regarding a possible acquisition by Trilogy, including proposals in July 2008 and October 2008. Its relationship with Trilogy was already contentious as a result of several patent infringement lawsuits. Trilogy also began acquiring Selectica's common stock, and on November 10, 2008, Trilogy informed Selectica that it had acquired more than 5 percent of Selectica's common stock. Selectica's board acted on November 16, 2008 to amend the existing rights plan to decrease the beneficial ownership trigger from 15 percent to 4.99 percent, while grandfathering then-existing 5 percent shareholders. Selectica's board determined that the NOLs were a significant asset and that the amendments to the rights plan were appropriate to protect that asset. Delaware courts had not previously reviewed a rights plan with such a low threshold, although a number of companies had adopted NOL pills. The amended rights plan maintained the provisions of the original rights plan, pursuant to which Selectica's board could determine, if the 4.9 percent threshold was triggered, to exchange the rights underlying the plan for shares of Selectica common stock or to do nothing and allow the rights to flip in

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automatically, becoming exercisable for $36 worth of newly issued Selectica common stock at a price of $18 per right.

Following the amendment of the rights plan, Trilogy increased its stake in Selectica, bringing its ownership to approximately 6.7 percent and breaching the poison pill's threshold, its published rationale being to "bring accountability" and to expose "illegal behavior" by the Selectica board. Following Trilogy's rejection of a standstill agreement to allow the parties to attempt to resolve the fact that the rights plan had been triggered, the Selectica board decided to implement the rights plan's exchange mechanism, resulting in dilution to Trilogy down to approximately 3.3 percent beneficial ownership. The Selectica board also amended its rights plan to reinstate the rights plan with the same 4.9 percent trigger and brought a declaratory judgment action in Delaware Chancery Court seeking to confirm that its actions amending the rights plan, authorizing the exchange and reinstating the rights plan were lawful. Trilogy and its subsidiary Versata countered with their claims that the initial Selectica NOL pill and the newly adopted replacement NOL pill were both invalid, sought an order enjoining or rescinding the exchange and asserted that the Selectica board had breached its fiduciary duties by implementing the amended rights plan, the exchange and the reinstated rights plan.

The Delaware Chancery Court stated that "poison pills remain a common feature of the corporate landscape" and observed that "courts have repeatedly upheld their adoption as consistent with a board's fiduciary duty and business judgment." The court upheld the validity of Selectica's NOL pill under Delaware's *Unocal*[2] standard, which is used in connection with defensive actions taken by a board in connection with a possible change of control, such as the adoption of a poison pill. Under *Unocal*, in order to be afforded the protections of the business judgment rule, a company's board must show it had reasonable grounds for believing that a danger to corporate policy and effectiveness existed and demonstrate that the defense response was reasonable in relation to the specific threat. Delaware courts have stated that a response is not reasonable if it is either coercive or preclusive.[3]

Vice Chancellor John W. Noble noted that "an NOL pill's principal function is to prevent the inadvertent forfeiture of potentially valuable assets, not to protect against hostile takeover attempts" and stated that "the protection of company NOLs may be an appropriate corporate policy meriting a defensive response when threatened." He further noted that the "protection of corporate assets against an outside threat is arguably a more important concern of the Board than restricting who the owners of the Company might be." In addition, Vice Chancellor Noble explained the preclusive standard that would violate *Unocal*, holding that "... the law affords boards of directors substantial latitude in defending the perimeter of the corporate bastion against perceived threats. .... It is not enough that a defensive measure would make proxy contests more difficult – even considerably more difficult. To find a measure preclusive (and avoid the reasonableness inquiry altogether), the measure must render a successful proxy contest a near impossibility or else utterly moot." Vice Chancellor Noble held that Selectica's NOL pill did not have either effect and therefore was not preclusive.

The court then evaluated the NOL rights plan under the standard of reasonableness and noted that the exchange of the rights employed by Selectica's board of directors was a more proportionate response than the flip in mechanism provided in the rights plan, and therefore, Trilogy experienced less dilution than it would have had the flip in mechanism been permitted to operate. The court found that there was no meaningfully different approach the board could have taken to protect against Trilogy's impairment of its NOLs. The court also found that the Selectica board properly evaluated the threat to its corporate asset and the NOL pill was a proportionate response in light of the Trilogy threat. "Trilogy posed a distinctly different threat to Selectica's NOLS . . . a longtime competitor sought to

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employ the shareholder franchise intentionally to impair corporate assets, or else to coerce the Company into meeting certain business demands under the threat of such impairment," the court explained.

As a result of the *Selectica* decision, the Delaware Chancery court confirmed the legality of the use of rights plans as a takeover defense under Delaware law, and also expressly acknowledged the validity of an NOL rights plan. Trilogy and Versata appealed the *Selectica* decision to the Delaware Supreme Court. Oral arguments were heard on July 7, 2010, at the Delaware Supreme Court, and we are awaiting the court's ruling.

A few practical lessons can be derived from Selectica's experience resulting from Trilogy's intentional acquisition of Selectica's common stock in excess of the rights plan threshold, which is the first known intentional breach of a rights plan with modern flip in and exchange provisions. First, there was significant pressure on the Selectica board during the period immediately following notice of Trilogy's acquisition of shares. During the ten-business-day period following Trilogy's acquisition of shares in excess of the threshold, the board had the right to exempt an acquirer from the impact of the rights plan if it were determined that the acquisition would not adversely impact the NOL. The board also had to determine whether to permit the flip in or utilize the exchange feature during that same period. Further, the announcement of the breach of the rights plan threshold resulted in a trading halt in Selectica's stock on Nasdaq from January 5, 2009, the trading day after the announcement of the exchange, until February 5, 2009.

The exchange feature was deemed to be a more proportionate response than a flip in. It is also the simplest mechanism, in that it can be effected by the board alone, does not require registration of the exchange shares and can be effected more quickly than a flip in, assuming the company has sufficient authorized and unissued shares available to implement the exchange. In order to satisfy the rights plan requirements that exchange shares not be provided to Trilogy or its affiliates, Selectica employed a trust to hold shares while verifying that holders were not Trilogy affiliates. It is important for modern rights plans to provide an exchange feature and permit the utilization of a trust as part of that mechanism to reduce the potential trading issues that could result on the triggering of a rights plan. The Delaware Supreme Court's decision in this case may provide additional or different lessons for us all, and we await the issuance of that opinion later this year.

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1 2010 WL 703062 (Del. Ch. Feb. 26, 2010).

2 *Unocal Corp. v. Mesa Petroleum Co.,* 493 A.2d 946 (Del. 1985).

3 See *Unitrin, Inc. v. A.m. Gen. Corp.*, 651 A.2d 1361 (Del. 1995).

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IN THE SUPREME COURT OF THE STATE OF DELAWARE

VERSATA ENTERPRISES, INC. and TRILOGY, INC.,	§	No. 193, 2010
Defendants/Counterclaim Plaintiffs Below, Appellants/ Cross Appellees,	§	Court Below—Court of Chancery of the State of Delaware C.A. No. 4241
v.	§	
SELECTICA, INC.,	§	
Plaintiff Below, Appellee/Cross Appellant,	§	
and	§	
SELECTICA, INC., JAMES ARNOLD, ALAN B. HOWE, LLOYD SEMS, JIM THANOS, and BRENDA ZAWATSKI,	§	
Counterclaim Defendants Below, Appellees/Cross Appellants.	§	

Submitted: July 7, 2010
Decided: October 4, 2010

Before **STEELE,** Chief Justice, **HOLLAND, BERGER, JACOBS** and **RIDGELY,** Justices, constituting the Court *en Banc*.

Upon appeal from the Court of Chancery. **AFFIRMED.**

Megan Ward Cascio, Esquire, Leslie A. Polizoti, Esquire and Ryan D. Stottmann, Esquire, Morris, Nichols Arsht & Tunnell, LLP, Wilmington, Delaware, and Nicholas Even, Esquire (argued) and Daniel Gold, Esquire, Haynes and Boone, LLP, Dallas, Texas, for appellants.

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Gregory V. Varallo, Esquire (argued), Lisa A. Schmidt, Esquire, John D. Hendershot, Esquire, Ethan A. Shaner, Esquire, Scott W. Perkins, Esquire and Jillian G. Remming, Esquire, Richards, Layton & Finger, P.A., Wilmington, Delaware, and Jonathan S. Kitchen, Esquire and Christian H. Cebrian, Esquire, Cox, Castle & Nicholson, LLP, San Francisco, California, for Selectica, Inc., James Arnold, Alan B. Howe, Lloyd Sems, James Thanos and Brenda Zawatski.

HOLLAND, Justice:

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This is an appeal from a final judgment entered by the Court of Chancery. On November 16, 2008 the Board of Directors of Selectica, Inc. ("Selectica") reduced the trigger of its "poison pill" Shareholder Rights Plan from 15% to 4.99% of Selectica's outstanding shares and capped existing shareholders who held a 5% or more interest to a further increase of only 0.5% (the "NOL Poison Pill"). Selectica's reason for taking such action was to protect the company's net operating loss carryforwards ("NOLs"). When Trilogy, Inc. ("Trilogy") subsequently purchased shares above this cap, Selectica filed suit in the Court of Chancery on December 21, 2008, seeking a declaration that the NOL Poison Pill was valid and enforceable. On January 2, 2009, Selectica implemented the dilutive exchange provision (the "Exchange") of the NOL Poison Pill, which reduced Trilogy's interest from 6.7% to 3.3%, and adopted another Rights Plan with a 4.99% trigger (the "Reloaded NOL Poison Pill"). Selectica then amended its complaint to seek a declaration that the Exchange and the Reloaded NOL Poison Pill were valid.

Trilogy and its subsidiary Versata Enterprises, Inc. ("Versata") counterclaimed that the NOL Poison Pill, the Reloaded NOL Poison Pill, and the Exchange were unlawful on the grounds that, before acting, the Board failed to consider that its NOLs were unusable or that the two NOL

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poison pills were unnecessary given Selectica's unbroken history of losses and doubtful prospects of annual profits. Trilogy and Versata also asserted that the NOL Poison Pill and the Reloaded NOL Poison Pill were impermissibly preclusive of a successful proxy contest for Board control, particularly when combined with Selectica's staggered director terms. After trial, the Court of Chancery held that the NOL Poison Pill, the Reloaded NOL Poison Pill, and the Exchange were all valid under Delaware law.

Trilogy and Versata now appeal and assert two claims of error. First, they contend that the Court of Chancery erred in applying the *Unocal* test for enhanced judicial scrutiny when confronting what they frame as a question of first impression. The issue (as framed by them) is: "what are the minimum requirements for a reasonable investigation before the board of a never-profitable company may adopt a [Rights Plan with a 4.99% trigger] for the ostensible purpose of protecting NOLs from an 'ownership change' under Section 382 of the Internal Revenue Code?" Second, they submit that the Court of Chancery erred in holding that the two NOL poison pills, either individually or in combination with a charter-based classified Board, did not have a preclusive effect on the shareholders' ability to pursue a successful proxy contest for control of the Company's board. We conclude that both arguments are without merit.

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In its cross-appeal, the Selectica related parties argue that the Court of Chancery erred in denying their application for an award of attorneys' fees under the bad faith exception to the American Rule. We conclude that argument is also without merit.

Facts[1]

The Court of Chancery described this as a case about the value of net operating loss carryforwards ("NOLs") to a currently profitless corporation, and the extent to which such a corporation may fight to preserve those NOLs. The Court of Chancery also provided a helpful overview of the concepts surrounding NOLs, their calculation, and possible impairment.

NOLs are tax losses, realized and accumulated by a corporation, that can be used to shelter future (or immediate past) income from taxation.[2] If taxable profit has been realized, the NOLs operate either to provide a refund of prior taxes paid or to reduce the amount of future income tax owed. Thus, NOLs can be a valuable asset, as a means of lowering tax payments and producing positive cash flow. NOLs are considered a contingent asset, their value being contingent upon the firm's reporting a future profit or having an immediate past profit.

[1] The facts are taken from the Court of Chancery's opinion.
[2] NOLs may be carried backward two years and carried forward twenty years.

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Should the firm fail to realize a profit during the lifetime of the NOL (twenty years), the NOL expires. The precise value of a given NOL is usually impossible to determine since its ultimate use is subject to the timing and amount of recognized profit at the firm. If the firm never realizes taxable income, at dissolution its NOLs, regardless of their amount, would have zero value.

In order to prevent corporate taxpayers from benefiting from NOLs generated by other entities, Internal Revenue Code Section 382 establishes limitations on the use of NOLs in periods following an "ownership change." If Section 382 is triggered, the law restricts the amount of prior NOLs that can be used in subsequent years to reduce the firm's tax obligations.[3] Once NOLs are so impaired, a substantial portion of their value is lost.

The precise definition of an "ownership change" under Section 382 is rather complex. At its most basic, an ownership change occurs when more than 50% of a firm's stock ownership changes over a three-year period. Specific provisions in Section 382 define the precise manner by which this determination is made. Most importantly for purposes of this case, the only shareholders considered when calculating an ownership change under

[3] The annual limitation on the use of past period NOLs following a change-in-control is calculated as the value of the firm's equity at the time of the ownership change, multiplied by a published rate of return, the federal long term exemption rate.

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Section 382 are those who hold, or have obtained during the testing period, a 5% or greater block of the corporation's shares outstanding.

The Parties

Selectica, Inc. ("Selectica" or the "Company") is a Delaware corporation, headquartered in California and listed on the NASDAQ Global Market. It provides enterprise software solutions for contract management and sales configuration systems. Selectica is a micro-cap company with a concentrated shareholder base: the Company's seven largest investors own a majority of the stock, while fewer than twenty-five investors hold nearly two-thirds of the stock.[4]

Trilogy, Inc. ("Trilogy") is a Delaware corporation also specializing in enterprise software solutions. Trilogy stock is not publicly traded, and its founder, Joseph Liemandt, holds over 85% of the stock. Versata Enterprises, Inc. ("Versata"), a Delaware corporation and a subsidiary of Trilogy, provides technology powered business services to clients.

Before the events giving rise to this action, Versata and Trilogy beneficially owned 6.7% of Selectica's common stock. After they intentionally triggered Selectica's Shareholder Rights Plan through the

[4] However, because of the Shareholder Rights Plan first instituted in 2003, no stockholder holds more than 15% of the outstanding shares.

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purchase of additional shares, Versata's and Trilogy's joint beneficial ownership was diluted from 6.7% to approximately 3.3%.

James Arnold, Alan B. Howe, Lloyd Sems, Jim Thanos, and Brenda Zawatski are members of the Selectica Board of Directors (the "Board").[5] Zawatski and Thanos also served as Co-Chairs of the Board during the events at issue in the case.[6] In this role, they handled the day-to-day operations of the Company, as Selectica had been without a Chief Executive Officer since June 30, 2008.

Selectica's Historical Operating Difficulties

Since it became a public company in March 2000, Selectica has lost a substantial amount of money and failed to turn an annual profit, despite routinely projecting near-term profitability. Its IPO price of $30 per share has steadily fallen and now languishes below $1 per share, placing Selectica's market capitalization at roughly $23 million as of the end of March 2009. By Selectica's own admission, its value today "consists primarily in its cash reserves, its intellectual property portfolio, its customer and revenue base, and its accumulated NOLs." By consistently failing to

[5] Alan Howe was elected to the Board on January 12, 2009, after the events at issue in this case. He has not been charged with any breach of fiduciary duty and has not been served with process. Trilogy purports to name Howe as a Counterclaim-Defendant solely "in order to afford [Trilogy] complete relief."

[6] On August 19, 2009, Thanos stepped down as Co-Chair and Zawatski became sole Chair of the Board and continued to handle the Company's daily operations.

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achieve positive net income, Selectica has generated an estimated $160 million in NOLs for federal tax purposes over the past several years.

Selectica's Relationship with Trilogy

Selectica has had a complicated and often adversarial relationship with Trilogy, stretching back at least five years. Both companies compete in the relatively narrow market space of contract management and sales configuration. In April 2004, a Trilogy affiliate sued Selectica for patent infringement and secured a judgment that required Selectica, among other things, to pay Trilogy $7.5 million. While their suit was pending, in January 2005 Trilogy made an offer to buy Selectica for $4 per share in cash—a 20% premium above the then-trading price—which Selectica's Board rejected. Nevertheless, during March and April of that year, a Trilogy affiliate acquired nearly 7% of Selectica's common stock through open market trades. In early fall 2005, Trilogy made another offer for Selectica's shares at a 16%-23% premium, which was also rejected.

In September 2006, a Trilogy-affiliated holder of Selectica stock sent a letter to the Board questioning whether certain stock option grants had been backdated.[7] The following month, Trilogy filed another patent

[7] A special committee empanelled by the Board ultimately concluded that certain options had, in fact, been backdated. Consequently, Selectica was required to restate its financial statements to record additional stock-based compensation and related tax effects for past

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infringement lawsuit against Selectica. That action was settled in October 2007, when Selectica agreed to a one-time payment of $10 million, plus an additional amount of not more than $7.5 million in subsequent payments to be made quarterly. In late fall 2006, Trilogy sold down its holdings in Selectica.

Steel Partners

Steel Partners is a private equity fund that has been a Selectica shareholder since at least 2006 and is currently its largest shareholder. One of Steel Partners' apparent investment strategies is to invest in small companies with large NOLs with the intent to pair the failing company with a profitable business in order to reap the tax benefits of the NOLs. Steel Partners has actively worked with Selectica to calculate and monitor the Company's NOLs since the time of its original investment.

By early 2008, Steel Partners was advocating a quick sale of Selectica's assets, leaving a NOL shell that could be merged with a profitable operating company in order to shelter the profits of the operating company. In October 2008, Steel Partners informed members of Selectica's

option grants and incurred fees associated with the investigation in excess of $6.2 million. This episode also led to the resignation of Selectica's then-Chairmen and Chief Executive Officer Stephen Bannion (who had been the Company's Chief Financial Officer at the time of the grants of question) and the appointment of then-Director Robert Jurkowski to the Chief Executive and Chair position.

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Board that it planned to increase its ownership position to 14.9% just below the 15% trigger of the 2003 Rights Plan, which it later did. Jack Howard, President of Steel Partners, lobbied for a Board seat twice in 2008, citing his experience dealing with NOLs, but was rebuffed.

Selectica Investigates Its NOLs

In 2006, at the urging of Steel Partners, Selectica directed Alan Chinn, its outside tax adviser, to perform a high-level analysis into whether its NOLs were subject to any limitations under Section 382 of the Internal Revenue Code. Chinn concluded that five prior changes in ownership had caused the forfeiture of approximately $24.6 million in NOLs. Selectica provided the results of this study to Steel Partners, although not to any other Selectica shareholder.

In March 2007, again at Steel Partner's recommendation, Selectica retained a second accountant who specialized in NOL calculations, John Brogan of Burr Pilger & Mayer, LLP, to analyze the Company's NOLs more carefully and report on Chinn's Section 382 analysis. Brogan had previously analyzed the NOLs at other Steel Partners ventures. Brogan ultimately determined that Chinn's conclusions were erroneous.

The Company engaged Brogan to perform additional work on the topic of NOLs in June 2007. One of Steel Partners's employees, Avi

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Goodman, worked closely with Brogan on the matter, although Brogan was working for and being paid by Selectica and received no compensation from Steel Partners. Brogan's draft letter opinion, concluding that the Company had not undergone an "ownership change" for Section 382 purposes since 1999, was shared with Steel Partners, although again not with any other outside investors.

In the fall of 2007, Brogan proposed a third, more detailed, Section 382 study, which Selectica's then-CEO, Robert Jurkowski, opposed. In February 2008, the Board voted against spending $40,000-$50,000 to fund this Section 382 study. By July, however, the Board asked Brogan to update his study. Brogan delivered the draft opinion that, as of March 31, 2008, the Company had approximately $165 million in NOLs. Brogan was later asked to advise the Board in the fall of 2008 on the updated status of its NOLs when the Board moved to amend its Rights Plan.

Lloyd Sems Elected Director

In April 2008, the Board began interviewing candidates for an open board seat, giving preference to the Company's large stockholders. Selectica investor Lloyd Sems had previously expressed interest in joining the Board and had sought support from certain shareholders, including Steel Partners, through Howard, and Lloyd Miller, another large Selectica

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shareholder not affiliated with Steel Partners. Both Miller and Howard wrote to the Board in support of Sems's appointment, although Sems was already favored by the Board by that time. In June 2008, Sems was appointed to the Board.

As large shareholders, Sems, Howard, and Miller had periodically discussed Selectica as early as October 2007. At that time, Sems had e-mailed Howard, stating, "I wanted to get your opinion of how or if you would like me to proceed with [Selectica]." Howard replied, "Lloyd [Miller] said he would call you about [Selectica]." Both before and after his appointment to the Board, Sems discussed with Howard and Miller a number of the proposals that Sems ultimately advocated as a director, including that Selectica should buy back its stock, that Selectica should consider selling its businesses, that the NOLs were important and should be preserved through the adoption of a Rights Plan with a 5% trigger, and that Jurkowski should be removed as CEO.

Selectica Restructures and Explores Alternatives

In early July 2008, after determining that the Company needed to change course, the Board terminated Jurkowski as CEO and eliminated several management positions in the sales configuration business. Later that month, prompted by the receipt of five unsolicited acquisition offers over the

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span of a few weeks, the Board announced that it was in the process of selecting an investment banker (ultimately, Jim Reilly of Needham & Company) to evaluate strategic alternatives for the Company and to assist with a process that ultimately might result in the Company's sale. In view of the potential sale, the Board decided to forgo the expense of replacing Jurkowski and, instead, asked Zawatski and Thanos jointly to assume the title of Co-Chair and to perform operational oversight roles on an interim basis.

The Needham Process

Needham has actively carried outs its task of evaluating Selectica's strategic options since its selection by the Board. Needham first discussed with the Board the various strategic choices that the Company could take. These included a merger of equals with a public company, a reverse IPO or other going-private transaction, the sale of certain assets, and the use of cash to acquire another company, as well as stock repurchases or the issuance of dividends if Selectica decided to continue as an independent public company in the absence of sufficient market interest for an acquisition.

In October 2008, Needham prepared an Executive Summary of the assets and operations of Selectica and subsequently reached out to potential buyers, keeping in touch with various interested parties throughout the

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remainder of the year and into the first part of 2009. By February 2009, at least half a dozen parties had come forward with letters of intent and were in the process of meeting with Selectica management and conducting due diligence in the Company, with Needham evaluating their various proposals for the purchase of all or part of Selectica's operations. As of April 2009, Selectica, through Needham, had signed a letter of intent and entered into exclusive negotiations with a potential buyer.

Trilogy's Offers Rejected

On July 15, 2008, Trilogy's President, Joseph Liemandt, called Zawatski to inquire generally about the possibility of an acquisition of Selectica by Trilogy. On July 29, Trilogy Chief Financial Officer Sean Fallon, Trilogy Director of Finance Andrew Price, and Versata Chief Executive Officer Randy Jacops participated in a conference call with Selectica Co-Chairs Zawatski and Thanos on the same topic. During the call, Thanos inquired as to how Trilogy would calculate a value for the Company's NOLs. Fallon replied that Trilogy, "really [did not] pursue them with as much vigor as other[s] might since that is not our core strategy."[8]

[8] However, as part of its 2005 effort to acquire Selectica, Trilogy had performed "a pretty detailed analysis" of Selectica's NOLs. Johnston testified that this analysis was occasionally updated and that similar analyses had been performed on a dozen or so other acquisition targets.

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The following evening, Fallon contacted Zawatski and outlined two proposals for Trilogy to acquire Selectica's business: (1) Trilogy's purchase of all of the assets of Selectica's sales configuration business in exchange for the cancellation of the $7.1 million in debt Selectica still owed under the October 2007 settlement with Trilogy; or (2) Trilogy's purchase of Selectica's entire operations for the cancellation of the debt plus an additional $6 million in cash. Fallon subsequently followed up with an e-mail reiterating both proposals and suggesting that either proposal would allow Selectica to still make use of its NOLs through the later sale of its corporate entity.

Shortly thereafter, the Board rejected both proposals, made no counterproposal, and there were no follow-up discussions. On October 9, 2008, Trilogy made a second bid to acquire all of the Selectica's assets for $10 million in cash plus the cancellation of the debt, which the Board also rejected. Although Trilogy was invited to participate in the sale process being overseen by Needham, Trilogy was apparently unwilling to sign a non-disclosure agreement, which was a prerequisite for participation. Around this same time, Trilogy had begun making open-market purchases for Selectica stock, although the Board apparently was not aware of this fact at the time.

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Trilogy Buys Selectica Stock

On the evening of November 10, Fallon contacted Zawatski and informed her that Trilogy had purchased more than 5% of Selectica's outstanding stock and would be filing a Schedule 13D shortly, which it did on November 13.[9] On a subsequent call with Zawatski and Reilly, Fallon explained that Trilogy had begun buying because it believed that "the company should work quickly to preserve whatever shareholder value remained and that we were interested in seeing this process that they announced with Needham, that we were interested in seeing that accelerate . . . ." Within four days of its 13D filing, Trilogy had acquired more than 320,000 additional shares, representing an additional 1% of the Company's outstanding shares.

NOL Poison Pill Adopted

In the wake of Trilogy's decision to begin acquiring Selectica shares, the Board took actions to gauge the impact of these acquisitions, if any, on the Company's NOLs, and to determine whether anything needed to be done to mitigate their effects. Sems immediately asked Brogan to revise his Section 382 analysis—which had not been formally updated since July—to take into account the recent purchases. The revised analysis was delivered

[9] The November 13, 2008, Schedule 13D reported that Versata and affiliates had purchased 1,437,891 shares of Selectica stock, increasing its ownership to 5.1%.

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to Sems and the Company's new CFO, Richard Heaps, on November 15. It showed that the cumulative acquisition of stock by shareholders over the past three years stood at 40%, which was roughly unchanged from the previous calculation, due to some double counting that occurred in the July analysis.[10]

The Board met on November 16 to discuss the situation and to consider amending Selectica's Shareholder Rights Plan, which had been in place since February 2003. As with many Rights Plans employed as protection devices against hostile takeovers, Selectica's Rights Plan had a 15% trigger. The Board considered an amendment that would reduce that threshold trigger to 4.99% in order to prevent additional 5% owners from emerging and potentially causing a change-in-control event, thereby devaluing Selectica's NOLs. Also present at the meeting were Heaps, Brogan, and Reilly, along with Delaware counsel.

Heaps gave an overview of the Company's existing Shareholder Rights Plan and reviewed the stock price activity since Trilogy had filed its Schedule 13D, noting that shares totaling approximately 2.3% of the Company had changed hands in the two days following the filing. Brogan reviewed the Section 382 ownership analysis that his firm had undertaken on

[10] A more formal analysis was provided on November 26, finding a 38.8% change in ownership over the relevant period.

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behalf of the Company, noting that additional acquisitions of roughly 10% of the float by new or existing 5% holders would "result in a permanent limitation on use of the Company's net operating loss carryforwards and that, once an ownership change occurred, there would be no way to cure the use limitation on the net operating loss carryforwards." He further advised the Board that "net operating loss carryforwards were a significant asset" and that he generally advises companies to consider steps to protect their NOLs when they experience a 30% or greater change in beneficial ownership. Lastly, Brogan noted that, while he believed that the cumulative ownership change calculations would decline significantly over the next twelve months, "it would decline only modestly, if at all, over the next three to four months," meaning that "the Company would continue to be at risk of an ownership change over the near term."

Reilly discussed the Company's strategic alternatives and noted that Steel Partners and other parties had expressed interest in pursuing a transaction that would realize the value of Selectica's NOLs. He also reviewed potential transaction structures in which the Company might be able to utilize its NOLs. Responding to questions from the Board, Reilly noted that "it is difficult to value the Company's net operating loss carryforwards with greater precision, because their value depends, among

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other things, on the ability of the Company to generate profits." He confirmed that "existing stockholders may realize significant potential value" from the utilization of the Company's NOLs, which would be "significantly impaired" if a Section 382 ownership change occurred.

At the request of the Board, Delaware counsel reviewed the Delaware law standards that apply for adopting and implementing measures that have an anti-takeover effect. The Board then discussed amending the existing Shareholder Rights Plan, and the possible terms of such an amendment. These included: the pros and cons of providing a cushion for preexisting 5% holders, the appropriate effective date of the new Shareholder Rights Plan, whether the Board should have authority to exclude purchases by specific stockholders from triggering the Rights Plan, and whether a review process should be implemented to determine periodically whether the Rights Plan should remain in effect.

The Board then unanimously passed a resolution amending Selectica's Shareholder Rights Plan, by decreasing the beneficial ownership trigger from 15% to 4.99%, while grandfathering in existing 5% shareholders and permitting them to acquire up to an additional 0.5% (subject to the original 15% cap) without triggering the NOL Poison Pill.

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The Board resolution also established an Independent Director Evaluation Committee (the "Committee") as a standing committee of the Board to review periodically the rights agreement at the behest of the Board and to "determine whether the Rights [Plan] continues to be in the best interest of the Corporation and its stockholders." The Committee was also directed to review "the appropriate trigger percentage" of the Rights Plan based on corporate and shareholder developments, any broader developments relating to rights plans generally—including academic studies of rights plans and contests for corporate control—and any other factors it deems relevant. The Board set April 30, 2009, as the first date that the Committee should report its findings.

Trilogy Triggers NOL Poison Pill

The Board publicly announced the amendment of Selectica's Rights Plan on Monday, November 17. Early the following morning, Fallon e-mailed Trilogy's broker, saying "[W]e need to stop buying SLTC. They announced a new pill and we need to understand it." Fallon also sent Liemandt a copy of Selectica's 8-K containing the amended language of the NOL Poison Pill. Trilogy immediately sought legal advice about the NOL Poison Pill. The following morning, Liemandt e-mailed Price, with a copy to Fallon, asking, "What percentage of [Selectica] would we need to buy to

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ruin the tax attributes that [S]teel [P]artners is looking for?"[11] They concluded that they would need to acquire 23% to trigger a change-in-control event.

Later that week, Trilogy sent Selectica a letter asserting that a Selectica contract with Sun Microsystems constituted a breach of the October 2007 settlement and seeking an immediate meeting with Selectica purportedly to discuss the breach, even though members of Trilogy's management had been on notice of the contract as early as July. Fallon, Liemandt, and Jacops from Trilogy, along with Zawatski, Thanos, and Heaps from Selectica met on December 17. The parties' discussions at this meeting are protected by a confidentiality agreement that had been circulated in advance. However, Selectica contends that "based solely on statements and conduct outside that meeting, it is evident that Trilogy threatened to trigger the NOL Poison Pill deliberately unless Selectica agreed to Trilogy's renewed efforts to extract money from the Company."

On December 18, Trilogy purchased an additional 30,000 Selectica shares, and Trilogy management verified with Liemandt his intention to

[11] Liemandt testified that his question meant, "what is the amount that we can buy without hurting it, which is the other way of asking, what's the amount you can buy to ruin it." Price testified, however, that he understood the question as being more straightforward, specifically, "what percentage would we have to buy to trigger a change of control as per Section 382."

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proceed with "buying through" the NOL Poison Pill. The following morning, Trilogy purchased an additional 124,061 shares of Selectica, bringing its ownership share to 6.7% and thereby becoming an "Acquiring Person" under the NOL Poison Pill. Liemandt testified that the rationale behind triggering the pill was to "bring accountability" to the Board and "expose" what Liemandt characterized as "illegal behavior" by the Board in adopting a pill with such a low trigger. Fallon asserted that the reason for triggering the NOL Poison Pill was to "bring some clarity and urgency" to their discussions with Selectica about the two parties' somewhat complicated relationship by "setting a time frame that might help accelerate discussions" on the direction of the business.

Fallon placed a telephone call to Zawatski on December 19 to advise her that Trilogy had bought through the NOL Poison Pill. During a return call by Zawatski later that evening, Fallon indicated that Trilogy felt, based on the conversations from December 17, that Selectica no longer wanted Trilogy as a shareholder or creditor. He then proposed that Selectica repurchase Trilogy's shares, accelerate the payment of its debt, terminate its license with Sun, and make a payment to Trilogy of $5 million "for settlement of basically all outstanding issues between our companies." Zawatski recalled that Fallon told her that Trilogy had triggered the pill "to

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get our attention and create a sense of urgency;" that, since the Board would have ten days to determine how to react to the pill trigger, "it would force the board to make a decision."

Board Considers Options and Requests a Standstill

The Selectica Board had a telephonic meeting on Saturday, December 20, to discuss Trilogy's demands and an appropriate response. The Board discussed "the desirability of taking steps to ensure the validity of the Shareholder Rights Plan," and ultimately passed a resolution authorizing the filing of this lawsuit, which occurred the following day. On December 22, Trilogy filed an amended Schedule 13D disclosing its ownership percentage and again the Selectica Board met telephonically to discuss the litigation. It eventually agreed to have a representative contact Trilogy to seek a standstill on any additional open market purchases while the Board used the ten-day clock under the NOL Poison Pill to determine whether to consider Trilogy's purchases "exempt" under the Rights Plan, and if not, how Selectica would go about implementing the pill.

The amended Rights Plan allowed the Board to declare Trilogy an "Exempt Person" during the ten-day period following the trigger, if the Board determined that Trilogy would not "jeopardize or endanger the availability to the Company of the NOLs . . . ." The Board could also decide

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during this window to exchange the rights (other than those held by Trilogy) for shares of common stock. If the Board did nothing, then after ten days the rights would "flip in" automatically, becoming exercisable for $36 worth of newly-issued common stock at a price of $18 per right.

The Board met again by telephone the following day, December 23, to discuss the progress of the litigation and to consider the potential impact of the various alternatives under the NOL Poison Pill. The Board agreed to meet in person the following Monday, December 29, along with the Company's financial, legal, and accounting advisors, to evaluate further the available options. The Board also voted to reduce the number of authorized directors from seven to five.

On Wednesday, December 24, the Board met once again by telephone upon learning that the Company's counsel had not succeeded in convincing Trilogy to agree to a standstill. The Board resolved that Zawatski should call Fallon to determine whether Trilogy was willing "to negotiate a standstill agreement that might make triggering the remedies available under the Shareholder Rights Plan, as amended, unnecessary at this time." Zawatski spoke with Fallon on the morning of December 26. Fallon stated that Trilogy did not want to agree to a standstill, that relief from the NOL Poison Pill was not Trilogy's goal, and that Trilogy expected that the NOL

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Poison Pill would apply to it. Fallon reiterated that the ten-day window would help "speed [the] course" towards a resolution of their claims.

The Board and its advisors met again on December 29. Thanos provided an update on recent developments at the Company, including financial results, management changes, and the Needham Process, as well as an overview of the make-up of the Company's shareholder base. Reilly then provided a more detailed report on the status of the Needham Process. Thereafter, Brogan presented his firm's updated analysis of Selectica's NOLs, which found that the Company had at least $160 million in NOLs and that there had been a roughly 40% ownership change by 5% holders over the three-year testing period. Since those were not expected to "roll off" in the near term, there was "a significant risk of a Section 382 ownership change."

Brogan subsequently discussed the possible consequences of the two principal mechanisms for implementing the triggered NOL Poison Pill to the change-in-control analysis. He stated that employing a share exchange would not likely have a materially negative impact on the Section 382 analysis. He expressed concern, however, about the uncertain effect of a flip-in pill on subsequent ownership levels (specifically, the possibility that a flip-in pill would, itself, trigger a Section 382 ownership change). Reilly

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once again addressed the Board to explain the ways he believed the NOLs would be valuable to the Company in its ongoing exploration of strategic alternatives, and reiterated his opinion that an ownership change would "reduce the value of the Company."

The Board also discussed Trilogy's settlement demands. It found them "highly unreasonable" and "lack[ing] any reasonable basis in fact," and that "it [was] not in the best interests of the Company and its stockholders to accept Trilogy/Versata's settlement demands relating to entirely separate intellectual property disputes as a precondition to negotiating a standstill agreement to resolve this dispute." The Board discussed Trilogy's actions at some length, ultimately concluding that they "were very harmful to the Company in a number of respects," and that "implementing the exchange was reasonable in relation to the threat imposed by Trilogy." In particular, that was because (1) the NOLs were seen as "an important corporate asset that could significantly enhance stockholder value," and (2) Trilogy had intentionally triggered the NOL Poison Pill, publicly suggested it might purchase additional stock, and had refused to negotiate a standstill agreement, even though an additional 10% acquisition by a 5% shareholder would likely trigger an ownership change under Section 382.

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The Board then authorized Delaware counsel to contact Trilogy in writing, one final time, to seek a standstill agreement. It also passed resolutions delegating the full power of the Board to the Committee to determine whether or not to treat Trilogy or its acquisition as "exempt," and nominating Alan Howe as a new member of the Board. On the evening of December 29, Selectica's Delaware counsel e-mailed Trilogy's trial counsel at the Board's instruction, seeking a standstill agreement "so that the Board could consider either declaring them an 'Exempt Person' under the Rights Plan . . . or alternatively, settle the litigation altogether in exchange for a long term agreement relating to your clients' ownership of additional shares." The following afternoon, Trilogy's counsel responded that Trilogy was not willing to agree to the proposed standstill.

Two days later, on December 31, the Board met telephonically and was informed of Trilogy's latest rejection of a standstill agreement. The Board discussed its options with its legal advisors and ultimately concluded that the NOL Poison Pill should go into effect and that an exchange was the best alternative and should be implemented as soon as possible in order to protect the NOLs, even at the risk of disrupting common stock trading. The Board directed advisers to prepare a technical amendment to the NOL

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Poison Pill to clarify the time at which the exchange would become effective.

Board Adopts Reloaded Pill and Dilutes Trilogy Holdings

On January 2, the Board met telephonically once more, reiterating its delegation of authority to the Committee to make recommendations regarding the implementation of the NOL Poison Pill. The Board also passed a resolution expressly confirming that the Board's delegation of authority to the Committee included the power to effect an exchange of the rights under the NOL Poison Pill and to declare a new dividend of rights under an amended Rights Plan (the "Reloaded NOL Poison Pill"). The Board then adjourned and the Committee—comprised of Sems and Arnold—met with legal and financial advisors, who confirmed that there had been no new agreement with representatives from Trilogy, reiterated that the NOLs remained "a valuable corporate asset of the Company in connection with the Company's ongoing exploration of strategic alternatives," and advised the Committee members of their fiduciary obligations under Delaware law.

Reilly presented information to the Committee about the current takeover environment and the use of Rights Plans (specifically, the types of pills commonly employed and their triggering thresholds), and reviewed the

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Company's then-current anti-takeover defenses compared with those of other public companies. Reilly stated that "a so-called NOL rights plan with a 4.99% trigger threshold is designed to help protect against stock accumulations that would trigger an 'ownership change,'" and that "implementing appropriate protections of the Company's net operating loss carryforwards was especially important at present," given Trilogy's recent share acquisitions superimposed on the Company's existing Section 382 ownership levels. Finally, Reilly reviewed the proposed terms and conditions of the Reloaded NOL Poison Pill, discussed the methodology for determining the exercise price of the new rights, and made recommendations. The Committee sought and obtained reconfirmed assurances by its financial and legal advisors that the NOLs were a valuable corporate asset and that they remained at a significant risk of being impaired.

The Committee concluded that Trilogy should not be deemed an "Exempt Person," that its purchase of additional shares should not be deemed an "Exempt Transaction," that an exchange of rights for common stock (the "Exchange") should occur, and that a new rights dividend on substantially similar terms should be adopted. The Committee passed resolutions implementing those conclusions, thereby adopting the Reloaded NOL Poison Pill and instituting the Exchange.

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The Exchange doubled the number of shares of Selectica common stock owned by each shareholder of record, other than Trilogy or Versata, thereby reducing their beneficial holdings from 6.7% to 3.3%. The implementation of the Exchange led to a freeze in the trading of Selectica stock from January 5, 2009 until February 4, 2009, with the stock price frozen at $0.69. The Reloaded NOL Poison Pill will expire on January 2, 2012, unless the expiration date is advanced or extended, or unless these rights are exchanged or redeemed by the Board some time before.

ANALYSIS

Unocal *Standard Applies*

In *Unocal*, this Court recognized that "our corporate law is not static. It must grow and develop in response to, indeed in anticipation of, evolving concepts and needs."[12] The Court of Chancery concluded that the protection of company NOLs may be an appropriate corporate policy that merits a defensive response when they are threatened. We agree.

The *Unocal* two part test is useful as a judicial analytical tool because of the flexibility of its application in a variety of fact scenarios.[13] Delaware courts have approved the adoption of a Shareholder Rights Plan as an anti-takeover device, and have applied the *Unocal* test to analyze a board's

[12] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 957 (Del. 1985).
[13] *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1153 (Del. 1990).

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response to an actual or potential hostile takeover threat.[14] Any NOL poison pill's principal intent, however, is to prevent the inadvertent forfeiture of potentially valuable assets, not to protect against hostile takeover attempts.[15] Even so, any Shareholder Rights Plan, by its nature, operates as an anti-takeover device. Consequently, notwithstanding its primary purpose, a NOL poison pill must also be analyzed under *Unocal* because of its effect and its direct implications for hostile takeovers.

Threat Reasonably Identified

The first part of *Unocal* review requires a board to show that it had reasonable grounds for concluding that a threat to the corporate enterprise existed. The Selectica Board concluded that the NOLs were an asset worth preserving and that their protection was an important corporate objective. Trilogy contends that the Board failed to demonstrate that it conducted a reasonable investigation before determining that the NOLs were an asset worth protecting. We disagree.

The record reflects that the Selectica Board met for more than two and a half hours on November 16. The Court of Chancery heard testimony from all four directors and from Brogan, Reilly, and Heaps, who also attended that

[14] *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985).
[15] The Court of Chancery found that "typically, companies with large NOLs would not be at risk of takeover attempts if the NOLs are the company's principal asset, as the takeover would likely trigger a change in control and impair the asset."

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meeting and advised the Board. The record shows that the Board first analyzed the NOLs in September 2006, and sought updated Section 382 analyses from Brogan in March 2007, June 2007, and July 2008. At the November 16 meeting, Brogan advised the Board that the NOLs were a "significant asset" based on his recently updated calculations of the NOLs' magnitude. Reilly, an investment banker, similarly advised the Board that the NOLs were worth protecting given the possibility of a sale of Selectica or its assets. Accordingly, the record supports the Court of Chancery's factual finding that the Board acted in good faith reliance on the advice of experts[16] in concluding that "the NOLs were an asset worth protecting and thus, that their preservation was an important corporate objective."

The record also supports the reasonableness of the Board's decision to act promptly by reducing the trigger on Selectica's Rights Plan from 15% to 4.99%. At the November 16 meeting, Brogan advised the Board that the change-of-ownership calculation under Section 382 stood at approximately

[16] The Delaware General Corporation Law Section § 141(e), states:

> A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member's duties, be fully protected in relying in good faith . . . upon such information, opinions, reports or statements presented to the corporation . . . by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.

Del. Code Ann. tit. 8, § 141(e) (2010).

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40%. Trilogy's ownership had climbed to over 5% in just over a month, and Trilogy intended to continue buying more stock. There was nothing to stop others from acquiring stock up to the 15% trigger in the Company's existing Rights Plan. Once the Section 382 limitation was tripped, the Board was advised it could not be undone.

At the November 16 meeting, the Board voted to amend Selectica's existing Rights Plan to protect the NOLs against a potential Section 382 "change of ownership." It reduced the trigger of its Shareholders Rights Plan from 15% to 4.99% and provided that existing shareholders who held in excess of 4.99% would be subject to dilutive consequences if they increased their holdings by 0.5%. The Board also created the Review Committee (Arnold and Sems) with a mandate to conduct a periodic review of the continuing appropriateness of the NOL Poison Pill.

The Court of Chancery found the record "replete with evidence" that, based upon the expert advice it received, the Board was reasonable in concluding that Selectica's NOLs were worth preserving and that Trilogy's actions presented a serious threat of their impairment. The Court of Chancery explained those findings, as follows:

> The threat posed by Trilogy was reasonably viewed as qualitatively different from the normal corporate control dispute that leads to the adoption of a shareholder rights plan. In this instance, Trilogy, a competitor with a contentious history,

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> recognized that harm would befall its rival if it purchased sufficient shares of Selectica stock, and Trilogy proceeded to act accordingly. It was reasonable for the Board to respond, and the timing of Trilogy's campaign required the Board to act promptly. Moreover, the 4.99% threshold for the NOL Poison Pill was driven by our tax laws and regulations; the threshold, low as it is, was measured by reference to an external standard, one created neither by the Board nor by the Court [of Chancery]. Within this context, it is not for the Court [of Chancery] to second-guess the Board's efforts to protect Selectica's NOLs.

Those findings are not clearly erroneous.[17] They are supported by the record and the result of a logical deductive reasoning process.[18] Accordingly, we hold that the Selectica directors satisfied the first part of the *Unocal* test by showing "that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership."[19]

Selectica Defenses Not Preclusive

The second part of the *Unocal* test requires an initial evaluation of whether a board's defensive response to the threat was preclusive or coercive and, if neither, whether the response was "reasonable in relation to the threat" identified.[20] Under *Unitrin*, a defensive measure is

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[17] *Homestore, Inc. v. Tafeen*, 888 A.2d 204, 217 (Del. 2005).
[18] *Levitt v. Bouvier*, 287 A.2d 671, 673 (Del. 1972).
[19] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d at 955 (citing *Cheff v. Mathes*, 199 A.2d at 554-55).
[20] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d at 955.

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disproportionate and unreasonable *per se* if it is draconian by being either coercive or preclusive.[21] A coercive response is one that is "aimed at 'cramming down' on its shareholders a management-sponsored alternative."[22]

A defensive measure is preclusive where it "makes a bidder's ability to wage a successful proxy contest and gain control either 'mathematically impossible' or 'realistically unattainable.'"[23] A successful proxy contest that is mathematically impossible is, *ipso facto*, realistically unattainable. Because the "mathematically impossible" formulation in *Unitrin* is subsumed within the category of preclusivity described as "realistically unattainable," there is, analytically speaking, only one test of preclusivity: "realistically unattainable."

Trilogy claims that a Rights Plan with a 4.99% trigger renders the possibility of an effective proxy contest realistically unattainable. In support of that position, Trilogy argues that, because a proxy contest can only be successful where the challenger has sufficient credibility, the 4.99% pill trigger prevents a potential dissident from signaling its financial

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[21] *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d at 1387.
[22] *Id.* at 1387 (citing *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d at 1154-1155 (Del. 1990)). There are no allegations contended that the NOL Poison Pill, the Exchange, and the Reloaded NOL Poison Pill are coercive.
[23] *Carmody v. Toll Bros., Inc.*, 723 A.2d 1180, 1195 (Del. Ch. 1998)(quoting *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d at 1389).

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commitment to the company so as to establish such credibility. In addition, Professor Ferrell, Trilogy's expert witness, testified that the 5% cap on ownership exacerbates the free rider problem already experienced by investors considering fielding an insurgent slate of directors, and makes initiating a proxy fight an economically unattractive proposition.[24]

This Court first examined the validity of a Shareholder Rights Plan in *Moran v. Household International, Inc.*[25] In *Moran* the Rights Plan at issue had a 20% trigger.[26] We recognized that, while a Rights Plan "does deter the formation of proxy efforts of a certain magnitude, it does not limit the voting power of individual shares."[27] In *Moran*, we concluded that the assertion that a Rights Plan would frustrate proxy fights was "highly conjectural" and pointed to "recent corporate takeover battles in which insurgents holding less than 10% stock ownership were able to secure corporate control through a proxy contest or the threat of one."[28]

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[24] According to Professor Ferrell, the free rider problem is that, even if an investor believes that replacing the board would result in a material benefit to shareholders, the investor has to bear the full cost of a proxy fight while only receiving her proportionate fraction of the benefit bestowed upon shareholders. Professor Ferrell testified that, along with the reduced likelihood of success at a 5% position, the capped position would mean that the challenger would be unable to internalize more of the benefits by increasing her share ownership.

[25] *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985).

[26] *Id.* at 1355.

[27] *Id.*

[28] *Id.* This Court additionally noted that "many proxy contests are won with an insurgent ownership of less than 20%," and that "the key variable in proxy contest success is the merit of an insurgent's issues, not the size of his holding." *Id.*

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The 5% trigger that is necessary for a NOL poison pill to serve its primary objective imposes a lower threshold than the Rights Plan thresholds that have traditionally been adopted and upheld as acceptable anti-takeover defenses by Delaware courts. Selectica submits that the distinguishing feature of the NOL Poison Pill and Reloaded NOL Poison Pill—the 5% trigger—is not enough to differentiate them from other Rights Plans previously upheld by Delaware courts, and that there is no evidence that a challenger starting below 5% could not realistically hope to prevail in a proxy contest at Selectica. In support of those arguments Selectica presented expert testimony from Professor John C. Coates IV and Peter C. Harkins.

Professor Coates identified more than fifty publicly held companies that have implemented NOL poison pills with triggers at roughly 5%, including several large, well-known corporations, some among the Fortune 1000. Professor Coates noted that 5% Rights Plans are customarily adopted where issuers have "ownership controlled" assets, such as the NOLs at issue in this case. Professor Coates also testified that Selectica's 5% Rights Plan trigger was narrowly tailored to protect the NOLs because the relevant tax law, Section 382, measures ownership changes based on shareholders who own 5% or more of the outstanding stock.

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Moreover, and as the Court of Chancery noted, shareholder advisory firm RiskMetrics Group now supports Rights Plans with a trigger below 5% on a case-by-case basis if adopted for the stated purpose of preserving a company's net operating losses.[29] The factors RiskMetrics will consider in determining whether to support a management proposal to adopt a NOL poison pill are the pill's trigger, the value of the NOLs, the term of the pill, and any corresponding shareholder protection mechanisms in place, such as a sunset provision causing the pill to expire upon exhaustion or expiration of the NOLs.[30]

Selectica expert witness Harkins of the D.F. King & Co. proxy solicitation firm analyzed proxy contests over the three-year period ending December 31, 2008. He found that of the fifteen proxy contests that occurred in micro-cap companies where the challenger controlled less than 5.49% of the outstanding shares, the challenger successfully obtained board seats in ten contests, five of which involved companies with classified

[29] Coates' Report at 11 (citing Simpson Thacher & Bartlett, LLP, Client Memo: Rights Plans Offer Special Benefits for Companies Whose Market Capitalization Has Declined to $500 Million or Below (2009), available at www.stblaw.com/content/Publications/pub795.pdf and RiskMetrics Group, U.S. Proxy Guidelines Concise Summary (Digest of Selected Key Guidelines)(2009), www.riskmetrics.com/sites/default/files/2009RMGUSPolicyConciseSummaryGuideline.pdf).
[30] *Id.*

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boards.[31] Harkins opined that Selectica's unique shareholder profile would considerably reduce the costs associated with a proxy fight, since seven shareholders controlled 55% of Selectica's shares, and twenty-two shareholders controlled 62%. Harkins testified that "if you have a compelling platform, which is critical, it would be easy from a logistical perspective; and from a cost perspective, it would be *de minimis* expense to communicate with those investors, among others." Harkins noted that to win a proxy contest at Selectica, one would need to gain only the support of owners of 43.2% plus one share.[32]

The Court of Chancery concluded that the NOL Poison Pill and Reloaded NOL Poison Pill were not preclusive. For a measure to be preclusive, it must render a successful proxy contest realistically unattainable given the specific factual context. The record supports the Court of Chancery's factual determination and legal conclusion that

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[31] There were eight such contests at micro-cap companies in which the challenging shareholder held less than 4.99% of the outstanding shares. Challengers prevailed in six of these contests, including at three companies that had classified boards.

[32] Trilogy rejects Selectica's position that due to the concentrated shareholder base, one could simply pick up the phone and call the shareholders, because Steel Partners, Director Sems, and Lloyd Miller owned 23.5% of Selectica's stock at the time. Thus, their opposition would result in having to conduct a traditional proxy contest. However, twenty-two shareholders own a combined 62% of the stock. If the 23.5% owned by Steel Partners, Sems, and Miller are subtracted from 62%, that leaves 38.5% of Selectica owned by nineteen shareholders. Those nineteen shareholders plus the 4.99% amount allowed before triggering the pill would equal 43.49% of Selectica's shares, an amount slightly in excess of what Harkins testified would be needed to win a proxy contest.

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Selectica's NOL Poison Pill and Reloaded NOL Poison Pill do not meet that preclusivity standard.

Our observation in *Unitrin* is also applicable here: "[I]t is hard to imagine a company more readily susceptible to a proxy contest concerning a pure issue of dollars."[33] The key variable in a proxy contest would be the merit of the bidder's proposal and not the magnitude of its stockholdings.[34] The record reflects that Selectica's adoption of a 4.99% trigger for its Rights Plan would not preclude a hostile bidder's ability to marshal enough shareholder votes to win a proxy contest.

Trilogy argues that, even if a 4.99% shareholder could realistically win a proxy contest "the preclusiveness question focuses on whether a challenger could realistically attain sufficient board control to remove the pill." Here, Trilogy contends, Selectica's charter-based classified board effectively forecloses a bid conditioned upon a redemption of the NOL Poison Pill, because it requires a proxy challenger to launch and complete two successful proxy contests in order to change control. Therefore, Trilogy argues that even if a less than 5% shareholder could win a proxy contest, Selectica's Rights Plan with a 4.99% trigger in combination with Selectica's

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[33] *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d at 1383.
[34] *Id.*

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charter-based classified board, makes a successful proxy contest for control of the board "realistically unattainable."

Trilogy's preclusivity argument conflates two distinct questions: first, is a successful proxy contest realistically attainable; and second, will a successful proxy contest result in gaining control of the board at the next election? Trilogy argues that unless both questions can be answered affirmatively, a Rights Plan and a classified board, viewed collectively, are preclusive. If that preclusivity argument is correct, then it would apply whenever a corporation has both a classified board and a Rights Plan, irrespective whether the trigger is 4.99%, 20%, or anywhere in between those thresholds.

Classified boards are authorized by statute[35] and are adopted for a variety of business purposes. Any classified board also operates as an anti-takeover defense by preventing an insurgent from obtaining control of the board in one election.[36] More than a decade ago, in *Carmody*, the Court of Chancery noted "because only one third of a classified board would stand for election each year, a classified board would *delay-but not prevent-a*

[35] Del. Code Ann. tit. 8, § 141(d) (2010).
[36] *MM Companies, Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1122 (Del. 2003) (citing Lucian Arye Bebchuk, John C. Coates, IV & Guhan Subramanian, *The Powerful Anittakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 Stanford L.Rev. 887 (2002)). *See also* Martin Lipton, *Pills, Polls and Professors Redux*, 69 U. Chi. L.Rev. 1037, 1059 (2002), & John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 Tex. L.Rev. 271, 328-29 (2000).

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hostile acquiror from obtaining control of the board, since a determined acquiror could wage a proxy contest and obtain control of two thirds of the target board over a two year period, as opposed to seizing control in a single election."[37] The fact that a combination of defensive measures makes it more difficult for an acquirer to obtain control of a board does not make such measures realistically unattainable, i.e., preclusive.[38]

In *Moran*, we rejected the contention "that the Rights Plan strips stockholders of their rights to receive tender offers, and that the Rights Plan fundamentally restricts proxy contests."[39] We explained that "the Rights Plan will not have a severe impact upon proxy contests and it will not *preclude* all hostile acquisitions of Household."[40] In this case, we hold that the combination of a classified board and a Rights Plan do not constitute a preclusive defense.[41]

Range of Reasonableness

If a defensive measure is neither coercive nor preclusive, the *Unocal* proportionality test "requires the focus of enhanced judicial scrutiny to shift

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[37] *Carmody v. Toll Bros., Inc.*, 723 A.2d at 1186 n.17 (emphasis added).
[38] *In re Gaylord Container Corp. Shareholders Litig.*, 753 A.2d 462, 482 (Del. Ch. 2000).
[39] *Moran v. Household Int'l, Inc.*, 500 A.2d at 1357.
[40] *Id.* at 1356 (emphasis added).
[41] We note that Selectica no longer has a classified Board. After trial, the Selectica Board amended its charter to eliminate its staggered board structure. On October 15, 2009 the Court of Chancery granted Trilogy's Second Motion for Judicial Notice, which requested the court to take judicial notice of the Selectica proxy statement that referenced the foregoing charter amendment eliminating the staggered board terms.

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to 'the range of reasonableness.'"[42] Where all of the defenses "are inextricably related, the principles of *Unocal* require that such actions be scrutinized collectively as a unitary response to the perceived threat."[43] Trilogy asserts that the NOL Poison Pill, the Exchange, and the Reloaded NOL Poison Pill were not a reasonable collective response to the threat of the impairment of Selectica's NOLs.

The critical facts do not support that assertion. On November 20, within days of learning of the NOL Poison Pill, Trilogy sent Selectica a letter, demanding a conference to discuss an alleged breach of a patent settlement agreement between the parties. The parties met on December 17, and the following day, Trilogy resumed its purchases of Selectica stock.

Fallon testified that he and Liemandt had a discussion wherein Fallon advised Liemandt that Trilogy had purchased additional shares, but not enough to trigger the NOL Poison Pill. Fallon then asked if Liemandt really wanted to trigger the pill, and Liemandt expressly directed Fallon to proceed. On December 19, 2008, Trilogy bought a sufficient number of shares to become an "Acquiring Person" under the NOL Poison Pill. According to Fallon, this was done to "'bring some clarity and urgency' to

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[42] *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d at 1388 (quoting *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 45-46 (Del. 1994)).
[43] *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d at 1387 (citing *Gilbert v. El Paso Co.*, 575 A.2d 1131, 1145 (Del. 1990)).

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Trilogy's discussions with Selectica about the two parties' somewhat complicated relationship by 'setting a time frame that might help accelerate discussions' on the direction of the business."

Fallon described Trilogy's relationship with Selectica as a "three-legged stool," referring to Trilogy's status as a competitor, a creditor, and a stockholder of Selectica. The two companies had settled prior patent disputes in 2007 under terms that included a cross-license of intellectual property and quarterly payments from Selectica to Trilogy based on Selectica's revenues from certain products. Selectica argues that Trilogy took the unprecedented step of deliberately triggering the NOL Poison Pill – exposing its equity investment of under $2 million to dilution – primarily to extract substantially more value for the other two "legs" of the stool.

Trilogy's deliberate trigger started a ten business day clock under the terms of the NOL Poison Pill. If the Board took no action during that time, then the rights (other than those belonging to Trilogy) would "flip-in" and become exercisable for deeply discounted common stock. Alternatively, the Board had the power to exchange the rights (other than those belonging to Trilogy) for newly-issued common stock, or to grant Trilogy an exemption. Three times in the two weeks following the triggering, Selectica offered Trilogy an exemption in exchange for an agreement to stand still and to

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withdraw its threat to impair the value and usability of Selectica's NOLs. Three times Trilogy refused and insisted instead that Selectica repurchase its stock, terminate a license agreement with an important client, sign over intellectual property, and pay Trilogy millions of dollars. After three failed attempts to negotiate with Trilogy, it was reasonable for the Board to determine that they had no other option than to implement the NOL Poison Pill.

The Exchange employed by the Board was a more proportionate response than the "flip-in" mechanism traditionally envisioned for a Rights Plan. Because the Board opted to use the Exchange instead of the traditional "flip-in" mechanism, Trilogy experienced less dilution of its position than a Rights Plan is traditionally designed to achieve.

The implementation of the Reloaded NOL Poison Pill was also a reasonable response. The Reloaded NOL Poison Pill was considered a necessary defensive measure because, although the NOL Poison Pill and the Exchange effectively thwarted Trilogy's immediate threat to Selectica's NOLs, they did not eliminate the general threat of a Section 382 change-in-control. Following implementation of the Exchange, Selectica still had a roughly 40% ownership change for Section 382 purposes and there was no longer a Rights Plan in place to discourage additional acquisitions by 5%

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holders. Selectica argues that the decision to adopt the Reloaded NOL Poison Pill was reasonable under those circumstances. We agree.

The record indicates that the Board was presented with expert advice that supported its ultimate findings that the NOLs were a corporate asset worth protecting, that the NOLs were at risk as a result of Trilogy's actions, and that the steps that the Board ultimately took were reasonable in relation to that threat.[44] Outside experts were present and advised the Board on these matters at both the November 16 meeting at which the NOL Poison Pill was adopted and at the Board's December 29 meeting. The Committee also heard from expert advisers a third time at the January 2 meeting prior to instituting the Exchange and adopting the Reloaded NOL Poison Pill.

Under part two of the *Unocal* test, the Court of Chancery found that the combination of the NOL Poison Pill, the Exchange, and the Reloaded NOL Poison Pill was a proportionate response to the threatened loss of Selectica's NOLs. Those findings are not clearly erroneous.[45] They are supported by the record and the result of a logical deductive reasoning process.[46] Accordingly, we hold that the Selectica directors satisfied the

[44] Del. Code Ann. tit. 8, § 141(e) (2010).
[45] *Homestore, Inc. v. Tafeen,* 888 A.2d at 217.
[46] *Levitt v. Bouvier,* 287 A.2d at 673.

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second part of the *Unocal* test by showing that their defensive response was proportionate by being "reasonable in relation to the threat" identified.[47]

Context Determines Reasonableness

Under a *Unocal* analysis, the reasonableness of a board's response is determined in relation to the "specific threat," at the time it was identified.[48] Thus, it is the specific nature of the threat that "sets the parameters for the range of permissible defensive tactics" at any given time.[49] The record demonstrates that a longtime competitor sought to increase the percentage of its stock ownership, not for the purpose of conducting a hostile takeover but, to intentionally impair corporate assets, or else coerce Selectica into meeting certain business demands under the threat of such impairment. Only in relation to that specific threat have the Court of Chancery and this Court considered the reasonableness of Selectica's response.

The Selectica Board carried its burden of proof under both parts of the *Unocal* test. Therefore, at this time, the Selectica Board has withstood the enhanced judicial scrutiny required by the two part *Unocal* test. That does not, however, end the matter.[50]

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[47] *Unocal Corp. v. Mesa Petroleum Co.,* 493 A.2d at 955.
[48] *See, e.g., Moran v. Household Int'l, Inc.,* 500 A.2d at 1354.
[49] *Unitrin, Inc. v. Am. Gen. Corp.,* 651 A.2d at 1384.
[50] *Moran v. Household Int'l, Inc.,* 500 A.2d at 1357.

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As we held in *Moran*, the adoption of a Rights Plan is not absolute.[51] In other cases, we have upheld the adoption of Rights Plans in specific defensive circumstances while simultaneously holding that it may be inappropriate for a Rights Plan to remain in place when those specific circumstances change dramatically. The fact that the NOL Poison Pill was reasonable under the specific facts and circumstances of this case, should not be construed as generally approving the reasonableness of a 4.99% trigger in the Rights Plan of a corporation with or without NOLs.[52]

To reiterate *Moran*, "the ultimate response to an actual takeover bid must be judged by the Directors' actions at that time."[53] If and when the Selectica Board "is faced with a tender offer and a request to redeem the [Reloaded NOL Poison Pill], they will not be able to arbitrarily reject the offer. They will be held to the same fiduciary standards any other board of directors would be held to in deciding to adopt a defensive mechanism."[54] The Selectica Board has no more discretion in refusing to redeem the Rights Plan than it does in enacting any defensive mechanism."[55] Therefore, the

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[51] *Id.* at 1354.
[52] *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d at 1378 (citing *Moran v. Household Int'l, Inc.*, 500 A.2d at 1355 and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 179 (Del. 1986)).
[53] *Moran v. Household Int'l, Inc.*, 500 A.2d at 1357.
[54] *Id.* at 1354.
[55] *Id.*

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Selectica Board's future use of the Reloaded NOL Poison Pill must be evaluated if and when that issue arises.[56]

Cross-Appeal

We review the Court of Chancery's denial of attorneys' fees under the bad faith exception to the American Rule for abuse of discretion.[57] Generally, the bad faith exception for the American Rule for attorneys' fees "does not apply to the conduct that gives rise to the substantive claim itself."[58] Accordingly, "an award of fees for bad faith conduct must derive from either the commencement of an action in bad faith or bad faith conduct taken during litigation, and not from conduct that gave rise to the underlying cause of action."[59]

In its cross-appeal, seeking to reverse the Court of Chancery's denial of its request for attorneys' fees, Selectica relies primarily on the following facts: first, Trilogy's deliberate decision to purchase shares beyond the NOL Poison Pill trigger; second, Trilogy's refusal to agree to a standstill in exchange for an exemption; and third, Trilogy's attempt to negotiate a global settlement with respect to its pending disputes with Selectica. In response to

[56] *Id.* at 1357.
[57] *M.G. Bancorporation, Inc. v. Le Beau*, 737 A.2d 513, 527-28 (Del. 1999).
[58] *Johnston v. Abitrium (Cayman Islands) Handels*, 720 A.2d 542, 546 (Del. 1998); *see also Montgomery Cellular Holding Co., Inc. v. Dobler*, 880 A.2d 206, 228 (Del. 2005).
[59] *Johnston v. Abitrium (Cayman Islands) Handels*, 720 A.2d at 546.

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Trilogy's insistence upon a global settlement of the parties' conflicts, Selectica engaged litigation counsel. Two days after Trilogy became an "Acquiring Person" under the NOL Poison Pill, Selectica filed its declaratory judgment lawsuit against Trilogy in the Court of Chancery, on December 21, 2008. On January 3, 2009, Selectica amended its Complaint to add factual allegations of Trilogy's deliberate decision to become an "Acquiring Person" under the NOL Poison Pill; Trilogy's refusal to agree to a standstill; and Trilogy's insistence that any settlement discussions relate to a global resolution of all disputes pending between the parties. These facts constitute the substance of Selectica's claim for declaratory relief. Therefore, they cannot provide a basis to award attorneys' fees under the general bad faith exception to the American Rule.[60]

We recognize that the Court of Chancery found as a fact that Trilogy deliberately triggered the NOL Poison Pill and did so realizing that the trigger would inflict harm on Selectica. Specifically, the Court of Chancery stated: "Trilogy, a competitor with a contentious history, recognized that harm would befall its rival if it purchased sufficient shares of Selectica stock, and Trilogy proceeded accordingly." However, even if the Court of Chancery's opinion is construed as finding that Trilogy acted in bad faith,

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[60] *Id.*; *Montgomery Cellular Holding Co., Inc. v. Dobler*, 880 A.2d at 228.

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and even if that finding pertained to conduct that occurred during the litigation, the Court of Chancery still had discretion to deny Selectica's attorneys' fee request.

Reasonable minds can differ about whether Selectica's motion for attorneys' fees should have been granted. However, the Court of Chancery's decision to deny that motion was neither arbitrary nor capricious. Our decision must be guided by the applicable standard of appellate review. When an act of judicial discretion is at issue, the appellate court "may not substitute its own notions of what is right for those of the trial judge, if [that] judgment was based upon conscience and reason, as opposed to capriciousness or arbitrariness."[61]

Conclusion

The judgments of the Court of Chancery are affirmed.

[61] *Dover Historical Society, Inc. v. City of Dover Planning Commission*, 902 A.2d 1084, 1089 (Del. 2006) (quoting *Chavin v. Cope*, 243 A.2d 694, 695 (Del.1968)).

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***eBay Domestic Hldgs., Inc. v. Newmark*, 2010 WL 3516473 (Del. Ch. Sept. 9, 2010).**

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Case Summary
In this post-trial opinion, the Court of Chancery concluded that the directors of craigslist, Inc. did not breach their fiduciary duties by implementing a staggered board structure for the purpose of preventing a stockholder, eBay Domestic Holdings, Inc. ("eBay"), from unilaterally electing a director to the craigslist board. The Court rescinded two other transactions, however — a shareholder rights plan (the "Rights Plan") and a stock issuance — concluding that craigslist's directors breached their fiduciary duties to eBay in implementing those measures.

eBay first became a stockholder of craigslist in August 2004, acquiring a 28.4% interest. Defendants Craig Newmark and James Buckmaster owned the remaining outstanding shares — approximately 42.6% and 29% interests, respectively. When eBay became a stockholder in 2004, it entered into a Shareholders' Agreement with Newmark, Buckmaster, and craigslist ("Defendants") that, among other things, granted eBay veto power over certain corporate transactions and gave the parties rights of first refusal over each other's shares. The Shareholders' Agreement expressly permitted eBay to compete with craigslist, but provided that if eBay engaged in "Competitive Activity," as defined in the Shareholders' Agreement, it would lose both its veto rights over certain corporate transactions and its right of first refusal over Newmark's and Buckmaster's shares. At the same time, however, Defendants would lose their right of first refusal over eBay's shares under such circumstances.

The Court noted that the eBay-craigslist relationship "was marred by inconsistent expectations" from the beginning, as Newmark and Buckmaster wanted eBay to be a supportive stockholder that would appreciate craigslist's "unique mission and philosophy," while eBay's goal was to acquire craigslist or, failing that, to enter into the online classifieds market itself. In March 2005, eBay launched its Kijiji online classifieds website outside the United States. Evidence introduced at trial suggested that eBay's development of the platform that spawned the Kijiji website was aided by nonpublic craigslist information. Evidence also showed that once eBay launched Kijiji internationally, eBay continued to internally circulate nonpublic craigslist information (in what the Court termed a "liberal" fashion) to enable eBay to launch Kijiji domestically, which it ultimately did on June 29, 2007. Upon that launch, Defendants promptly informed eBay that it was engaged in Competitive Activity within the meaning of the Shareholders' Agreement and, in accordance with that Agreement, gave eBay 90 days to cure. eBay did not cure.

On January 1, 2008, Buckmaster and Newmark executed written consents in their capacities as directors and stockholders approving (i) the adoption of the Rights Plan; (ii) amendments to craigslist's certificate of incorporation and bylaws, which divided the three member board into three classes with staggered three-year terms (the "Staggered Board Amendments"); and (iii) a transaction whereby craigslist offered one new share of stock for every five shares of currently outstanding stock over which any stockholder (including eBay) granted craigslist a right of first refusal (the "ROFR Issuance") (collectively the "Actions"). The Rights Plan effectively prevented any current stockholder from acquiring additional craigslist shares or transferring blocks of 15% or more of the shares to third parties without board approval. The Staggered Board Amendments essentially eliminated the effect of the cumulative voting provision in craigslist's certificate of incorporation, which had previously enabled eBay to unilaterally elect one of the three craigslist directors. Furthermore, as eBay had not

accepted the ROFR, while Newmark and Buckmaster had, the ROFR Issuance increased Newmark's and Buckmaster's share ownership and decreased eBay's percentage ownership from 28.4% to 24.9%.

Focusing first on the Rights Plan, the Court noted that Newmark and Buckmaster adopted the Rights Plan neither to preclude other craigslist stockholders from considering a potentially value-maximizing transaction nor to protect their own board seats (which had already been ensured through a voting agreement requiring each to vote the other onto the board). Nonetheless, the Court found that the *Unocal* analysis was the most appropriate standard of review. The Court, therefore, focused on whether Newmark and Buckmaster "properly and reasonably perceive[ed] a threat to craigslist's corporate policy and effectiveness" and, if so, whether the Rights Plan was "within the range of reasonableness" to respond to such a threat. Defendants argued the Rights Plan was a necessary protection to the continued existence of craigslist's corporate culture because, upon the eventual deaths of Newmark and Buckmaster, eBay would be able to purchase their shares from their heirs and thereby "fundamentally alter craigslist's values, culture and business model from [craigslist's] public-service mission in favor of increased monetization of craigslist." While the Court expressed personal admiration for Defendants' desire to service communities through free online classifieds, the Court concluded that Defendants had failed to prove that such a business model gives rise to a "palpable, distinctive and advantageous culture that sufficiently promotes stockholder value." Furthermore, even if a sufficiently distinctive corporate culture had been established, the Court found that the Defendants failed to show that the Rights Plan was deployed in defense of such a culture rather than as a "punitive response" to eBay's competitive actions. The Court also noted that, as controlling stockholders, Newmark and Buckmaster are presently able to maintain the craigslist culture regardless of whether eBay sells any of its shares in the Company. Thus, the Rights Plan affected neither when eBay could sell its shares nor when the craigslist culture could change, and, therefore, did not have a reasonable connection to Defendants' professed goal of protecting the craigslist culture at some point in the future.

Unlike the Rights Plan, the Court found that the Staggered Board Amendments were not a defensive measure and should not be analyzed under *Unocal* because, even without the amendments, Newmark and Buckmaster would still be able to control a majority of the craigslist Board. Entire fairness review was also not appropriate because Newmark and Buckmaster did not realize any financial benefit and eBay was not deprived of any right to which it was entitled because Delaware law expressly grants corporations the power to implement staggered boards and requires neither board representation nor cumulative voting for the benefit of minority stockholders. The Court therefore analyzed the Staggered Board Amendments under the business judgment rule and found that, although they effectively stripped eBay of the ability to unilaterally elect one director, Newmark and Buckmaster did not adopt the Staggered Board Amendments in bad faith, but rather for the legitimate and rational business purpose of preventing eBay, now a direct competitor, from gaining continued access to confidential corporate information by having the power to unilaterally elect one of the three directors. In addition, such a result was not inequitable because eBay, before launching its domestic Kijiji website in direct competition with craigslist, was aware that such Competitive Activity would trigger Section 8.3 of the Shareholders' Agreement and strip eBay of its veto power over certain charter and bylaw amendments.

With respect to the ROFR Issuance, the Court concluded that entire fairness was the appropriate level of review because Newmark and Buckmaster had stood on both sides of the transaction by first approving the transaction in their capacities as directors and then counter-signing in their individual capacities as stockholders. The Court explained that "[t]he entire fairness test is not bifurcated; the Court must consider allegations of unfair dealing and unfair price. Price, however, is the paramount consideration because procedural aspects of the deal are circumstantial elements of whether the price is fair." Starting with the fair price analysis, the Court noted that although all craigslist stockholders were

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technically offered the same consideration, Newmark's and Buckmaster's shares were already encumbered under the Shareholders' Agreement (pursuant to which they still had rights of first refusal with respect to each other's shares), whereas eBay's shares had been released from any encumbrance as a result of its Competitive Activity. Thus, while eBay would have to surrender full transferability of its shares, Newmark and Buckmaster simply transferred the right of first refusal from themselves to craigslist. Additionally, the Court found that eBay was forced to make one of two choices. If eBay refrained from participating, its ownership position would decrease from 28.4% to 24.9%. Conversely, if eBay did participate, the expected value of its craigslist shares would immediately decrease as third parties would be less willing to incur the transaction costs associated with bidding on eBay's shares when craigslist could match any offer. Furthermore, the Court concluded that Newmark and Buckmaster had implemented the ROFR Issuance to "control craigslist's stockholder composition for their personal and sentimental benefit at eBay's expense" without advancing a valid corporate purpose. As a result, the Court held that the ROFR Issuance failed the price element of entire fairness review. Having reached such a conclusion, the Court found it unnecessary to address eBay's allegations related to fair dealing as well as whether the ROFR Issuance violated the DGCL.

Finally, the Court rejected eBay's request for attorneys' fees, finding Defendants to have "subjectively believed the [] Actions . . . were legally permissible under Delaware law" and to have throughout trial "vigorously defended their legal position without making frivolous arguments."

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***NACCO Indus., Inc. v. Applica Inc.*, 997 A.2d 1 (Del. Ch. 2009).**

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Case Summary

The Court of Chancery declined to dismiss claims by NACCO Industries, Inc. ("NACCO"), a disappointed bidder for Applica, Inc. ("Applica), that Applica and jumping bidder Harbinger Management Corporation ("Harbinger") (1) breached a merger agreement, (2) tortiously interfered with a merger agreement, (3) committed fraud, and (4) committed civil conspiracy. NACCO had entered into a binding merger agreement with Applica, which Applica eventually terminated in favor of a jumping bid by Defendant Harbinger. Importantly, the Court permitted NACCO to pursue damages over and above the termination fee and expense reimbursement authorized by the merger agreement, and held that NACCO could pursue Delaware common law fraud claims arising from alleged misstatements in Harbinger's Schedule 13d and 13g filings. As the Court noted, it necessarily applied a "plaintiff-friendly"; standard at this motion to dismiss stage, and assumed that the "extreme and unusual"; facts in the complaint, as stated below, could be proved at trial.

NACCO, a publicly-traded corporation which operates Hamilton Beach, a designer and distributor of small appliances, entered a merger agreement with Defendant Applica, also a distributor of small appliances (the "Hamilton Beach Merger Agreement"), following the entry of a non-disclosure and standstill agreement which prohibited NACCO from acting unilaterally to acquire Applica, and provided for a period of due diligence.

The Hamilton Beach Merger Agreement contained a No-Shop provision and a Prompt Notice provision. The No Shop provision only permitted Applica to provide information to and enter into discussions with an offeror, if it received an unsolicited bona fide written offer that the Applica board determined was reasonably likely to constitute a "Superior Proposal", meaning that, after consultation with financial and legal advisors, the board believed that, if consummated, the offer would result in a more favorable transaction. The Prompt Notice provision obligated Applica to give NACCO prompt notice of "any inquiry or proposal relating to an [Applica] Competing Transaction." The term "[Applica] Competing Transaction" included "any merger, consolidation, share exchange, business combination or other transaction or series of transactions involving [Applica] that is conditioned on the termination of this Agreement or could reasonably be expected to preclude or materially delay the completion of the Merger."

Unbeknownst to NACCO, however, Harbinger allegedly had been "in covert contact with members of Applica's management", first in violation of the non-disclosure agreement and, later, the merger agreement. The complaint further alleged that the covert discussions enabled Harbinger to increase its stake in Applica to almost 40% before it started a bidding contest, while NACCO was barred from the same opportunity because of its standstill agreement. This covert tipping of information to Harbinger continued throughout the entire deal process, giving Harbinger an unfair advantage over NACCO.

At the same time, Harbinger filed several Schedules 13g and 13d each time it acquired Applica common stock, each time certifying that its acquisitions were for investment purposes only, and not to gain control of Applica. Internally, however, NACCO alleged Harbinger was planning to acquire

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Applica and one of its competitors, Salton, Inc. ("Salton"), to create and sell the two combined companies "for a massive gain".

After acquiring control of Salton, Harbinger notified Applica that it would be making a competing acquisition proposal, and Applica alerted Harbinger that an all cash offer would likely be successful. Applica did not disclose to NACCO any of its communications with Harbinger or Salton, and NACCO alleged Applica even gave NACCO false information that Harbinger would support the Hamilton Beach Merger Agreement after learning of Harbinger's dissatisfaction with that agreement. In reliance on Applica's assurances that Harbinger would support the Hamilton Beach Merger Agreement, Harbinger's Schedule 13g and 13d filings, and Harbinger's lack of any prior deal jump attempts, NACCO believed that Harbinger would not make a competing bid.

When Harbinger announced its competing bid to acquire Applica, it amended its prior Schedule 13 forms to disclose that it had been acquiring Applica shares in order to acquire control. Upon receipt of Harbinger's competing bid, Applica informed NACCO that it was reasonably likely to constitute a Superior Proposal. Applica then terminated the Hamilton Beach Merger Agreement and accepted Harbinger's bid, paying NACCO the $4 million termination fee and $2 million in expense reimbursement. According to the Complaint, when Applica and Harbinger entered into a merger agreement (the "Harbinger Merger Agreement"), Applica's preliminary proxy statement soliciting votes for the Harbinger Merger Agreement, revealed in the "Background of the Merger" section, a markedly different set of facts compared to Harbinger's 13d filings. A bidding contest ensued which Harbinger won. Applica's stockholders approved the Harbinger Merger Agreement, and Harbinger subsequently closed a Salton-Applica transaction.

NACCO brought this action, initially seeking to enforce the Hamilton Beach Merger Agreement, but was not able to get an expedited trial date. NACCO also sought and was denied injunctive relief in the United States District Court for the Northern District of Ohio. In this opinion, the Court of Chancery denied motions to dismiss NACCO's claims that (1) Applica breached the No Shop and Prompt Notice provisions of the merger agreement, (2) Harbinger committed fraud in connection with its Schedule 13 disclosures, (3) Harbinger tortiously interfered with the Hamilton Beach Merger Agreement, and (4) Defendants were engaged in a civil conspiracy.

On NACCO's breach of contract claim, the Court ruled that the Complaint adequately pled a breach of the "customary" No Shop and Prompt Notice provisions. Specifically, NACCO alleged that Applica leaked information to its favored bidder, failed to inform NACCO about its covert conversations with Harbinger and Salton, and failed to notify NACCO of its intent to negotiate a competing transaction with Harbinger. The Court based its ruling on the breadth of both provisions which covered all discussions that could "reasonably be expected to preclude or materially delay the completion" of the merger, not merely firm offers. The Court was also "influenced by the Complaint as a whole, which alleges that throughout the deal timeline, Harbinger representatives received timely and accurate tips and assistance from Applica" even before the NACCO merger agreement was executed, because Applica's senior management feared they would lose their jobs following a strategic deal and thus favored Harbinger as a financial buyer. It was insufficient for Applica to merely provide NACCO with the same information that it provided publicly to its stockholders.

In addition to finding sufficient allegations that Applica breached the Hamilton Beach Merger Agreement, the Court found that damages could exceed the termination fee and expense reimbursement set forth in the merger agreement, despite NACCO's losing the bidding contest,

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reasoning that to establish a rule that a losing bidder cannot plead damages "would have serious and adverse ramifications for merger and acquisitions practice and for our capital markets." The Court ruled that NACCO is entitled to make its case that it should receive its "full expectancy damages", or "an alternative damages measure, such as its reliance interest", because "Applica's right to terminate and pay the termination fee without further liability depended on Applica complying with its obligations under ...the No-Shop and Prompt Notice Clauses." The Hamilton Beach Merger Agreement specifically excluded from the limitation on liability, any termination resulting "from the willful and material breach by a party of any of its representations, warranties or covenants in this Agreement."

Next, the Court found that it had jurisdiction over the well-pled common law fraud claim, based on Harbinger's statements in its Section 13 federal securities filings. For jurisdiction, the Court relied on the Delaware Supreme Court opinion in Rossdeutscher v. Viacom, Inc., 768 A.2d 8 (Del. 2001), as well as federal removal cases, and the policy that its ability to enforce a common law fraud remedy for false statements in an Exchange Act filing where a Delaware entity has been accused of fraud serves important Delaware interests. The Court held that federal courts do not have exclusive jurisdiction to hear common law fraud claims based on statements in federal securities filings, and that it could exercise jurisdiction over NACCO's claim that the information in Harbinger's filings was false and misleading, but that Delaware's jurisdiction does not extend to fraud claims that arise solely from the violation of the line item requirements for filling out a Schedule 13g or 13d.

NACCO adequately pled facts meeting the elements of fraud, by alleging that (1) Harbinger made false statements that it intended to hold Applica shares for investment purposes while pursuing actively its preferred strategic alternative of an Applica-Salton combination, (2) Harbinger intended to induce NACCO to act or refrain from acting, (3) NACCO acted in justifiable reliance on the false statements, and (4) the false statements were material.

The Court rejected Harbinger's argument that hedge funds who frequently file Schedule 13d disclosures need not disclose any intent other than an investment intent until they actually make a bid. The intent and reliance elements were "a close call" because Delaware's common law fraud does not recognize a general "fraud on the market" theory of reliance. The Court nonetheless found it reasonable, given NACCO's allegations that Harbinger was provided inside tips, to infer at the pleading stage that Harbinger drafted its securities filings with the intent to gain control of Applica by misleading NACCO. The Court also found it plausible that Harbinger's fraud enabled it to amass its nearly 40% ownership of Applica at a low cost basis, while NACCO was bound by a standstill, giving Harbinger an insurmountable advantage in the subsequent bidding contest. The Court granted NACCO the inference that it ceased bidding because it could not overcome Harbinger's advantage.

The Court next declined to dismiss NACCO's tortious interference claim against Harbinger, finding it adequately pled (1) a contract, (2) about which defendant knew and (3) an intentional act that is a significant factor in causing the breach of such contract (4) without justification (5) which causes injury. Harbinger's contacts with Applica violated the No-Shop and Prompt Notice provisions, when Harbinger had knowledge of their existence. In addition, the allegations of Harbinger's false Schedule 13 filings demonstrate that Harbinger did not limit itself to legitimate vehicles of competition when seeking to acquire Applica, but instead made false statements "to hide its intent and get the drop on NACCO". As a result of Harbinger's successful acquisition of a nearly 40% stock position, facilitated by its false disclosures and unfair advantage, NACCO was deprived of the full benefit of the contractual protections for which that it bargained.

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Lastly, the Court declined to dismiss plaintiff's civil conspiracy claim, finding that all three elements, (1) a combination of two or more persons, (2) unlawful act done in furtherance of a conspiracy, and (3) actual damage, were adequately pled. NACCO alleged that Applica and Harbinger conspired to commit fraud, when Applica management tipped Harbinger about non-public events to facilitate Harbinger's ability to influence the outcome of the Hamilton Beach merger and subsequent bidding contest, delayed in providing information to NACCO at Harbinger's request, and provided false information to NACCO to further Harbinger's agenda.

The Court dismissed the remaining claims of breach of the implied covenant of good faith and fair dealing, equitable fraud and civil conspiracy claim with respect to claims that Applica and Harbinger conspired to breach the Hamilton Beach Merger Agreement, and that Applica conspired to commit tortious interference.

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***In re CNX Gas Corp. S'holder's Litig.*, 2010 WL 2349097 (Del. Ch. May 25, 2010), *appeal refused*, 333, 2010, 2010 WL 2690402 (Del. July 8, 2010).**

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Case Summary
In this action, the Court of Chancery denied plaintiffs' motion to preliminary enjoin a controlling stockholder freeze-out transaction, which was structured as a tender offer followed by a short-form merger. The Court first determined that the transaction was subject to entire fairness because the special committee appointed by the subsidiary's board of directors to evaluate the offer did not recommend in favor of the transaction. Despite the entire fairness review, the Court denied plaintiffs' request for a preliminary injunction because (i) any harm to the putative class could be remedied by a post-closing damages action; (ii) there was no viable disclosure claim; and (iii) the tender offer was not coercive. The court discussed the contours of the entire fairness standard as well as the considerations applicable to determining what stockholders constitute part of the "minority" for purpose of a majority of the minority vote on a transaction.

In 2005, CONSOL Energy, Inc ("CONSOL") formed CNX Gas Corp. ("CNX") as a subsidiary. Three of the four CNX directors were also directors of CONSOL. As of April 26, 2010, CONSOL owned approximately 83.5% of the outstanding shares of CNX. 87% of the remaining shares of CNX were held by approximately 25 institutional investors. The largest minority shareholder of CNX is T. Rowe Price, which owns 6.3% of the common stock and 37% of the public float. T. Rowe Price also owns approximately 6.5% of CONSOL's outstanding common stock.

On March 10, 2010, T. Rowe Price placed CONSOL and CNX on its restricted list, which enabled them to negotiate with CONSOL over a potential acquisition of CNX in a freeze-out transaction. T. Rowe Price and CONSOL entered into an agreement whereby T. Row Price agreed to tender its shares for $38.25 per share in connection with any tender offer initiated by CONSOL. On April 28, 2010, CONSOL commenced a tender offer for all of the shares of CNX it did not already own for $38.25, which represented a 45.83% premium over the closing price of CNX's common stock on the day before CONSOL announced its tender offer. CONSOL committed to effect a short-from merger of the remaining shares for the same price if it achieve ownership of 90% or more of the CNX shares as a result of its Tender Offer. Consummation of the Tender Offer was subject to a non-waivable condition that a majority of the outstanding minority shares be tendered, excluding shares owned by directors or officers of CONSOL or CNX. The T. Rowe Price shares were included in the majority-of-the-minority calculation.

The CNX board authorized the formation of a one-person special committee, consisting of the lone director independent of CONSOL. The Special Committee's financial advisor found the $38.25 price to be fair, but it attempted to negotiate a higher price (even though it was not technically authorized to negotiate). The Special Committee decided to remain neutral on the merger and disclosed its position in a Form 14D-9.

In determining the appropriate standard of review, the Court of Chancery engaged in a lengthy analysis of Delaware law regarding controlling stockholder freeze-out transactions.

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First, the Court noted that a negotiated merger between a controlling stockholder and its subsidiary is subject to entire fairness review under the Delaware Supreme Court's holding in *Kahn v. Lynch Communication Systems, Inc.* Second, the Court explained that, under *In re Siliconix Inc. S'holders Litig.*, a controller's unilateral tender followed by a short-form merger is reviewed under "an evolving standard far less onerous than *Lynch*" (i.e., business judgment rule). Next, the Court noted Vice Chancellor Strine's decision in *Pure Resources*, which held that entire fairness should not apply if (i) the tender offer is subject to a non-waivable majority-of-the-minority tender condition, (ii) the controlling stockholder commits to consummate a prompt short-form merger at the same price, and (iii) the controlling stockholder has made no retributive threats.

In departing from the standard espoused in other recent Court of Chancery decisions such as *Siliconix, Aquila,* and *Pure Resources*, the Court adopted the so-called "unified standard" proposed by Vice Chancellor Strine in *In re Cox Communications, Inc. S'holders Litig.*, holding that entire fairness applies to a controlling stockholder freeze-out tender offer unless the tender offer is both (i) negotiated and affirmatively recommended by a special committee of independent directors and (ii) conditioned on the affirmative tender of a majority of the minority shares.

The Court held that an effective special committee must be "provided with authority comparable to what a board would possess in a thirdparty transaction," which the special committee in this case did not possess. The Court also found that the role of T. Rowe Price "undercut the effectiveness of the majority-of-the-minority tender condition." Citing to the Delaware Supreme Court's decision in *Crown EMAK Partners, LLCv. Kurz*, the Court noted that economic incentives should be taken into account when determining the "effectiveness of a legitimizing mechanism like a majority-of-the-minority tender condition or a stockholder vote." The Court was concerned that, given T. Rowe Price's 6.5% ownership stake in CONSOL, it was "indifferent to the allocation of value between CONSOL and CNX." Accordingly, the Court held that the transaction would be reviewed under the entire fairness standard.

In light of the application of the unified standard of Cox Communications, the Court held that there was no need to enjoin the transaction because the remedy of post-trial money damages would be sufficient.

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***Binks v. DSL.net, Inc.*, 2010 WL 1713629 (Del. Ch. Apr. 29, 2010).**

This case summary is provided by Potter Anderson & Corroon LLP of Wilmington, Delaware (www.potteranderson.com).

Case Summary

The Court of Chancery granted a motion to dismiss all claims brought against DSL.net, Inc. ("DSL"), and various individuals and entities who had corporate dealings with DSL, by a self-represented former stockholder of DSL who challenged a financing transaction between DSL and MegaPath, Inc. ("MegaPath"). The Court held that the plaintiff, Charles M. Binks, failed to allege facts sufficient to support his many claims, which included allegations that the directors of DSL breached Revlon duties in connection with the financing transaction. The Court noted that Binks did not have standing to bring many of his claims because they were purely derivative. The Court denied Binks's request for leave to further amend his complaint.

DSL entered into the financing transaction with MegaPath when DSL's financial advisor, after a six-month exploration of options, informed DSL that the financing transaction was the only alternative to bankruptcy. Pursuant to the financing transaction, in exchange for a loan, DSL issued notes to MegaPath that would represent more than 90% of DSL's shares if fully converted. Six months after completing the financing transaction, MegaPath exercised its conversion rights and effected a short-form merger.

Binks contended that the defendant DSL directors breached fiduciary duties owed under Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986) because they failed to obtain the best price reasonably available when they approved the financing transaction, which he argued was a change in control transaction. Despite the six-month delay between the financing transaction and the short-form merger, and despite the holding in Glassman v. Unocal Exploration Corp., 777 A.2d 242 (Del. 2001) that appraisal is the exclusive remedy available to a minority stockholder who objects to a short-form merger, the Court assumed without deciding that Revlon applied. The Court was mindful of the fact that Binks represented himself and noted that a heightened standard of review would give Binks the most favorable analytical framework for the assessment of his claims. Moreover, the Court emphasized that treating the financing transaction and the short-form merger as one transaction arguably made Binks's fiduciary claims direct and, therefore, they would not be derivative claims extinguished by the short-form merger.

The Court held that the board did not breach any Revlon obligations because it was independent and disinterested with respect to the financing transaction, was well informed by independent advisors of available alternatives, and acted in good faith especially in light of the scarcity of options available to DSL. Because the Court found no breaches of fiduciary duty, the Court also dismissed the claims that the non-DSL defendants aided and abetted the DSL board's breaches of fiduciary duties.

The Court held that Binks failed to allege any facts to support his argument that MegaPath controlled the board of DSL before the financing transaction; therefore, the Court dismissed claims that MegaPath had breached fiduciary duties and engaged in corporate waste as a controlling stockholder of DSL. The Court also dismissed the corporate waste claim brought against the DSL directors because (i) the Court's decision that such directors met their Revlon obligations precluded a claim for corporate waste on the same facts, and (ii) Binks did not have standing to bring this derivative claim because it was extinguished by the short-form merger.

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Binks alleged that the DSL directors (i) grossly mismanaged DSL by abandoning and abdicating their responsibilities and (ii) breached the implied duty of good faith and fair dealing in connection with the payment of certain dividends in 2003 and 2004. The Court held that these claims were derivative and, therefore, the short-form merger extinguished them. The Court further found that these claims were barred by laches.

Binks argued that the DSL directors failed to disclose material information in a 2007 proxy statement with respect to the financing transaction and the short-form merger. The Court dismissed this claim because the proxy statement in question had been distributed in connection with a charter amendment, and not with the short-form merger, and because, even if the proxy statement had failed to disclose material information, the only available remedy, supplemental disclosure, was no longer relevant.

The Court held that it did not have personal jurisdiction over the CEO of MegaPath pursuant to 10 Del. C. § 3104(c)(4) because Binks failed to allege that the CEO personally engaged in any persistent course of conduct within the physical boundaries of Delaware.

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***Robotti & Co., LLC v. Liddell*, 2010 WL 157474 (Del. Ch. Jan. 14, 2010).**

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Case Summary
In this memorandum opinion, Vice Chancellor Noble considered certain direct and derivative claims relating to a stockholder rights offering and the triggering of the anti-dilution provisions of options and warrants. The Court dismissed such claims for failure to state a claim upon which relief could be granted and failure to plead demand excusal under Chancery Court Rules 12(b)(6) and 23.1, respectively.

Plaintiff Robotti and Company, LLC ("Robotti") brought a class and derivative action challenging a stockholder rights offering by nominal defendant Gulfport Energy Corporation ("Gulfport"). The stated purpose of the offering was to raise capital to fund a proposed drilling program and repay an outstanding balance on a line of credit. The offering permitted current stockholders to purchase additional shares, and because the price of the offering was below the then-market value of Gulfport shares, it triggered an anti-dilution provision permitting holders of outstanding options and warrants to exercise the options and warrants at reduced prices per share. Plaintiff alleged that the directors, as option holders, breached their fiduciary duty of loyalty by engaging in self-dealing and obtaining a personal financial benefit, resulting in a dilution in the value of the company and therefore the public stockholders' shares.

Because plaintiff brought both direct and derivative claims, the Court analyzed the claims under *Gentile*. The Delaware Supreme Court held in *Gentile* that claims were both direct and derivative where a transaction resulting in a stock overpayment to the controlling stockholder caused harm to both the corporation (by exchanging corporate property for less than it was worth) and to public stockholders (by having economic value and voting power "'redistributed' to the controlling shareholder out of the minority interest"). In the present case, the Court noted the similar dual nature of the plaintiff's claims, but found that plaintiff had not adequately plead self-dealing by the defendant directors. Although plaintiff alleged that the anti-dilution provision that was triggered by the offering permitted the directors to increase their equity position in the corporation, the provision merely permitted the directors to maintain the same ownership percentage they had before the offering, at a price set by their pre-offering option agreements. Therefore, the directors received no personal benefit that did not also accrue to the public stockholders.

As to the derivative claim, the Court found that the plaintiff's allegations of bad faith on the part of the board in implementing the offering simply did not meet the high standard set by *Lyondell*. The record showed that the board met several times to discuss the offering and considered alternative methods of obtaining capital, and therefore "did not completely abdicate their fiduciary responsibilities." Because plaintiff failed to plead that the defendant directors either received a personal benefit or consciously disregarded their duties, the Court held the decision to initiate the offering was protected by the business judgment rule. Additionally, plaintiff failed to meet the requirements of Rule 23.1 for demand excusal because plaintiff did not allege facts sufficient to raise a doubt that a majority of the board was independent and disinterested.

Lastly, the Court noted in a lengthy footnote that plaintiff likely had a claim that the defendant directors were dominated by Gulfport's controlling stockholder, but neglected to plead such a claim. The effect of the offering on the options and warrants was quite different, but plaintiff failed to analyze

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the effect of the offering on the warrants held by the controlling stockholder. While the options held by the defendant directors only permitted them to buy additional shares to maintain their ownership percentage in Gulfport, the warrants permitted the controlling stockholder to increase its ownership percentage significantly. Additionally, the offering operated so that the lower the price set by the offering, the more shares the controlling stockholder could acquire pursuant to the warrants. The Court stated that those alleged facts may have supported a claim for breach of the duty of loyalty against the directors for being beholden to, and acting for, the controlling stockholder, but plaintiff had not properly brought such a claim before the Court. Accordingly, the Court dismissed all claims.

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Delaware Court of Chancery

Mediation and Arbitration

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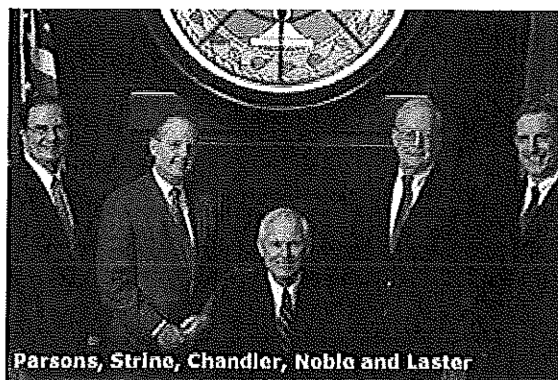
The Deal Pipeline

Line extension

Marc Wolinsky And Graham W. Meli

July 2, 2010


Parsons, Strine, Chandler, Noble and Laster

Recent legislation and rule changes in Delaware now permit the Court of Chancery to arbitrate a broad range of business disputes. Arbitration in the Court of Chancery, which is widely regarded as the nation's premier business court, is a promising alternative to more traditional forms of arbitration and litigation, and it should prove to be an effective method for resolving many complex disputes.

Under the new rules, Court of Chancery arbitration is available for business disputes in which at least one party either is a Delaware business entity (that is, corporation, limited partnership, or limited liability company) or has its principal place of business in the state, the amount in controversy exceeds $1 million or equitable relief is sought, and the parties have consented to arbitration in the court.

Cases will be decided by a single arbitrator, appointed by the chancellor from among the judges and masters of the court; however, the parties should be able to specify that the arbitrator must be a judge. One of the most significant advantages of Delaware Chancery arbitration is that the rules provide that the final hearing will be held within 90 days after the arbitration is filed. Although the rules allow prehearing discovery, including depositions, this accelerated time frame is likely to curtail discovery significantly.

The arbitrator has the power to grant any relief that he or she deems just and equitable. Arbitration awards will be enforceable in foreign jurisdictions under the New York Convention, just like any other arbitration award. The rules also preserve other typical features of arbitration, including confidentiality and limited appellate review. The Court of Chancery arbitration rules are designed to be more effective, more efficient and less expensive than both litigation and other forms of arbitration. Among the key advantages is the quality of arbitrators. The judges of the Court of Chancery are well known and respected in the business and legal communities, with extensive experience in handling complex business disputes.

The Court of Chancery also has a reputation as one of the fastest and most efficient courts in the country. The new arbitration rules are crafted to provide a fast alternative to its traditional

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procedures. Prolonged battles over the selection of the arbitrator cannot happen, as the arbitrator will be appointed by the chancellor within 10 days of the commencement of the arbitration. Arbitration in Delaware also promises to combat two common criticisms of traditional arbitration. First, the unfortunate trend in arbitration is toward increasingly onerous discovery, even when it may not be necessary. The rules should allow for an appropriate balance: Litigation-style discovery, including depositions, is available when it is called for, but the arbitrator is empowered to cabin discovery to what is "necessary and appropriate."

Second, a common criticism of arbitrators is that they make compromise awards rather than choosing a clear winner. As sitting judges who decide difficult cases on a routine basis, arbitrators in the Court of Chancery should be less inclined to just "split the baby." The Court of Chancery arbitration rules also grant arbitrators broad power to render any decision that is just and equitable, and the judges serving on that court have extensive experience in crafting equitable remedies.

Arbitration in the Court of Chancery should be desirable in a broad range of significant business and contract disputes in which the judges of the court can draw on their extensive experience in resolving complex business disputes. Indeed, almost any dispute requiring a decision maker with general business acumen could be a candidate for arbitration in the Court of Chancery. Some examples may include disputes regarding partnership, limited partnership and LLC agreements; asset purchase agreements; joint venture agreements; private-company mergers and acquisitions; investment advisory agreements; and investment banking, accounting, audit or other professional-services agreements.

Although Delaware's new arbitration rules have not as yet been tested, we believe that they have much promise. Clients and counsel should give close consideration to this new alternative when they draft dispute resolution clauses in their agreements.

Marc Wolinsky is a partner and Graham W. Meli an associate at Wachtell, Lipton, Rosen & Katz.

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Draft arbitration provision can be found in Rule 96, paragraph (7).

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN RE: COURT OF CHANCERY RULES 96, 97 AND 98

This 5th day of January, 2010, IT IS HEREBY ORDERED that the Court of Chancery adopts Rules 96, 97 and 98 effective February 1, 2010.

Rule 96. Scope Of Rules

(a) These rules shall govern the procedure in arbitration proceedings for business disputes pursuant to 10 Del. C. § 349.

(b) In the case of business disputes involving solely a claim for monetary damages, a matter will be eligible for arbitration only if the amount in controversy exceeds one million dollars.

(c) The parties with the consent of the Arbitrator may change any of these arbitration rules by agreement and/or adopt additional arbitration rules. Except to the extent inconsistent with these rules, or as modified by the Arbitrator or the parties, Court of Chancery Rules 26 through 37 shall apply to the Arbitration proceeding.

(d) *Definitions.* (1) "Arbitration" means the voluntary submission of a dispute to an Arbitrator for final and binding determination and includes all contacts between the Arbitrator and any party or parties, until such time as a final decision is rendered or the parties discharge the Arbitrator.

(2) "Arbitrator" means a judge or master sitting permanently in the Court. Absent agreement of the parties, the Arbitrator shall not have served as the Mediator in a mediation of the dispute under Court of Chancery Rules.

(3) "Preliminary conference" means a telephonic conference with the parties and/or their attorneys or other representatives (i) to obtain additional information about the nature of the dispute and the anticipated length of hearing and scheduling, (ii) to obtain conflicts statements from the parties, and (iii) to consider with the parties whether mediation or other non-adjudicative methods of dispute resolution might be appropriate.

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(4) "Preliminary hearing" means a telephonic conference with the parties and/or their attorneys or other representatives to consider, without limitation: (i) service of statements of claims, damages and defenses, a statement of the issues asserted by each party and positions with respect thereto, and any legal authorities upon which the parties rely, (ii) stipulations of fact, (iii) the scope of discovery, (iv) exchanging and premarking of exhibits for the hearing, (v) the identification and availability of witnesses, including experts, and such matters with respect to witnesses, including their qualifications and expected testimony as may be appropriate, (vi) whether, and to what extent, any sworn statements and/or depositions may be introduced, (vii) the length of hearing, (viii) whether a stenographic or other official record of the proceedings shall be maintained, (ix) the possibility of mediation or other non-adjudicative methods of dispute resolution, and (x) the procedure for the issuance of subpoenas.

(5) "Scheduling order" means the order of the Arbitrator setting forth the pre-hearing activities and the hearing procedures that will govern the arbitration.

(6) "Arbitration hearing" means the proceeding, which may take place over a number of days, pursuant to which the petitioner presents evidence to support its claim and the respondent presents evidence to support its defense, and witnesses for each party shall submit to questions from the Arbitrator and the adverse party, subject to the discretion of the Arbitrator to vary this procedure so long as parties are treated equally and each party has the right to be heard and is given a fair opportunity to present its case.

(7) "Consent to Arbitrate," means a written or oral agreement to engage in arbitration in the Court of Chancery and shall constitute consent to these rules. Provided that the parties and the amount in controversy meet the eligibility requirements in 10 Del. C. § 347, which apply to the arbitration of business disputes under 10 Del. C. § 349, a consent to arbitrate is acceptable if it contains the following language: "The parties agree that any dispute arising under this agreement shall be arbitrated in the Court of Chancery of the State of Delaware, pursuant to 10 Del. C. § 349."

Rule 97. Commencement Of Arbitration

(a) *Petition.* (1) Arbitration is commenced by submitting to the Register in Chancery a petition for arbitration (hereinafter a "petition") and the filing fee specified by the Register in Chancery. The petition must be signed by Delaware counsel, as defined in Rule 170(b). Sufficient copies shall be submitted so that one

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copy is available for delivery to each party as hereafter provided, unless the Court directs otherwise.

(2) The petition shall be sent by the Register in Chancery, via next business-day delivery, to either a person specified in the applicable agreement between the parties to receive notice of the petition or, absent such specification, to each party's principal place of business or residence. The petitioning party shall provide the Register in Chancery with addresses of each party.

(3) The petition shall contain a statement setting forth the nature of the dispute, the names and addresses of all other parties, the claims and the remedy sought. The petition must also contain a statement that all parties have consented to arbitration by agreement or stipulation, that at least one party is a business entity, that at least one party is a business entity formed or organized under the laws of Delaware or having its principal place of business in Delaware, and that no party is a consumer with respect to the dispute. In the case of business disputes involving solely a claim for monetary damages, the petition must contain a statement of the amount in controversy.

(4) *Confidentiality.* The Register in Chancery will not include the petition as part of the public docketing system. The petition and any supporting documents are considered confidential and not of public record until such time, if any, as the proceedings are the subject of an appeal. In the case of an appeal, the record shall be filed by the parties with the Supreme Court in accordance with its Rules, and to the extent applicable, the Rules of this Court.

(b) *Appointment of the Arbitrator.* Upon receipt of a petition, the Chancellor will appoint an Arbitrator.

(c) *Preliminary Conference.* The Arbitrator will contact the parties' counsel to set the date and time of the preliminary conference, which shall occur within 10 days after the commencement of the arbitration, unless the parties and the Arbitrator agree, pursuant to Rule 96(c), to extend that time.

(d) *Preliminary Hearing.* The preliminary hearing shall take place as soon as practicable after the preliminary conference. The Arbitrator shall issue a scheduling order promptly after the preliminary hearing.

(e) *Date, Time, and Place of Arbitration.* The Arbitrator will set the date, time, and place of the arbitration hearing at the preliminary hearing. The arbitration hearing generally will occur no later than 90 days following receipt of the petition.

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(f) *Exchange of Information.* There shall be prehearing exchange of information necessary and appropriate for the parties to prepare for the arbitration hearing and to enable the Arbitrator to understand the dispute, unless the parties agree, with the approval of the Arbitrator, to forego prehearing exchange of information. The parties shall, in the first instance, attempt to agree on prehearing exchange of information, which may include depositions, and shall present any agreement to the Arbitrator for approval at the preliminary hearing or as soon thereafter as possible. The Arbitrator may require additional exchange of information between and among the parties, or additional submission of information to the Arbitrator. If the parties are unable to agree, they shall present the dispute to the Arbitrator who shall direct such prehearing exchange of information as he/she deems necessary and appropriate.

Rule 98. Arbitration Hearing

(a) *Participation.* At least one representative of each party with an interest in the issue or issues to be arbitrated and with authority to resolve the matter must participate in the arbitration hearing. Delaware counsel, as defined in Rule 170(b), shall also attend the arbitration hearing on behalf of each party.

(b) *Confidentiality.* Arbitration hearings are private proceedings such that only parties and their representatives may attend, unless all parties agree otherwise. An Arbitrator may not be compelled to testify in any judicial or administrative proceeding concerning any matter relating to service as an Arbitrator. All memoranda and work product contained in the case files of an Arbitrator are confidential. Any communication made in or in connection with the arbitration that relates to the controversy being arbitrated, whether made to the Arbitrator or a party, or to any person if made at an arbitration hearing, is confidential. Such confidential materials and communications are not subject to disclosure in any judicial or administrative proceeding with the following exceptions: (1) where all parties to the arbitration agree in writing to waive the confidentiality, or (2) where the confidential materials and communications consist of statements, memoranda, materials, and other tangible evidence otherwise subject to discovery, which were not prepared specifically for use in the arbitration hearing.

(c) *Civil Immunity.* Arbitrators shall be immune from civil liability for or resulting from any act or omission done or made in connection with the Arbitration, unless the act or omission was made or done in bad faith, with malicious intent, or in a manner exhibiting a willful, wanton disregard of the rights, safety, or property of another.

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(d) *Mediation Option.* The parties may agree at any stage of the arbitration process to submit the dispute to the Court for mediation. The judge or master assigned to mediate the dispute may not be the Arbitrator unless the parties agree.

(e) *Settlement Option.* The parties may agree, at any stage of the arbitration process, to seek the assistance of the Arbitrator in reaching settlement with regard to the issues identified in the petition prior to a final decision from the Arbitrator. Any settlement agreement shall be reduced to writing and signed by the parties and the Arbitrator. The agreement shall set forth the terms of the resolution of the issues and the future responsibility of each party.

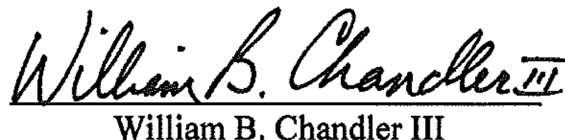
(f) *Award.* (1) The Arbitrator may grant any remedy or relief that the Arbitrator deems just and equitable and within the scope of any applicable agreement of the parties.

(2) In addition to a final award, the Arbitrator may make other decisions, including interim, interlocutory, or partial rulings, orders and awards.

(3) Upon the granting of a final award, a final judgment or decree shall be entered in conformity therewith and be enforced as any other judgment or decree.

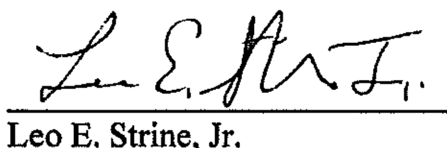
(4) The Arbitrator is ineligible to adjudicate any subsequent litigation arising from the issues identified in the petition.

(g) *Costs for Arbitration.* Costs for filing and per-day (or partial day) fees shall be assessed in accordance with a schedule to be maintained by the Register in Chancery.



William B. Chandler III

Respectfully advised:



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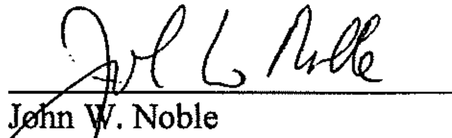
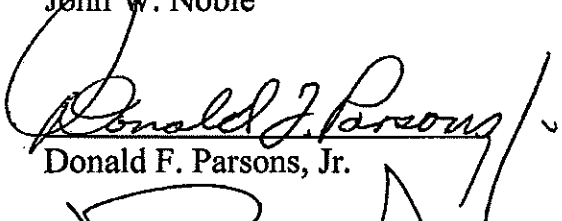
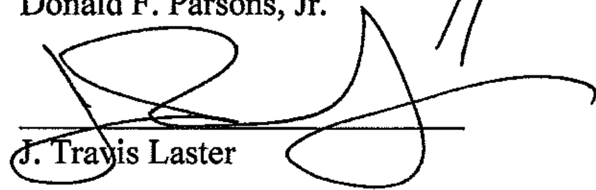


John W. Noble



Donald F. Parsons, Jr.



J. Travis Laster

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IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

STANDING ORDER

WHEREAS, the Chancellor and Vice Chancellors of the Court of Chancery have given consideration to the potential filing costs associated with arbitration of business disputes under Court of Chancery Rules 96-98, and costs for scanning documents to be filed electronically under Court of Chancery Rule 79.1;

Now, therefore, this 4th day of January, 2010, it is ORDERED:

1) The fee for filing a petition for arbitration under Chancery Rules 96-98 shall be a total of $12,000. The fee shall be divided equally between the parties.

2) In addition, for each day (or partial day) after the first day that the Chancellor, a Vice Chancellor or a Master in Chancery is engaged in arbitration, a total fee of $6,000 per day (or partial day) shall be equally divided between the parties. All such arbitration fees shall be deposited by the Register in Chancery in the Court's Arbitration Fund Account.

3) The fee for scanning documents for purposes of e-Filing shall be $2.00 per page, and shall be payable by the party requesting such scanning to the office of the Register in Chancery.

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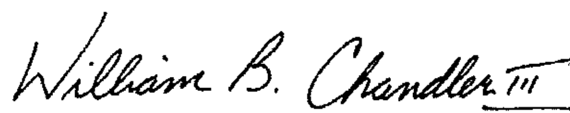
This Standing Order shall be effective immediately, and shall be posted in the offices of the Register in Chancery in New Castle, Kent and Sussex County.



William B. Chandler III

xc: Vice Chancellors
Masters
Registers in Chancery

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COURT OF CHANCERY

TITLE 10

Courts and Judicial Procedure

Organization, Powers, Jurisdiction and Operation of Courts

CHAPTER 3. COURT OF CHANCERY

Subchapter III. General Jurisdiction and Powers

§ 346. Technology disputes.

(a) Notwithstanding any other provision in this Code, and without limiting the jurisdiction vested in any court in this State, the Court of Chancery shall have power to mediate and jurisdiction to hear and determine technology disputes as defined herein when:

(1) The parties have consented to the jurisdiction of or mediation by the Court of Chancery by agreement or by stipulation;

(2) At least 1 party is a "business entity" as defined herein;

(3) At least 1 party is a business entity formed or organized under the laws of this State or having its principal place of business in this State;

(4) No party is a "consumer", as that term is defined in § 2731 of Title 6, with respect to the technology dispute; and

(5) In the case of technology disputes involving solely a claim for monetary damages, the amount in controversy is no less than $1,000,000 or such greater amount as the Court of Chancery determines by rule.

Neither punitive damages nor a jury trial shall be available for a technology dispute heard and determined by the Court of Chancery pursuant to this section. Mediation proceedings shall be considered confidential and not of public record.

(b) A "business entity" means a corporation, statutory trust, business trust or association, a real estate investment trust, a common-law trust, or any other unincorporated business, including a partnership (whether general (including a limited liability partnership) or limited (including a limited liability limited partnership)) or a limited liability company.

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(c)(1) A "technology dispute" means a dispute arising out of an agreement and relating primarily to: the purchase or lease of computer hardware; the development, use, licensing or transfer of computer software; information, biological, pharmaceutical, agricultural or other technology of a complex or scientific nature that has commercial value, or the intellectual property rights pertaining thereto; the creation or operation of Internet web sites; rights or electronic access to electronic, digital or similar information; or support or maintenance of the above.

(2) The term "technology dispute" does not include a dispute arising out of an agreement:

a. That is primarily a financing transaction; or

b. Merely because the parties' agreement is formed by, or contemplates that communications about the transaction will be by, the transmission of electronic, digital or similar information.

(3) The court shall interpret the term "technology dispute" liberally so as to effectuate the intent of this section to provide an expeditious and expert forum for the handling of technology disputes involving parties who have agreed to resolve their disputes in the Court of Chancery, whether the parties are seeking to have the Court of Chancery:

a. Mediate the dispute only;

b. Mediate the dispute initially, and if that fails, adjudicate the dispute; or

c. Adjudicate the dispute.

The court shall adopt rules to facilitate the efficient processing of technology disputes, including rules to govern the filing of mediation only technology disputes, and to set filing fees and other cost schedules for the processing of technology disputes.

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§ 347. Mediation proceedings for business disputes.

(a) Without limiting the jurisdiction of any court of this State, the Court of Chancery shall have the power to mediate business disputes when:

(1) The parties have consented to the mediation by the Court of Chancery by agreement or by stipulation;

(2) At least one party is a business entity as defined in § 346 of this title;

(3) At least one party is a business entity formed or organized under the laws of this State or having its principal place of business in this State;

(4) No party is a consumer, as that term is defined in § 2731 of Title 6, with respect to the business dispute; and

(5) In the case of disputes involving solely a claim for monetary damages, the amount in controversy is no less than one million dollars or such greater amount as the Court of Chancery determines by rule.

A mediation pursuant to this section shall involve a request by parties to have a member of the Court of Chancery, or such other person as may be authorized under rules of the Court, act as a mediator to assist the parties in reaching a mutually satisfactory resolution of their dispute. Mediation proceedings shall be considered confidential and not of public record.

(b) By rule, the Court of Chancery may define those types of cases that are eligible for submission as a business dispute mediation. This section is intended to encourage the Court of Chancery to include complex corporate and commercial disputes, including technology disputes, within the ambit of the business dispute mediation rules. The Court of Chancery should interpret its rule-making authority broadly to effectuate that intention.

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§ 349. Arbitration proceedings for business disputes.

(a) The Court of Chancery shall have the power to arbitrate business disputes when the parties request a member of the Court of Chancery, or such other person as may be authorized under rules of the Court, to arbitrate a dispute. For a dispute to be eligible for arbitration under this section, the eligibility criteria set forth in § 347(a) and (b) of this title must be satisfied, except that the parties must have consented to arbitration rather than mediation.

(b) Arbitration proceedings shall be considered confidential and not of public record until such time, if any, as the proceedings are the subject of an appeal. In the case of an appeal, the record shall be filed by the parties with the Supreme Court in accordance with its rules, and to the extent applicable, the rules of the Court of Chancery.

(c) Any application to vacate, stay, or enforce an order of the Court of Chancery issued in an arbitration proceeding under this section shall be filed with the Supreme Court of this State, which shall exercise its authority in conformity with the Federal Arbitration Act, and such general principles of law and equity as are not inconsistent with that Act.

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West's Delaware Code Annotated Currentness
Delaware Rules of Court
Chancery Court Rules
XI. General Provisions
RULE 93. SCOPE OF RULES

(a) These rules shall govern the procedure in mediation proceedings for technology disputes and business disputes pursuant to 10 *Del. C.* §§ 346 and 347.

(b) In the case of disputes involving solely a claim for monetary damages, a matter will be eligible for mediation only if the amount in controversy exceeds one million dollars.

(c) The parties with the consent of the Mediator may change any of these mediation rules by agreement.

(d) Definitions. (1) "Mediation" means the process by which a Mediator assists and facilitates two or more parties to a controversy in reaching a mutually acceptable resolution and includes all contacts between the Mediator and any party or parties, until such time as a resolution is agreed to by the parties or the parties discharge the Mediator.

(2) "Mediator" means a judge or master sitting permanently in the Court.

(3) "Mediation conference" means that process, which may consist of one or more meetings or conferences, pursuant to which the Mediator assists the parties in seeking a mutually acceptable resolution of their dispute through discussion and negotiation.

(4) "Consent to Mediate," means a written or oral agreement to engage in mediation in the Court of Chancery. Provided that the parties and the amount in controversy meet the eligibility requirements in 10 *Del. C.* § 347, a consent to mediate is acceptable if it contains the following language: "The parties agree that any dispute arising under this agreement shall be mediated in the Court of Chancery of the State of Delaware, pursuant to 10 *Del. C.* § 347."

CREDIT(S)

[Adopted effective September 29, 2003.]

Chancery Court Rules, Rule 93, DE R CH CT Rule 93

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Delaware Rules of Court
Chancery Court Rules
XI. General Provisions
RULE 94. COMMENCEMENT OF MEDIATION

(a) Petition. (1) Mediation is commenced by submitting to the Register in Chancery a petition for mediation (hereinafter a "petition") and the filing fee specified by the Register in Chancery. The petition must be signed by Delaware counsel, as defined in Rule 170(b). Sufficient copies shall be submitted so that one copy is available for delivery to each party as hereafter provided, unless the Court directs otherwise.

(2) The petition shall be sent by the Register in Chancery, via next-day delivery, to either a person specified in the applicable agreement between the parties to receive notice of the petition or, absent such specification, to each party's principal place of business or residence. The petitioning party shall provide the Register in Chancery with addresses of each party.

(3) The petition will identify the issues to be mediated and specify the method by which the parties shall attempt to resolve the issues. The petition must also contain a statement that all parties have consented to mediation by agreement or stipulation, that at least one party is a business entity, that at least one party is a business entity formed or organized under the laws of Delaware or having its principal place of business in Delaware, and that no party is a consumer with respect to the dispute. In the case of disputes involving solely a claim for monetary damages, the petition must contain a statement of the amount in controversy.

(4) *Confidentiality*. The petition and any supporting documents are considered confidential and not of public record. The Register in Chancery will not include the petition as part of the public docketing system.

(b) Appointment of the Mediator. Upon receipt of a petition, the Court will appoint a Mediator.

(c) Date, Time, and Place of Mediation. The Mediator will set the date, time, and place of the mediation conference within 15 days following receipt of the petition. The mediation conference generally will occur no later than 60 days following receipt of the petition.

(d) Submission of Documents. There shall be no formal discovery in connection with a mediation proceeding under these Rules. The Mediator may request parties to exchange or provide to the Mediator documents or other material necessary to understand the dispute or facilitate a settlement. The parties may agree to exchange any documents or other material in the possession of the other that may facilitate a settlement.

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XI. General Provisions
→ **RULE 95. MEDIATION CONFERENCE**

(a) Participation. At least one representative of each party with an interest in the issue or issues to be mediated and with authority to resolve the matter must participate in the mediation conference. Delaware counsel, as defined in Rule 170 (b), shall also attend the mediation conference on behalf of each party.

(b) Confidentiality. Mediation conferences are private proceedings such that only parties and their representatives may attend, unless all parties agree otherwise. A Mediator may not be compelled to testify in any judicial or administrative proceeding concerning any matter relating to service as a Mediator. All memoranda and work product contained in the case files of a Mediator are confidential. Any communication made in or in connection with the mediation that relates to the controversy being mediated, whether made to the Mediator or a party, or to any person if made at a mediation conference, is confidential. Such confidential materials and communications are not subject to disclosure in any judicial or administrative proceeding with the following exceptions: (1) Where all parties to the mediation agree in writing to waive the confidentiality, or (2) where the confidential materials and communications consist of statements, memoranda, materials, and other tangible evidence otherwise subject to discovery, which were not prepared specifically for use in the mediation conference. A mediation agreement, however, shall not be confidential unless the parties otherwise agree in writing.

(c) Civil Immunity. Mediators shall be immune from civil liability for or resulting from any act or omission done or made in connection with efforts to assist or facilitate a mediation, unless the act or omission was made or done in bad faith, with malicious intent, or in a manner exhibiting a willful, wanton disregard of the rights, safety, or property of another.

(d) Mediation Agreement. If the parties involved in the mediation conference reach agreement with regard to the issues identified in the petition, their agreement shall be reduced to writing and signed by the parties and the Mediator. The agreement shall set forth the terms of the resolution of the issues and the future responsibility of each party.

(e) Termination of Mediation Conference. (1) The Mediator shall officially terminate the mediation conference if the parties are unable to agree. The termination shall be without prejudice to either party in any other proceeding. The Mediator shall have no authority to make or impose any adjudication, sanction, or penalty upon the parties. No party shall be bound by anything said or done at the conference unless an agreement is reached.

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(2) The Mediator is ineligible to adjudicate any subsequent litigation arising from the issues identified in the petition.

(f) Compensation for Mediation. The Court will be compensated by the parties to the mediation in accordance with the schedule of fees maintained by the Register in Chancery.

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[Adopted effective September 29, 2003.]

Chancery Court Rules, Rule 95, DE R CH CT Rule 95

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Chancery Court Rules
XVI. Judicial Ethics, Attorneys, Etc.
RULE 174. VOLUNTARY MEDIATION IN THE COURT OF CHANCERY

The Chancellor or Vice Chancellor presiding in a case, with the consent of the parties, may refer any case or issue in a case to any other judge or master sitting permanently in the Court of Chancery, who has no involvement in the case, or to a designated mediator for voluntary mediation. Cases may be referred to voluntary mediation at any stage during the proceedings. Voluntary mediation is intended to provide the parties convenient access to dispute resolution proceedings that are fair, confidential, effective, inexpensive, and expeditious.

(a) Definitions.

(1) "Mediation" means the process by which a mediator assists and facilitates two or more parties to a controversy in reaching a mutually acceptable resolution of the controversy and includes all contacts between the mediator and any party or parties, until such time as a resolution is agreed to by the parties or the parties discharge the mediator.

(2) "Mediator" means (i) a judge or master sitting permanently in the Court of Chancery, or (ii) an impartial person appointed by the Court or selected by agreement of the parties to a controversy to assist them in mediation ("a designated mediator"). A person is not eligible to serve as a designated mediator under this rule until the person has been a member of the Delaware Bar for 5 years, completed at least 25 hours of training in conflict resolution techniques, and has been certified pursuant to guidelines promulgated by the Chancellor. If authorized by the Chancellor, conflict resolution technique training for designated mediators may be provided in conjunction with training conducted pursuant to Superior Court Rule 16.2(g). A current listing of all persons eligible to serve as designated mediators pursuant to this Rule shall be maintained as a public record in the office of the Register in Chancery.

(3) "Mediation conference" means that process, which may consist of one or more meetings or conferences, pursuant to which the mediator assists the parties in seeking a mutually acceptable resolution of their dispute through discussion and negotiation.

(b) Participation. Once mediation has been elected, at least one representative of each party with an interest in the issue or issues to be mediated and with authority to resolve the matter must participate in the mediation conference.

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(c) Written Consent to Mediation. Prior to the commencement of the mediation conference, the parties to a controversy shall enter into a written consent that identifies the issues to be mediated and specifies the methods by which the parties shall attempt to resolve the issues.

Confidentiality. Mediation conferences are private proceedings such that only parties and their representatives may attend, unless all parties agree otherwise. A mediator may not be compelled to testify in any judicial or administrative proceeding concerning any matter relating to service as a mediator. All memoranda, work product, and other materials contained in the case files of a mediator are confidential. Any communication made in or in connection with the mediation that relates to the controversy being mediated, whether made to the mediator or a party, or to any person if made at a mediation conference, is confidential. Such confidential materials and communications are not subject to disclosure in any judicial or administrative proceeding with the following exceptions:

(1) Where all parties to the mediation agree in writing to waive the confidentiality, or

(2) Statements, memoranda, materials, and other tangible evidence otherwise subject to discovery, which were not prepared specifically for use in the mediation conference.

A mediation agreement, however, shall not be confidential unless the parties otherwise agree in writing.

Civil Immunity. Designated mediators shall be immune from civil liability for or resulting from any act or omission done or made while engaged in efforts to assist or facilitate a mediation, unless the act or omission was made or done in bad faith, with malicious intent, or in a manner exhibiting a willful, wanton disregard of the rights, safety, or property of another.

Termination of Mediation Conference. The mediator shall officially terminate the mediation conference if the parties are unable to agree. The termination shall be without prejudice to either party in any other proceeding. The mediator shall have no authority to make or impose any adjudication, sanction, or penalty upon the parties. No party shall be bound by anything said or done at the conference unless an agreement is reached.

Mediation Agreement. If the parties involved in the mediation conference reach agreement with regard to the issues identified in the consent to mediation, their agreement shall be reduced to writing and signed by the parties and the mediator. The agreement shall set forth the terms of the resolution of the issues and the future responsibility of each party. The agreement will be binding on all parties to it and, upon filing by the mediator, will become part of the Court record. If the parties choose to keep the terms of the agreement confidential, a Stipulation of Dismissal may be filed in the alternative.

If the mediator appointed is the Chancellor, a Vice Chancellor or Master, the mediator shall not be compensated. Instead, a filing fee shall be assessed against the parties as court costs in the amount of $5,000 for the first day of mediation and $5,000 for every additional day required. These fees shall be deposited into a separate account maintained by the Court of Chancery, which shall be used from time to time in the discretion of the Court for

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mediation training and/or refunds or any other purpose designated by the Chancellor. This mediation filing fee and the fee for each additional day of mediation shall be divided between the parties and may be waived or modified in the discretion of the presiding Chancellor, Vice Chancellor or Master.

Stay of Pending Litigation. Cases referred to mediation pursuant to this Rule may be stayed in the discretion of the Court pending the conclusion of the mediation process.

CREDIT(S)

[Adopted effective April 1, 1998; amended effective November 12, 2002; November 20, 2002; July 1, 2005; Aug. 1, 2009.

Chancery Court Rules, Rule 174, DE R CH CT Rule 174

Current with amendments received through 3/1/2010.

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Mediation Guideline Pamphlet

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VOLUNTARY MEDIATION IN THE DELAWARE COURT OF CHANCERY[1]

Preface

The State of Delaware wishes to remain preeminent in its ability to meet the needs of its business community, including the needs of all business entities domiciled in Delaware. The mediation program available in Delaware's Court of Chancery is one way the State is attempting to meet these needs. Mediation is intended to provide the participants convenient access to dispute resolution proceedings that are fair, confidential, effective, inexpensive, and expeditious.

There are now two types of non-mandatory mediation[2] available in the Court of Chancery: (i) mediation pursuant to Court of Chancery Rule 174, which provides for mediation in an ongoing case pending in the Court of Chancery ("Rule 174 Mediations"), and (ii) mediation pursuant to 10 *Del. C.* § 347 and Rules 93 to 95, which now provide for "mediation only" dispute resolution for certain types of business disputes where there is no pre-existing pending action (the "Mediation Only Program"). Mediation in both cases is voluntary and can only proceed with consent of the parties.

Who May Participate In The Mediation Program?

First, parties to an ongoing case pending in the Court of Chancery may agree to mediation pursuant to Court of Chancery Rule 174.

Second, under the Mediation Only Program, parties who consent by agreement to mediation may have a business dispute mediated, so long as at least one party is a business entity (as defined in 10 *Del. C.* § 346), at least one party is a business entity formed or organized under Delaware law or having its principal place of business in Delaware and a consumer is not a party to the dispute.

Who Will Serve As The Mediator?

In Rule 174 Mediations, the Chancellor or Vice Chancellor presiding in a case, with the consent of the parties, may refer any case or issue in a case to any other judge or master sitting permanently in the Court of Chancery who has had no

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[1]*This pamphlet is intended to provide a general summary of the mediation process in the Delaware Court of Chancery. The Court's official rules should be consulted and govern in the case of any inconsistencies between statements contained herein and the rules.*

[2]Mandatory mediation is required in certain guardianship and estate cases under Court of Chancery Rule 174.1. This pamphlet is intended to describe only the two types of non-mandatory mediation procedures in the Court of Chancery; it has no application to the mandatory mediation required by Rule 174.1.

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involvement in the case or to another person agreed upon by the parties for voluntary mediation. In the Mediation Only Program, a member of the Court of Chancery (or the Master in Chancery) will act as the mediator and the parties may request a particular member of the Court to act as mediator.

What Types of Business Disputes Qualify for the Mediation Only Program?

Only "business disputes" where one of the parties is a business entity formed in Delaware or having its principal place of business in Delaware, and no party to the dispute is a consumer eligible for the Mediation Only Program. In the case of business disputes involving solely a claim for money damages, the amount in controversy must exceed $1 million.

By rule, the Court of Chancery has defined business disputes that are eligible for submission as any complex corporate commercial or alternative entity dispute, including technology disputes, as that term is defined in 10 *Del. C.* § 346(c). A "technology dispute" means a dispute arising out of an agreement and relating primarily to: the purchase or lease of computer hardware; the development, use, licensing or transfer of computer software; information, biological, pharmaceutical, agricultural or other technology of a complex or scientific nature that has commercial value, or the intellectual property rights pertaining thereto; the creation or operation of Internet web sites; rights or electronic access to electronic, digital or similar information; or support or maintenance of the above. The term does not include a dispute arising out of an agreement (i) that is primarily a financing transaction, or (ii) merely because the parties' agreement is formed by, or contemplates that communications about the transaction will be by, the transmission of electronic, digital or similar information.

Will I Need Local Counsel?

Yes, local counsel must be present and prepared to participate in a meaningful way.

Is There A Filing Or Other Fee?

Yes, for Rule 174 Mediations, if the mediator appointed is the Chancellor, one of the Vice Chancellors or the Master, the mediator shall not be compensated. Instead, a total court fee in the amount of $2,500 for each mediated case shall be assessed against the parties as court costs. *See* Ch. Ct. Rule 174(c)(2). Designated mediators will be compensated by the parties in a manner consistent with the compensation of an ADR specialist pursuant to 6 *Del. C.* § 7713, and there shall be consultation and agreement among the parties and the designated mediator as to compensation before the mediation commences.

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For the Mediation Only Program, there is an initial filing fee of $10,000 that must accompany the petition to mediate. In addition, a $2,500 per day fee shall be assessed for each day that a mediation conference is convened. These costs are divided equally between the parties.

Are Mediation Proceedings Confidential?

Yes. The strict confidentiality provisions set forth in Rule 174(3)(c) apply with respect to both types of mediation. See Ch. Ct. Rules 94(a)(4), 95(b). Any communication made in or in connection with the mediation that relates to a controversy being mediated, whether made to the mediator or a party or to any person if made at a mediation conference is confidential. In Rule 174 Mediations, the mediator shall not discuss the substance of any mediation with the trial judge and shall treat all aspects of the mediation as confidential, unless otherwise agreed by the parties. A mediation agreement, however, shall not be confidential unless the parties otherwise agree in writing.

Information disclosed to the Mediator by a party or counsel during the mediation session, including in any written submissions, is not disclosed to the other party without consent. All mediation proceedings are confidential, are not admissible as evidence in any other proceedings, and may not be recorded without prior consent of the parties and the Mediator.

Who Must Attend?

Rule 174(3)(b) governs participation in all mediation conferences. It provides that at least one representative with an interest in the issue or issues to be mediated and with authority to resolve the matter should participate in the mediation conference. Delaware counsel, as defined in Rule 170(a), must also attend the mediation conference on behalf of each party. This rule also applies in the Mediation Only Program. *See* Rule 95(a). In the Mediation Only Program the initial mediation conference will generally be scheduled between 15 and 60 days after the filing of the petition. Rule 94(c).

If a person with authority to resolve the matter is unable to participate, that must be disclosed at the commencement of the mediation and must be set forth in the mediation order and approved by the mediator. Also, the method by which authority will be obtained must be set forth.

What Documents Must the Parties Prepare?

First, before the mediation commences, the parties must enter into a written consent and order of mediation that identifies the issues to be mediated and specifies the methods by which the parties shall attempt to resolve the issues. *See*

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Ch. Ct. Rules 93(d)(4), 94(a)(3) and 174(3)(c). The parties should attempt to identify clearly the matters to be resolved.

Second, a petition for mediation must be submitted to the Register in Chancery. It must identify the issues to be mediated, the amount in controversy and a statement that all parties consent and that the jurisdictional requirements have been met. *See* Ch. Ct. Rule 94(a)(3).

Third, a mediation statement will normally be required, which statement may not exceed 15 pages. Chancery Court Rule 171(d) should be followed regarding form. The mediation statement is not to be shared with the other parties. The mediation statement should provide the following:

- A description of who the parties are, their relationship, if any, to each other and by whom each party is represented, **including the identity of all individuals participating on behalf of a party during the mediation conference.**

- A brief factual background, clearly indicating those facts not in dispute.

- A brief summary of the law, including applicable statutes, cases and standards. Any unreported decisions, including decisions from this jurisdiction, are to be included as exhibits.

- An **honest** discussion of the party's claims and/or defenses, including the strengths and weaknesses of the party's position.

- A brief description or history of prior settlement negotiations and discussions, including the party's assessment as to why settlement has not been reached, the party's proposed term(s) for a resolution and a description of how the party believes the Court may be able to assist in reaching an agreement.

- The amount of attorneys' fees and costs **listed separately** that have been incurred by the party to date, with a fair estimate of such additional fees and expenses, including expert witness fees, if this matter is not settled. In the case of a contingency fee or non-hourly rate fee arrangement, the percentage of that fee, if applicable, the number of hours and costs incurred by the party to date, with a fair estimate of additional expenses,

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including expert witness fees, and the amount of hours if this matter is not settled.

The original and a copy of the Statement shall be submitted to the Mediator at least 10 days before the Mediation Conference, shall not be filed with the Register in Chancery, shall not be exchanged with other parties, shall not be provided to the trial judge and shall not become part of the court record.

Third, if the parties reach agreement with regard to the issues set forth in their mediation agreement, their agreement shall be reduced to writing and signed by the parties and the mediator. *See* Ch. Ct. R. 95(d) and 174(3)(c). The agreement will be binding on all parties to it and, upon filing by the mediator, will become part of the Court record. If, however, the parties choose to keep the terms of the agreement confidential, a stipulation of dismissal may be filed instead. See Rule 95(b) (A mediation agreement, however, shall not be confidential unless the parties otherwise agree in writing.)

Parties are expected to prepare in advance for the mediation so that the mediator's time can be used most efficiently.

What Happens If No Agreement Is Reached?

The mediator shall officially terminate the mediation conference. The termination shall be without prejudice to any party in any other proceeding. No party shall be bound by anything said or done at the conference unless an agreement is reached. See Rule 95(e). (The mediation in a mediation only matter is not eligible to adjudicate any matter arising from the issues identified.)

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IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

MEDIATION REQUESTED IN:	)	
	)	
[Corporation, Inc.]	)	Mediation No. _________
	)	
and	)	
	)	
[Party B]	)	

JOINT PETITION FOR MEDIATION

[Corporation, Inc. and Party B], by and through their undersigned counsel, hereby petition the Court pursuant to 10 *Del. C.* §§ 346 and 347 and Court of Chancery Rules 93 through 95, as follows:

1. IF LITIGATION IS PENDING: [Corp., Inc.] and [Party B] are parties to certain litigation currently pending as [give caption and Civil Action Nos.] in the [Court Name].

2. IF NO LITIGATION PENDING: [Briefly state nature of action, and/or include draft complaints or exhibits.]

3. [Corp., Inc. or Party B or both] is [are] a [specify type of business entity] organized and existing under the laws of the State of Delaware or having its principal place of business in Delaware.

4. [Corp., Inc. and Party B] hereby consent to mediation in an attempt to reach a resolution of the issues raised in their dispute. By this Petition, the parties jointly request that the mediation be conducted in the Court of Chancery of the State of Delaware, pursuant to 10 *Del. C.* §§ 346 and 347 and Court of Chancery Rules 93 through 95.

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5. The disputes between the parties involve [provide brief description; for a patent dispute, for example, the description might be "involve patent technologies and include (a) the alleged infringement of U.S. patents and the damages therefore, (b) the validity of the patents-in-suit, and (c) certain equitable issues."] No consumers are parties to this [dispute or action.] IN THE CASE OF A DISPUTE INVOLVING SOLELY A CLAIM FOR MONEY DAMAGES: The amount in controversy in the pending [dispute or action] is in excess of one million dollars ($1,000,000).

WHEREFORE, [Corp., Inc. and Party B] hereby request that the Court enter an order scheduling a Mediation Conference in accordance with Court of Chancery Rules 93-95. A proposed form of order is attached to this Petition.

Dated:

____
[Attorney for Corp., Inc.]
[Attorney's address]

____
[Attorney for Party B]
[Attorney's address]

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Superior Court of the State of Delaware

Complex Commercial Litigation Division

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The Metropolitan Corporate Counsel®
SPECIAL REPORT
Delaware

CCLD: Another Great Delaware Business Court

The Editor interviews the Hon. Myron T. Steele, Chief Justice, Supreme Court of Delaware.

Editor: Why was a Complex Commercial Litigation Division needed within the Superior Court?

Steele: Before we created this division, complex commercial cases were assigned within a broad mix of diverse cases filed in the Superior Court. We thought that identifying complex commercial litigation cases and sending them to the new division would allow for more uniform and streamlined case administration.

Editor: What qualifies a case to be handled by the CCLD?

Steele: First the amount in controversy must exceed $1 million or be a case involving an exclusive choice of court agreement or a judgment that results from an exclusive choice of court agreement. What we don't include in the category is almost as important as what we include, because we want to make sure that our focus is on genuine commercial disputes between heavy-weight litigants. We exclude claims for personal, physical or mental injury. We exclude mortgage foreclosures. We exclude mechanics' liens or condemnation proceedings and any claim that is brought by an individual that is primarily for personal, family or household purposes or cases that involve agreements for an individual that relate to collective bargaining or a contract of employment.

HIGHLIGHTS

Law Firms

The Delaware Superior Court Establishes A Complex Commercial Litigation Division To Address The Concerns Of The Business Litigant Thomas E. Hanson, Jr. Morris James LLP Page 42

Bankruptcy: The Game-Changer For Directors And Officers Who May Face Claims By Shareholders Or Others William D. Johnston, Michael R. Nestor and Kristen Salvatore DePalma Young Conaway Stargatt & Taylor, LLP Page 43

Editor: Will CCLD involve cases that might have otherwise gone to the Court of Chancery?

Steele: No. The CCLD is focused on cases that are at law and not cases that would involve an equitable claim or seek an equitable remedy, which would remain in Chancery – although Chancery would have the option under our statute to transfer cases to the CCLD if they are in both law and equity. The focus of the CCLD is basically on contract disputes and mass complex litigation.

Editor: Would class actions be included?

Steele: Yes. But, the class action has to arise out of law and not equity. If it's under the corporate code or if it seeks an equitable remedy, it would still be in Chancery.

Editor: What are the jurisdictional requirements with respect to eligible parties?

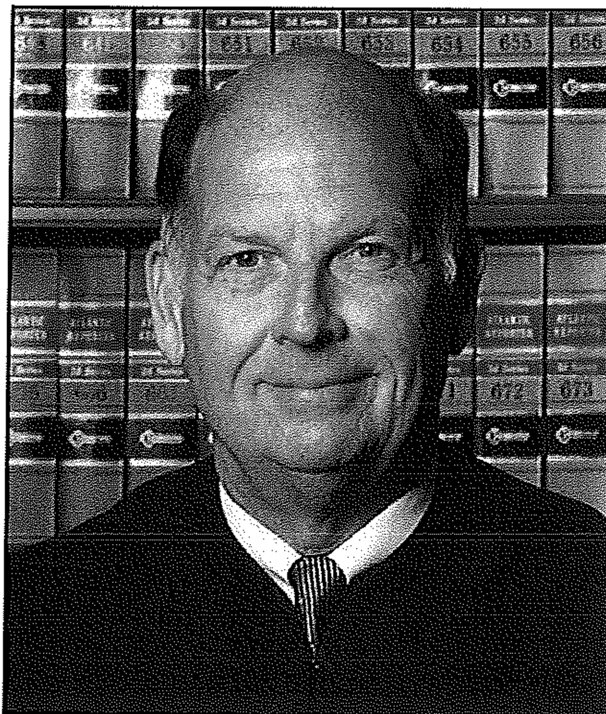
Steele: At the present time, the jurisdictional requirements are the same as they currently exist. You would have to be able to file a claim that would entitle you to jurisdiction over the defendant. After Congress implements legislation under the Hague Convention on Choice of Courts Agreements, we probably will see Delaware legislation adopted as soon as we see what Congress is going to do and what the Commission on Uniform State Laws suggests the states do. At that time, Delaware courts would probably expand the opportunity for disputes to come to them by not requiring any tie to Delaware if the parties agree to select Delaware as the choice of court.

Editor: Will the judgments of the court be enforceable outside Delaware?

Steele: Yes, to the extent the other country gives U.S. judgments full faith and credit and comity – the same as any other judgment.

Editor: How were the judges in the CCLD selected? What qualifications do they have?

Steele: The president judge of the Superior Court has already exercised his discretion as assignment judge and selected three judges, two of whom come from extensive private practice in commercial and complex litigation and the other is a very experienced judge whose track record on the court demonstrated to the president judge that he was eminently well qualified to handle these cases. Like the selections for the Court of Chancery, the judges that were selected are people with a business law background or a demonstrable record of understanding complex civil litigation.



Hon. Myron T. Steele

Editor: Will the same judge be used throughout a case in the CCLD?

Steele: Yes. It is very important that the same judge sticks with the case from beginning to end. From a case management point of view, the judge who starts at the beginning of the case determines the path the case is supposed to follow, keeps the parties under control, assures efficient management, cuts costs and increases the speed of the resolution of the complaint. If you bounce cases around from judge to judge you've got multiple calendars that you have to take into consideration. If a judge sticks with the case from the very beginning, the judge has only one calendar to manage. If you bounce a motion to dismiss to one judge, a motion for summary judgment to another judge, trial to another judge and the original case scheduling order to a different judge, you've got four different calendars you have to manage. It is obvious that using a single judge throughout a case is more efficient and expeditious.

Editor: How does the CCLD deal with the issue of getting judges to decide cases promptly?

Steele: We have guidelines throughout the Delaware court system (including the CCLD) for when a case should come to trial, but most importantly, we also have a 90-day rule throughout the system that says the case must be decided by the judge within 90 days of the final submission. Whenever judges fail to do this, they are put on what we call the "90-day list" and are required to explain the delay and set a target date for when their decision will be rendered. Fulfillment of this commitment is very closely monitored by the presiding judge of their court and then ultimately is brought to my attention. This year, the Supreme Court changed its administrative directive to say that after July 1, if a judge fails to decide within 90 days, and if the judge doesn't have an explanation for why that makes sense and the parties agree, then the judge will be referred to

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Delaware

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the court on judiciary for whatever discipline may be appropriate under the willful neglect standard.

Editor: I understand that promptly after all responsive pleadings have been filed, the judge will hold an early Rule 16 scheduling conference.

Steele: Yes. The rule explains explicitly what's supposed to happen, but the way it works in actuality is that the parties will meet and confer with the assigned judge about the progression of the case all the way through trial, and there will be at the end of the day the preparation of a case management order, which will establish a procedure for handling discovery disputes in dispositive motions. It will require early mandatory disclosures similar to those in the Federal Rule 26(a), and it will establish procedures for e-discovery and address other matters set forth in Rule 16.

Editor: How will e-discovery be handled?

Steele: Meet and confer is essential in cases involving e-discovery. Questions are answered in the E-Discovery Plan Guidelines, which is Appendix B of the Administrative Directive. After the meet and confer, the parties submit to the court a summary of an e-discovery plan with any disputes noted, as a basis for the entry of an order of the court. That order focuses on such things as the treatment of electronically stored Information (ESI) that is not reasonably accessible because of undue burden or expense. The order also provides for a safe harbor for the destruction of ESI not required by court order to be produced. It makes clear that inadvertent production of ESI does not constitute a waiver of the privilege if the party asserting the privilege promptly takes reasonable steps to recover the ESI.

Editor: How will expert witnesses be handled? What standards will be applied in determining their qualifications?

Steele: There are always issues that arise with respect to expert witnesses, particularly as to their command of the facts and whether or not their methodology for rendering their opinion meets the *Daubert* standard. The protocol for handling expert discovery is in Exhibit A2 to the Administrative Directive. It establishes procedures for deposing experts. In the absence of an agreement by the parties, depositions will take place in Wilmington. The parties will provide the other party with a list and copies of the documents reviewed or utilized by their expert. A party will be required to give the other party good faith estimates of the amount of time that it anticipates its testifying experts will require. Each party will bear its testifying experts' fees and expenses. As far as the standard for admissibility of expert witness's testimony, it will be under our Rule 702 and *Daubert*.

Editor: Tell us about the efforts to expand the use of arbitration and mediation in both the Superior Court and the Court of Chancery.

Steele: Let me start with the Court of Chancery because Chancery was the first to offer arbitration services. Chancery requires that in order for a party to have arbitration in that court, it must have some jurisdictional tie to Delaware: either it or the other party must be chartered here or one of the parties must have its principal place of business here. Chancery also offers mediation without regard to whether a party has a tie to Delaware. The Chancery's mediation services have been a very successful program even though the upfront fee is something like nine times what an ordinary filing fee would be.

There is a bill drafted by the court that we expect to introduce in our legislature that will give the Superior Court statutory arbitration and mediation authority. This would expand the services that Superior Court can offer in both arbitration and mediation – more on a parallel with Chancery with one exception. As I mentioned earlier, it is likely that events following in the wake of the Hague Convention will permit the Superior Court to resolve disputes using arbitration where there is no tie to Delaware if the parties agree to select Delaware as the choice of court.

Editor: You have just returned from the Far East, including China. Reflecting on the opportunities offered by the Hague Convention to expand the jurisdiction of the CCLD to serve the needs of parties with no ties to Delaware, what role do you see for the CCLD in respect of serving the needs of companies doing business in China?

Steele: In the wake of the Hague Convention and the other actions I addressed earlier, if the parties to a joint venture or other business arrangement in any country arising out of a contractual relationship choose Delaware as the court system to resolve a dispute arising out of the contract, Delaware will be an appropriate choice of venue and would apply the law of the jurisdiction they had chosen to govern the relationship.

I learned from visiting China and talking to the various law firms there that the core issue is that no matter what choice of court or law you select, if the judgment is against the Chinese party to an agreement, you have an issue of getting that judgment enforced in the Chinese courts. That's a serious issue.

When Delaware judges make these trips abroad, we make it a point to talk to the courts in the cities we visit. When we talk to law firms in the cities we visit, we try to suggest to them that when in doubt, Delaware is always available as a place to charter and a place to resolve your disputes. I also visited the counterpart of our SEC and the legal department of the Shanghai Stock Exchange to find out what their issues were.

I found that their issues were the same as those that triggered litigation in our courts. They too were looking to improve corporate governance in a way that will improve performance and not just be political window dressing, which unfortunately is often the case in this country.

I came away from my visit with a feeling that the winds of positive change were blowing in China and that as Chinese companies come to the U.S. and set up businesses here, even the issue of enforcing judgments will be resolved over time – and Delaware courts will be ready.

Privacy And Data Security

Continued from page 39

Be Aware of Information Requests, Internally and Externally.

Each request necessitates the retrieval of data from a system. Therefore it is important for management to consider who has access during that process and a hierarchical access process might be implemented as well. Examine where the company's PII is gathered, retained, maintained and shared. There should be an inventory list of Internet sites operated by the organization, as well as all shared servers. The firm's privacy policy should call for the examination of what the organization is doing to protect itself from risks that range from exchange ports and thumb drives to handheld PDAs and laptop computers.

Examine Physical Aspects of PII Security.

Management should ensure that the IT department inspects the sites where information is held, both in-house and at outside storage facilities. IT should build protocols to protect both the information and storage tools. Protocols should cover, among other items, the physical security of personnel files; who has access to files and how personnel are hired and trained; how long the material is retained and the policy regarding document destruction. These protocols should be developed in accordance with the many specific state and federal regulations the company is responsible for knowing and following.

Conclusion

A privacy risk assessment outlines the internal and external vulnerabilities based on the types of sensitive information. The executive management of an organization needs to review its overall privacy compliance program by first identifying which privacy laws can be triggered by a breach or through noncompliance and then through its business processes where personally identifiable information is collected and maintained.

Privacy compliance and data protection programs encompass the processes that an organization employs to protect and secure its systems, media, and facilities for processing and maintaining vital information. The processes to safeguard confidential data are the primary defenses of an information security safeguard program. An organization can be adversely affected if information becomes known to unauthorized parties, is altered, or is not available when needed. Executives need to assess the effectiveness of their information security safeguard program, in particular the financial, operational, and reputational risks to their organizations. Now more than ever, the ability to proactively manage, protect and share PII, intellectual property, and other sensitive data in a cost-effective manner – both within an organization and with strategic partners, trusted advisors, clientele, and other parties – is crucial.

Please email the author at jfodera@eisnerllp.com with questions about this article.

Partners Notes

Seasoned Litigator And Judge Joins Proskauer Rose

Daniel B. Winslow, an experienced litigator and former trial court judge, and the former Chief Legal Counsel to Massachusetts Governor Mitt Romney and Scott Brown's U.S. Senate Campaign, has joined the Boston office of global law firm Proskauer as a Senior Counsel in the Litigation & Dispute Resolution Department.

Mr. Winslow's practice focuses on complex civil and criminal cases for individuals and corporations, including bet-the-company litigation and alternative dispute resolution involving commercial disputes, securities law, state and federal administrative law, corporate compliance, intellectual property, consumer protection, products liability, construction, procurement, and white-collar criminal defense.

In addition to his work in private practice, Mr. Winslow has a long history of involvement in government and public service. This included overseeing the largest legal department in Massachusetts as Chief Legal Counsel to former Governor Romney and, most recently, serving as Chief Counsel for Scott Brown's campaign for U.S. Senate, in addition to continuing to act as Chief Counsel for the Brown Committee, the senator's reelection team. He also served for seven years as a Massachusetts trial judge, including as a presiding justice in the Wrentham District Court, a civil managing justice for the Southeast Region, Cape and Islands, and an associate justice in the Southern Appellate Division.

According to Steven M. Ellis, head of Proskauer's Boston office, Mr. Winslow brings a distinguished background as a lawyer, as well as a reputation for creativity and problem solving that will serve the firm and its clients extremely well.

SUPERIOR COURT
OF THE
STATE OF DELAWARE

JAMES T. VAUGHN, JR.
PRESIDENT JUDGE

KENT COUNTY COURTHOUSE
38 The Green
Dover, Delaware 19901

ADMINISTRATIVE DIRECTIVE OF THE PRESIDENT JUDGE OF THE SUPERIOR COURT OF THE STATE OF DELAWARE

NO. 2010-3

COMPLEX COMMERCIAL LITIGATION DIVISION

Effective May 1, 2010.

IT IS DIRECTED THAT:

1. A new division is created in New Castle County known as the Complex Commercial Litigation Division ("CCLD").

2. Any case commenced hereafter which (1) includes a claim asserted by any party (direct or declaratory judgment) with an amount in controversy of One Million Dollars or more (designated in the pleadings for either jury or non-jury trials), or (2) involves an exclusive choice of court agreement or a judgment resulting from an exclusive choice of court agreement, or (3) is so designated by the President Judge, qualifies for assignment to the CCLD (hereinafter "qualifying case(s)"); except the following, which are excluded: any case containing a claim for personal, physical or mental injury; mortgage foreclosure actions; mechanics' lien actions; condemnation proceedings; and any case involving an exclusive choice of court agreement where a party to the agreement is an individual acting primarily for personal, family, or

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COMPLEX COMMERCIAL LITIGATION DIVISION
May 1, 2010

household purposes or where the agreement relates to an individual or collective contract of employment; .

3. Identification of a qualifying case shall be made by any party by stating the letters CCLD for the Civil Case Code and Complex Commercial Litigation for the Civil Case Type on the Case Information Statement (CIS).

4. Unless specially assigned by the President Judge, a case identified as a qualifying case shall be assigned, on a rotating basis, to a Judge on the panel of the CCLD (hereinafter the "Panel"). The Panel shall be appointed by the President Judge from among the Judges of the Superior Court, and each judge on the Panel shall serve a term of three (3) years unless earlier replaced by the President Judge. If a case is assigned initially to a Judge of the Court under another case category and is subsequently identified as a qualifying case by a CIS filed by a responding party, it shall be reassigned to a Judge of the Panel.

5. A party opposing identification of a case as a qualifying case shall do so by motion filed before the Rule 16 scheduling conference referred to below, or at such other time as the assigned Panel Judge may direct. The filing of such a motion shall not affect the time for filing any pleading, motion, or required response under the Court's rules. If the assigned Panel Judge determines that the case is not a qualifying case, the Judge shall notify the Prothonotary who will reassign the case within the appropriate Civil Case Type Category as determined by the Prothonotary.

6. The following principles shall govern the administration of cases assigned to the CCLD:

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May 1, 2010

a. The case will remain assigned to the same Panel Judge for all purposes through final disposition. If the assigned Judge rotates off the Panel, the case will remain with that Judge through final disposition.

b. The Panel shall establish uniform procedures and Case Management forms for the handling of qualifying cases. The assigned Panel Judge will hold an early Rule 16 scheduling conference after all responsive pleadings have been filed. At such conference the parties shall meet and confer with the Panel Judge concerning the progression of the case through trial and preparation of a case management order. A sample case management order is attached as Exhibit A. Unless otherwise ordered by the Judge after conferring with the parties at the Rule 16 scheduling conference, the case management order shall:

(i) establish a procedure for handling discovery disputes and dispositive motions which may include the handling of such disputes by the Panel Judge or a particular Commissioner or appointed Special Master;

(ii) require early mandatory disclosures such as those contemplated by Federal Rule of Civil Procedure 26(a);

(iii) establish procedures for electronic discovery and other matters relevant to the case (e.g. appropriate protective orders and alternative

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May 1, 2010

dispute resolution procedures). A sample E-Discovery Plan is attached as Exhibit B; and

(iv) address other matters set forth in Rule 16 and any other matters appropriate in the circumstances of the case.

c. Firm pretrial and prompt trial dates will be established which will not be continued due to scheduling conflicts with other civil cases. Trials will be scheduled during the Panel Judge's scheduled civil rotation on the soonest practicable date given the pretrial complexities of the case and will be given priority as among the Panel Judge's other trial assignments. Prior to trial, the Court will:

(i) establish procedures for the conduct of the trial as a bench trial, should the parties agree to a bench trial, including procedures to streamline the presentation of evidence, to efficiently present legal issues in pre- and/or post-trial briefs, and to ensure prompt and effective post-trial decision(s) on the merits; and

(ii) establish appropriate special procedures for the selection of the jury and the conduct of the trial before a jury should the parties elect a jury trial.

7. Judges assigned to the Panel are expected to collaborate to promote uniformity in case management.

8. Judges assigned to the Panel may establish standing orders and protocols.

9. A CCLD section will be created on the Court's Web site which will include,

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inter alia, sample case management orders, standing orders or protocols, recent opinions, sample jury instructions and other pertinent information.

Dated: April 26, 2010

/s/ James T. Vaughn, Jr.
President Judge

oc: Prothonotaries
cc: Superior Court Judges
Superior Court Commissioners
Court Administrator
Margaret Derrickson
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APPENDIX A

IN THE SUPERIOR COURT OF THE STATE OF DELAWARE
IN AND FOR NEW CASTLE COUNTY

Plaintiff,	)	
	)	C.A. No.
v.	)	
	)	
Defendants.	)	

CASE MANAGEMENT ORDER

After consideration of the proposals of the parties, as well as the interests of justice, the Court hereby enters this Case Management Order.

I. GENERAL

A. Application

This Case Management Order shall apply to the presently pending action entitled: ________________________________.

B. Service of Case Management Order on New Parties

Upon the addition of any party to the Action, the party adding the new party to the Action shall serve a copy of this Case Management Order at the same time that it serves a copy of the pleading joining such new party.

C. Applicable Court Rules

Unless otherwise provided by the Initial Case Management Order, the Superior Court Civil Rules shall apply.

D. Discovery Master

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Upon application of any party, the Court may issue an Order of Reference to a Special Master or Commissioner, who shall thereafter handle all matters referred to in that Order of Reference.

II. LEXIS/NEXIS E-FILING PROCEDURES

The filing and service of documents shall be in accordance with Rule 79.1 of the Superior Court Civil Rules and the Administrative Directive of the President Judge of the Superior Court of the State of Delaware, No. 2007-6, E-File Administrative Procedures, dated December 13, 2007, published by the Prothonotary, except that documents initiating discovery requests (interrogatories, requests for production of documents, and requests for admission) and responses to such discovery requests (excluding the actual production of documents) shall be served electronically through LEXIS/NEXIS.

III. DISCOVERY SCHEDULE

A. Document Production

1. Requests for production of documents shall be served on or before ___________ with all documents to be produced on or before ___________.

2. Privilege logs shall be produced in accordance with the Superior Court Civil Rules and Rule 502 of the Delaware Uniform Rules of Evidence so as to be completed on or before ______________.

3. Inadvertent Production of Documents. In the event a party discovers that it has inadvertently produced a document that it considers privileged or confidential, or receives a document that it believes was inadvertently produced on the ground that it is privileged or confidential, the parties shall undertake to resolve the inadvertent disclosure issue through the Protective Order entered in this case or, in the absence of such an Order, in the Protocol for the Inadvertent Production of Documents

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attached as Exhibit A.1 hereto. The Court will determine any issues not resolved by the parties.

B. Fact Depositions

1. Each party will be limited to taking ________ fact depositions, unless the Court for good cause extends that limit. Each deposition shall be limited to seven hours unless extended by agreement or Court order.

2. Depositions shall proceed as follows: (a) depositions of document records custodians may be noticed for deposition on and after ____________ so as to be completed by __________ and (b) all other non-expert depositions may be noticed for deposition on or after ____________ so as to be completed by: ______________.

C. Fact Discovery Cut-off

The parties shall conduct fact discovery so that it is completed on or before ______________.

D. Expert Discovery

Expert Discovery shall commence on ____________ and shall be completed no later than _____________. Exhibit A.2 hereto shall govern expert discovery.

IV. DISPOSITIVE MOTIONS

Dispositive motions may be filed on or before _______________.

V. PRETRIAL STIPULATION AND ORDER; TRIAL

A. Trial Date and Jury Selection

The trial of this Action shall begin on ____________ at ____ a.m., and continue for______________, if necessary. Jury selection will be conducted on ______ at _______a.m.

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B. Jury Questionnaire

To expedite the selection of jurors who will be able to serve for as long as __ weeks, the parties will exchange proposed jury questionnaires on or before ____________. The parties shall confer immediately upon the exchange of the questionnaires and submit a joint agreed upon questionnaire or a joint questionnaire that reflects areas of disagreement to the Court no later than ________________.

C. Pre-Trial Stipulation and Order, Jury Instructions, Special Interrogatories, and Pre-Trial Conference

1. On or before __________, the parties collectively shall:

   a. exchange drafts of a Pre-Trial Stipulation and Order that shall address the items set forth in Superior Court Civil Rule 16(c) to the extent not previously resolved; and

   b. exchange proposed jury instructions and special interrogatories.

2. Immediately following the exchange of the proposed Pre-Trial Stipulation and Order, the parties shall meet and confer in an attempt to reach an agreement on a final Pre-Trial Stipulation and Order, jury instructions and any special interrogatories. On or before __________, the parties shall submit to the Court a proposed Pre-Trial Stipulation and Order. In the event the parties cannot reach agreement on all the terms of the Pre-Trial Stipulation and Order, jury instructions and special interrogatories, a single proposed order shall be filed and any areas of disagreement shall be appropriately noted in the one proposed order submitted and plaintiff shall submit a set of jury instructions and special interrogatories that contain any party's proposal.

3. The Pre-Trial Conference with the Court shall take place on __________

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at _______ __.m.

D. Motions In Limine

All motions in limine shall be filed no later than _______ and all responses to those motions shall be filed no later than ________.

VI. MOTIONS

A. All motions shall be heard at the Court's convenience.

B. All motions shall be accompanied with an opening brief supporting the motion. Subject to the requirements of this Order, any defendant may file a separate joinder or brief adopting or supporting a motion or opposition of another defendant provided it is served within three (3) business days after service of the motion or opposition and does not exceed three (3) pages, exclusive of appendices.

C. Subject to the requirements of this Order, any party may file an answering brief to a motion. Unless an alternative schedule has been agreed to by the parties or ordered by the Court, such answering brief shall be filed and served the later of _____ (_) days after any service of the motion, or _________ (_) days after any defendant files a separate joinder or brief adopting or supporting a motion or opposition of another defendant.

D. Reply briefs may be filed ten (10) days after responses are received, but no later than three (3) days before any hearing on the motion.

E. All briefs shall conform to the requirements of Superior Court Civil Rule 107, except that in the case of discovery motions, whether handled by the Court or the Special Discovery Master in the first instance, the timing of such discovery motion practice and the length of the briefs on discovery motions shall comport with the requirements in the Order of Reference to Special Discovery Master, dated

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___________. The Court may set page limitations that differ from Superior Court Civil Rule 107.

This Case Management Order may be amended by the Court or supplemented by additional Case Management Orders as deemed appropriate by the Court. Nothing herein shall prevent any party from seeking relief from any provision for good cause shown.

IT IS SO ORDERED this ___ day of ______, 200__.

____
Judge

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EXHIBIT A.1

PROTOCOL FOR THE
INADVERTENT PRODUCTION OF DOCUMENTS

In the absence of a Protective Order governing inadvertent production of documents, in the event a party discovers that it has inadvertently produced a document that it considers privileged or confidential, or received a document that it believes was inadvertently produced on the ground that it is privileged or confidential, the parties will undertake to resolve the issue by complying with the following protocol:

1. If a party produces privileged or confidential information or documents ("Privileged Material") that the recipient believes were produced inadvertently, the recipient immediately shall either return such Privileged Material to the producing party or notify the producing party of the apparent inadvertent production.

2. If a producing party discovers that it inadvertently produced information or documents that it considers Privileged Material, in whole or in part, it may retrieve such Privileged Material or parts thereof as follows:

a. During the period within one hundred twenty (120) days after the date of the inadvertent production, the producing party may give written notice to all parties that the producing party claims said document, in whole or in part, to be privileged material and must state the nature of the privilege.

b. Upon receipt of such notice, all parties who have received copies of the produced documents shall promptly return them to the producing party or destroy them and shall certify that all copies of the documents in their possession, and in the possession of anyone who receives copies from them, have either been

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returned or destroyed. Moreover, all parties who have received copies of the produced documents shall not make any use of the contents of the allegedly Privileged Material, unless and until a party challenges the privileged claim and the court determines the claim of the producing party is not well founded. In the event that only parts of documents are claimed to be Privileged Material, the producing party shall furnish redacted copies of such documents, removing only the part(s) thereof claimed to be Privileged Material, to all parties within ten (10) days of their return to the producing party or their destruction by the receiving party.

c. After timely service of such notice, no motion to compel the production of the inadvertently produced document may rely on an allegation that any protection as to the document was waived by its inadvertent production. Nothing in this paragraph shall preclude any recipient of such notice from promptly moving for an order compelling production of such document on the ground that the claim of privilege is not well founded.

d. During the period more than one hundred twenty (120) days after the inadvertent production, but in no event later than thirty (30) days prior to trial, the producing party may request the return of said document which it claims, in whole or in part, to be Privileged Material, pursuant to and in accordance with the following procedure:

i. The producing party must give written notice to all parties that the producing party claims said document, in whole or in part, to be Privileged Material and must state the nature of the privilege;

ii. Within ten (10) days of giving written notice pursuant to paragraph (i) above, the parties shall meet and confer to discuss the assertion of privilege. If the parties cannot reach agreement within ten (10)

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days of the giving of such written notice, the producing party shall file a Motion for Protective Order in accordance with the Superior Court Civil Rules that seeks the return or destruction of the inadvertently produced privileged document(s).

e. Inadvertent production of privileged material, the return of which is requested in accordance with this section, shall not be considered a waiver of any claim of privilege.

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EXHIBIT A.2

PROTOCOL FOR EXPERT DISCOVERY

Expert discovery in this Action shall be conducted pursuant to the following protocol:

A. Identification of Expert Witnesses

1. On or before ___________ the parties shall identify expert witnesses and submit Superior Court Civil Rule 26(b) statements. On or before ____________, any party may designate additional expert witness(es) whose function shall be solely to rebut an opinion taken by a designated expert witness. At the same time a party designates a rebuttal expert witness, the party designating the rebuttal expert witness shall produce corresponding Rule 26(b) statements for that witness.

2. Depositions of expert witnesses shall take place during the period of _______________ through ________________.

B. Depositions of Expert Witnesses

1. As soon as practicable, the party taking a deposition will advise the other side of its good faith estimate of the amount of time it is anticipated that the testifying expert's deposition will take.

2. Each party will pay its testifying experts' fees and expenses incurred in connection with the deposition of such experts. All costs incurred in the production of documents discussed herein shall also be borne by the party producing the documents.

3. The parties will make a good faith effort to schedule testifying expert depositions at locations convenient for counsel and the experts. In the absence of any agreement, each deposition will take place in Wilmington, Delaware. If the deposition is taken in Wilmington, Delaware, the deposition will be held at a location

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to be selected by counsel for the party taking the deposition.

4. Testifying expert witnesses will appear for depositions without the necessity of subpoenas.

C. **Document Identification And Production Of Documents Relied Upon By Experts**

1. On or before fourteen (14) calendar days before the expert's deposition begins, the party proffering the testifying expert shall provide the other side with a list of the documents reviewed by each testifying expert in his capacity as a testifying expert in this case. The list will include the Bates numbers (if any) or a deposition exhibit number (if any), the date, and a brief description of each document, such as the names of the author and addressee and the title or line reference.

2. On or before fourteen (14) calendar days before each expert deposition begins, the party proffering a testifying expert will produce to the party taking the testifying expert's deposition the following documents relied upon by a testifying expert in his capacity as a testifying expert in this case:

a. Documents relied upon by a testifying expert in his capacity as a testifying expert in this case that were obtained by one side from third parties and not produced to the other side in this action;

b. Documents relied upon by a testifying expert in his capacity as a testifying expert in this case that were produced in this action for which there is no common Bates numbering or a deposition exhibit number;

c. Documents prepared by a non-testifying expert that were relied upon by a testifying expert in his capacity as a testifying expert in this case;

d. All publications of any type relied upon by a testifying expert in his capacity as a testifying expert in this case, including by way of example

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only, documents considered to be "learned treatises" under D.U.R.E. 803(13). This subparagraph is not intended to include publications that merely form part of the basis of a testifying expert's education, training and experience in a particular field, but rather, only those on which a testifying expert is relying or about which he will testify at trial. Further, if a publication otherwise required to be produced pursuant to this subparagraph is shown by the party proffering a testifying expert to be readily accessible in its entirety from other sources, then only the relevant portions thereof must be produced;

e. Notwithstanding any of the provisions set forth herein, no communications between counsel for a party and the party's expert shall be produced; and

f. No party shall be required to produce any work product between the expert witness and the proffering party's counsel.

3. No later than ten (10) days after a party's designation of a testifying expert, each party proffering a testifying expert will produce to the party taking the expert's deposition: (a) the testifying expert's curriculum vitae and (b) a list that will include, at a minimum, the cases, administrative matters or other proceedings in which the expert has given trial or other testimony in public within the last four (4) years, without prejudice to any party's right to request such information for a period not to exceed ten (10) years. If the request for information exceeding four (4) years is opposed, the party seeking such additional information may apply to the Court for relief. The list also will include the name of the matter, the name of the court or other public body, the names of the parties and their attorneys, whether the expert or the party for which he is testifying has a copy of the testimony, and a brief description of the nature of the proceeding.

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4. The cost of producing documents, as required herein, for a party's testifying expert, shall be borne by the party designating the testifying expert.

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APPENDIX B

E-DISCOVERY PLAN GUIDELINES

(a) *Meet and Confer Requirement.* Unless the parties otherwise agree or the Court otherwise orders, not later than 21 days before the first scheduling conference with the Court, all parties that have appeared in the proceeding shall hold a meet and confer session concerning discovery of electronically stored information ("ESI") that is reasonably likely to be sought in the proceeding, and if so the parties shall discuss:

(1) any issues relating to preservation of ESI;

(2) the form in which each type of ESI will be produced and any problems relating thereto;

(3) the scope of production, including the custodians, time period, file types and search protocol to be used to identify which ESI will be produced;

(4) the method for asserting or preserving claims of privilege or of protection of ESI as trial-preparation materials, including whether such claims may be asserted after production;

(5) the method for asserting or preserving confidentiality and proprietary status of ESI relating to a party or a person not a party to the proceeding;

(6) whether allocation among the parties of the expense of preservation and production is appropriate; and,

(7) any other issue relating to the discovery of ESI.

(b) *e-Discovery Plan and Report to the Court.* The parties shall:

(1) develop a proposed plan relating to discovery of ESI; and

(2) not later than 14 days after the meet and confer session under subsection (a), submit to the Court a written report that summarizes the plan and states the position of each party as to any issue about which they are unable to agree.

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(c) *Form of Court Order*. Following the submission of the discovery plan and any disputes over the plan, the Court will enter an order governing discovery of ESI that will address:

(1) preservation of ESI;

(2) the form in which each type of ESI is to be produced;

(3) the scope of production, including the custodians, time period, file types and search protocol to be used to identify which ESI is to be produced;

(4) the permissible scope of discovery of ESI;

(5) the method for asserting or preserving claims of privilege or of protection of ESI as trial-preparation material after production;

(6) the method for asserting or preserving confidentiality and the proprietary status of ESI relating to a party or a person not a party to the proceeding;

(7) allocation of the expense of production; and

(8) any other issue relating to the discovery of ESI.

(d) Limitations On Discovery.

In developing a discovery plan and in entering any discovery order, the plan or order shall provide that a party may object to discovery of ESI from sources that the party identifies as not reasonably accessible because of undue burden or expense. In its objection the party shall identify the reason for such undue burden or expense. On a motion to compel discovery or for a protective order relating to the discovery of ESI, the objecting party bears the burden of showing that the information is from a source that is not reasonably accessible because of undue burden or expense.

The Court may order discovery of ESI that is from a source that is not reasonably accessible because of undue burden or expense if the need for proposed discovery outweighs the likely burden or expense, taking into account the amount in

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controversy, the resources of the parties, the importance of the issues, and the importance of the requested discovery in resolving the issues.

If the Court does order discovery of ESI under this subsection, it may set conditions for discovery of the information, including allocation of the expense of discovery. The Court shall limit the frequency or extent of discovery of ESI, whether or not that ESI is from a source that is reasonably accessible, if the Court determines that:

(1) it is possible to obtain the information from some other source that is more convenient, less burdensome, or less expensive;

(2) the discovery sought is unreasonably cumulative or duplicative;

(3) the party seeking discovery has had ample opportunity by discovery in the proceeding to obtain the information sought; or

(4) the likely burden or expense of the proposed discovery outweighs the likely benefit, taking into account the amount in controversy, the resources of the parties, the importance of the issues, and the importance of the requested discovery in resolving the issues.

(e) Safe Harbors.

The order governing e-discovery shall also provide that:

(1) A party that is subject to an order entered by the court to deal with e-discovery and who acts in compliance with the terms of that order may thereafter apply its regular document destruction procedures to any ESI that has not been ordered to be produced and shall not be subject to any sanction for the destruction of ESI that is not subject to its obligation to produce under such court order. The order entered by the Court may be modified upon application for good cause and shall thereafter be applicable to the preservation of ESI.

(2) The production of ESI shall not constitute a waiver of

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attorney-client privilege or work-product protection if the disclosure was inadvertent and the party making the claim of privilege or protection shall promptly take reasonable steps to recover the ESI.

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