Welcome to the inaugural edition of the Directors and Officers Liability Report. We aim to become the site of choice for inside and outside counsel and practitioners aiming to stay current with the latest case law and statutory developments affecting director and officer liability. In a world of rapid change, understanding the risks to officers and directors and the rules and practices regarding insurance, indemnification and advancement is vital for those who are called upon to advise officers and directors or the corporations, stockholders and other constituencies they serve. If you are receiving this in due course as a member of our section, we hope this report contributes to your satisfaction as a section member. And if you wish to help by contributing to the newsletter, we welcome your participation. Feel free to email me at llazarus@morrisjames.com or one of the co-editors, Corinne Amato at camato@morrisjames.com, Frances Goins at fgoins@ulmer.com or Michaela Sozio at msozio@tressler.com. Special thanks to Corinne, Frances and Michaela for getting this project off the ground. I hope to see you at our next meeting on April 5, 2013 during the ABA Business Law Section spring meeting in Washington D.C. where we will meet from 10:00 to 11:30 a.m. in The Independence Room, Lobby Level, of the Washington Hilton Hotel in Washington, D.C.

Lewis H. Lazarus  
Morris James LLP  
Chair, Directors and Officers Liability Committee  
ABA Business Law Section
fourth quarter of 2007 to transfer the loans into its own portfolio. Allegedly, these loans generated losses of $600 million. In July of 2008, IndyMac closed, with the FDIC appointed as receiver.

Perry argued in the Motion to Dismiss that the plaintiff had not pleaded facts sufficient to overcome the business judgment rule. Perry was both an officer and director at the time of the challenged conduct. California Corporations Code § 309, which codifies California's common law business judgment rule, expressly makes reference to directors and directors' duties and liabilities but does not make reference to officers. The district court found that the plaintiff had sufficiently alleged that Perry's actions were undertaken primarily in his capacity as an officer. The district court focused on two lines of argument. First, the court suggested that the scant case law on point tended to support the holding that the common law business judgment rule does not apply to corporate officers. Second, the court found that the California Legislature spoke clearly on the issue when it omitted any mention of officers in its legislation. Moreover, the legislative committee's comments revealed that it was the drafters' intent to exclude officers from the protection of the business judgment rule.

The Perry opinion interprets only California law. However, the opinion may be persuasive authority in the interpretation of other states' common law and corporate statutes that do not explicitly provide for the application of the business judgment rule to officers, given that so little precedent exists in this area.


In a pair of Complaints filed in December of 2011, the United States Securities and Exchange Commission alleged that certain senior executive officers of Freddie Mac and Fannie Mae approved misleading statements which asserted that the companies had minimal holdings in high-risk mortgage loans—primarily sub-prime loans. For a copy of the Complaints please click [here](#) and [here](#). As a result of these misleading statements, the SEC alleged, investors materially underestimated Freddie Mac's and Fannie Mae's exposure to the risk of such loans. The SEC alleged that the officers violated Rule 10b-5 under the Securities Exchange Act of 1934 (the "Exchange Act") and Section 17(a) of the Securities Act of 1933, in addition to Section 302 of the Sarbanes-Oxley Act of 2002. With regard to the Freddie Mac officers, the SEC alleged that the officers were aware of Freddie Mac's increasing subprime exposure and were responsible for Freddie Mac's disclosures to investors, and that each officer made, or aided and abetted Freddie Mac or each other in making, false and misleading credit risk disclosures regarding sub-prime loans in a "single family" guarantee portfolio. With regard to the Fannie Mae officers, the SEC alleged that each of the officers made or substantially assisted others in making materially false and misleading statements regarding Fannie Mae's exposure to sub-prime and so-called "Alt-A" (reduced documentation) loans.

**Louisiana Municipal Police Employee’s Retirement System v. Pyott**

Important developments in the law of demand futility in derivative actions also emerged in 2012. The Delaware Court of Chancery, in *Louisiana Municipal Police Employee's Retirement System v. Pyott*, held that a previous dismissal with prejudice of a companion California federal court derivative action brought by stockholder plaintiffs on behalf of the corporation based on the same allegations of the same alleged wrongs did not collaterally estop the Delaware plaintiffs of the same corporation or finally determine the demand futility issue under Rule 23.1. 46 A.3d 313 (Del. Ch. 2012). Instead, the California federal court's dismissal was merely persuasive on the issue, not preclusive. *Pyott* is significant because it upsets decades of established precedent across the country on collateral estoppel. For a copy of the Pyott opinion please click [here](#).

*Pyott* arises from Allergan Inc.'s settlement with the United States Department of Justice pursuant to which Allergan pleaded guilty to criminal misdemeanor misbranding and paid $600 million relating to its off-label promotion of Botox. Very soon after the settlement, several law firms filed derivative actions in California federal court and the Delaware Court of Chancery. The California court ultimately dismissed a consolidated
complaint pursuant to Rule 23.1 with prejudice for failure to demonstrate demand futility, reasoning that because a stockholder plaintiff in a derivative action sues in the name of the corporation, all other stockholder plaintiffs whose suits arise under the same facts are in privity with the plaintiff.

The defendants then moved to dismiss the complaint in the Court of Chancery on grounds, among others, of collateral estoppel. Denying the motion, the Court of Chancery held that the issue of privity is governed by the prudential doctrine and, accordingly, would be governed by Delaware law. The Court of Chancery stated that Delaware Supreme Court precedent requires that until a Rule 23.1 motion has been denied, a derivative plaintiff does not have authority to sue in the name of the corporation; thus, privity does not exist at the early stages of such lawsuits. The Court of Chancery proceeded to analyze the defendant's motion to dismiss on grounds of Rule 23.1 and Rule 12(b)(6). The Court of Chancery disagreed with the California federal court on the Rule 23.1 issue and denied the motion.

If Pyott survives as the law of Delaware, successive derivative actions could become the norm. Corporate defendants had relied on the grant of a motion to dismiss a derivative case for failure to sufficiently plead demand futility to collaterally estop other similar suits. However, such early-won victories could have significantly less impact in the future.

**Monday v. Meyer**

The U.S. District Court for the Northern District of Ohio in *Monday v. Meyer* issued an opinion granting a motion to dismiss, which, while not groundbreaking, provides a thorough defense-friendly analysis of demand futility in a derivative case—an area in which there is an increasing amount of director liability litigation. The complaint in the case alleged that the directors of KeyCorp violated Section 10(b) of the Exchange Act and Rule 10b-5, breached their fiduciary duties, committed corporate waste, and were unjustly enriched by way of their approval of certain tax strategies. Defendants moved to dismiss the complaint on grounds, among others, that plaintiffs had failed to make any pre-suit demand. The court reasoned that * [d]emand is excused only when Plaintiffs adequately plead actionable claims against a majority of the board at the time the suit was filed, thus showing that a majority of the board faces a substantial likelihood of liability.* The court's analysis of the complaint's allegations against specific directors and officers at the time the complaint was filed is instructive: "It is insufficient to allege that, because Defendants were members of certain committees, and because of the defined roles of those committees, Defendants automatically knew or should have known about the falsity of financial statements. . . . In order to allege futility based on a director's committee membership, the complaint would have to show some specific report or piece of information that the committee was given which would have tipped them off to misconduct. Click [here](http://apps.americanbar.org/buslaw/committees/CL996000pub/newsletter/201303/home.shtml) to read more.

**Hermelin v. K-V Pharmaceutical Co.**

The Delaware Court of Chancery, in *Hermelin v. K-V Pharmaceutical Co.*, issued a noteworthy decision in summary judgment involving Delaware law and contract indemnity provisions. 54 A.3d 1093 (Del. Ch. 2012). For a copy of the opinion, please click [here](http://apps.americanbar.org/buslaw/committees/CL996000pub/newsletter/201303/home.shtml). The opinion provides a rare analysis of indemnity provisions under Delaware case law. Marc Hermelin, former CEO and member of the board of directors of the defendant K-V Pharmaceutical Company (K-V), filed suit against his former employer seeking indemnification or advancement for several criminal, civil, and regulatory matters that arose due to K-V's manufacturing and distributing oversized morphine tablets. Hermelin pleaded guilty to criminal misdemeanor charges under the "Responsible Corporate Officer" doctrine. Separately, the U.S. Food and Drug Administration and K-V entered into a consent decree to refrain from manufacturing, holding or distributing any drug until the defendants undertook certain quality control measures, and the U.S. Department of Health and Human Services barred Hermelin from all federal healthcare programs for twenty years. Hermelin and K-V were parties to an indemnification agreement which, crucially, made mandatory the otherwise permissive provisions for indemnification under the General Corporation
Law of the State of Delaware ("DGCL") (K-V's bylaws also made those provisions mandatory).

The court looked to four different proceedings for which Hermelin sought a declaration that he was entitled to indemnification - the criminal matter, the HHS exclusion matter, the FDA consent decree matter and the Audit Committee matters. The court held that Hermelin was not entitled to mandatory indemnification under Section 145(c) of the DGCL for the criminal matter and the HHS exclusion matter, since his guilty plea meant he was not "successful on the merits or otherwise." However, the court held that he was entitled to mandatory indemnification for the FDA consent decree matter. The court then performed an analysis of the matters for which indemnification is permitted under Section 145(a) of the DGCL, which generally applies to indemnification of directors, officers, employees and agents in third-party proceedings and criminal actions. That provision was made mandatory by the indemnification agreement and the bylaws. The court held that with regard to the criminal matter, the HHS exclusion matter and the Audit Committee matter, Hermelin might be entitled to the otherwise permissive indemnification due to the expansive scope of his indemnification agreement, as long as he met the standard of conduct in Section 145(a) (i.e., he "acted in good faith and in a manner [he] reasonably believed to be in or not opposed to [KV's] best interest." Whether he met this standard of conduct would depend on the results of a further evidentiary hearing. In short, the court held that there could be room between an indemninee's failure to be "successful on the merits or otherwise" and Section 145(a)'s standard of conduct. In raising the question of good faith, this opinion highlights an area for which there is little case law and provides practitioners with additional guidance when drafting indemnifications and advancement provisions.

**America's Mining Corporation v. Theriault**

In 2012, in *America's Mining Corporation v. Theriault* (a decision affirming the Court of Chancery's decision in the Southern Peru Copper litigation), the Delaware Supreme Court affirmed what is believed to be the largest award-$2 billion for breach of fiduciary duty in addition to approximately $304 million in attorney fees—in a shareholder derivative case in Delaware history, 51 A.3d 1213 (Del. 2012). For a copy of the opinion, please click [here](http://www.abanet.org/buslaw/commissions/CL996000pub/newsletter/201303/home.shtml). The Court of Chancery had held that the defendant-appellants breached their fiduciary duty of loyalty to a subsidiary and its minority stockholders by causing the subsidiary to acquire the controller's 99.15% interest in a Mexican mining company.

The Delaware Supreme Court, in a 110-page opinion, held that the Court of Chancery was correct in concluding after a full trial that, in analyzing fiduciary duty, the "inquiry must focus on how the special committee actually negotiated the deal—was it 'well-functioning'" rather than merely focusing on the mandate of the committee and how it was composed. The Delaware Supreme Court determined that, applying this standard, "evidence of unfairness was . . . overwhelming."

The attorney fee award represented approximately 15% of the judgment for breach of fiduciary duty, plus post-judgment interest until the attorney fee and expense award is satisfied. Plaintiff had sought 22.5% of the recovery, plus interest. The Court of Chancery had explored whether the fee award "fairly implements" numerous factors, including "1) the results achieved; 2) the time and effort of counsel; 3) the relative complexities of the litigation; 4) any contingency factor; and 5) the standing and ability of counsel involved." In addition, the court looked to whether the fee award "creates a healthy incentive" for plaintiff's lawyers to seek substantial achievement for plaintiffs in derivative actions and the classes that they represent in class actions, among other factors. In this analysis, the Court of Chancery, in determining whether the fee award was appropriate, looked beyond a mere examination of counsel's time and effort. The Delaware Supreme Court, after a careful analysis, held that the fee award was a proper exercise of the Court of Chancery's broad discretion in applying the multi-factored test.
Jeffrey Baddeley

When a company files for bankruptcy protection, the search for scapegoats is nearly inevitable. If the company has failed, someone must have breached a duty. And if the company fails, someone will get less than they want. As "bankruptcy protection" becomes synonymous with "orderly liquidation," creditors will start to investigate claims against officers and directors. When the auction comes up short, directors and officers become targets.

One increasingly prevalent pattern in Chapter 11 cases is:

1. The lenders and the company management agree to a series of forbearance agreements;
2. The lenders strengthen their collateral positions;
3. The debtor's collateral will not repay the debt;
4. The debtor and the lenders agree that the debtor will file for bankruptcy to sell the debtor's assets as a going concern;
5. The assets are sold; and
6. Avoidance claims held by the debtor are left for the creditors’ committee to pursue.

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UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA
WESTERN DIVISION

FEDERAL DEPOSIT INSURANCE CORPORATION, AS RECEIVER FOR
INDYMAC BANK, F.S.B.,

Plaintiff,

v.

MATTHEW PERRY,

Defendant.

Case No. CV 11-5561 ODW (MRWx)

ORDER DENYING DEFENDANT’S
MOTION TO DISMISS [18]

I. INTRODUCTION

Currently before the Court is Defendant Matthew Perry’s (“Perry” or “Defendant”) Motion to Dismiss Plaintiff Federal Deposit Insurance Corporation (“FDIC”), as Receiver for Indymac Bank, F.S.B.’s, (“Plaintiff”) Complaint. (Dkt. No. 18.) After careful consideration, the Court deems the matter appropriate for decision without oral argument. See Fed. R. Civ. P. 78 (“Rule ___”); L.R. 7-15. For the following reasons, the Court DENIES Defendant’s Motion.
II. FACTUAL BACKGROUND

This case arises from Defendant’s actions related to Indymac Bank, F.S.B.’s (“Indymac”) investment in risky residential loans. Specifically, between at least April and October 2007, Defendant, Indymac’s chief executive office (“CEO”), is alleged to have negligently permitted the production of a pool of more than $10 billion in risky, residential loans intended for sale into a secondary market. (Compl. ¶ 3.) Due to the volatility of the secondary market, however, Indymac was forced by the fourth quarter of 2007 to transfer the loans into its own investment portfolio. (Id.) Plaintiff alleges that Defendant’s actions, whereby he chose to aggressively gamble by investing in these risky loans, were beyond what a reasonable banker would have done under similar circumstances. (Compl. ¶ 3, 97-98.) As a result, the loans that had to be transferred into Indymac’s investment portfolio generated substantial losses in excess of $600 million. (Compl. ¶ 3.) On July 11, 2008, Indymac ultimately closed and the FDIC was appointed as its receiver. (Compl. ¶ 13.)

Based on the foregoing, Plaintiff brings this action pursuant to 12 U.S.C. § 1821(d)(2) and 12 U.S.C. § 1821(k) alleging that Defendant, as CEO, breached his duties to Indymac and acted negligently in allowing Indymac to continue to generate and purchase loans for sale into the secondary market.¹ (Compl. ¶ 97.) As a result of the Defendant’s conduct, Plaintiff alleges that it was damaged in a sum in excess of $600 million. (Compl. ¶ 98.)

III. LEGAL STANDARD

“To survive a motion to dismiss for failure to state a claim under Rule 12(b)(6), a complaint generally must satisfy only the minimal notice pleading requirements of Rule

¹ The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") provides that directors and officers of insured depository institutions may be held liable for money damages brought by the FDIC for “gross negligence, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care (than gross negligence) including intentional tortious conduct, as such terms are defined and determined under applicable State law.” 12 U.S.C. § 1821(k). “[S]tate law sets the standard of conduct as long as the state standard (such as simple negligence) is stricter than that of the federal statute.” Atherton v. FDIC, 519 U.S. 213, 215-16 (1997). Because California’s simple negligence standard is stricter than the gross negligence standard provided for in 12 U.S.C. § 1821(k), California law and its simple negligence standard is applicable for assessing liability under Atherton. FDIC v. Castetter, 184 F.3d 1040, 1043 (9th Cir. 1999).
8(a)(2).” Porter v. Jones, 319 F.3d 483, 494 (9th Cir. 2003). Rule 8(a)(2) requires “a short and plain statement of the claim showing that the pleader is entitled to relief.” Fed. R. Civ. P. 8(a)(2). For a complaint to sufficiently state a claim, its “[f]actual allegations must be enough to raise a right to relief above the speculative level.” Bell Atlantic Corp. v. Twombly, 550 U.S. 554, 555 (2007). Mere “labels and conclusions” or a “formulaic recitation of the elements of a cause of action will not do.” Id. Rather, to overcome a 12(b)(6) motion, “a complaint must contain sufficient factual matter, accepted as true, to state a claim to relief that is plausible on its face.” Ashcroft v. Iqbal, 129 S. Ct. 1937, 1949 (2009) (internal quotation and citation omitted). “The plausibility standard is not akin to a probability requirement, but it asks for more than a sheer possibility that a defendant has acted unlawfully. Where a complaint pleads facts that are merely consistent with a defendant’s liability, it stops short of the line between possibility and plausibility of entitlement of relief.” Id. (internal quotation and citation omitted).

When considering a 12(b)(6) motion, a court is generally limited to considering materials within the pleadings and must construe “[a]ll factual allegations set forth in the complaint . . . as true and . . . in the light most favorable to [the plaintiff].” See Lee v. City of L.A., 250 F.3d 668, 688 (9th Cir. 2001) (citing Epstein v. Washington Energy Co., 83 F.3d 1136, 1140 (9th Cir. 1996)). A court is not, however, “required to accept as true allegations that are merely conclusory, unwarranted deductions of fact, or unreasonable inferences.” Sprewell v. Golden State Warriors, 266 F.3d 979, 988 (9th Cir. 2001). Thus, the Ninth Circuit has summarized the governing standard, in light of Twombly and Iqbal, as follows: “In sum, for a complaint to survive a motion to dismiss, the non-conclusory factual content, and reasonable inferences from that content, must be plausibly suggestive of a claim entitling the plaintiff to relief.” Moss v. U.S. Secret Serv., 572 F.3d 962, 969 (9th Cir. 2009) (internal quotation marks omitted).

IV. DISCUSSION

The parties dispute as to whether the business judgment rule (“BJR”) protects corporate officers as well as directors from judicial second guessing business decisions.
made on behalf of the corporation. Specifically, Defendant moves to dismiss Plaintiff’s Complaint arguing that the allegations fail to plead facts sufficient to overcome BJR. In making this argument, Defendant contends that California law applies BJR to corporate decision makers including both directors and officers. In addition, Defendant avers that even if BJR does not apply to officers, the Complaint focuses on Indymac’s allegedly flawed core business strategy. Thus, Defendant argues that BJR applies in this case as the allegations implicate Defendant’s performance as a director and not as his role as Indymac’s CEO. In any event, Defendant contends that BJR applies and insulates him from personal liability related to his actions during the alleged time period prior to Indymac’s demise.

Plaintiff opposes Defendant’s Motion arguing that BJR does not apply to officers in California. Likewise, Plaintiff contends that Defendant is being sued in his capacity as Indymac’s CEO as opposed to his role as director, and consequently, Plaintiff argues that BJR need not apply. As a result, Plaintiff contends that it was not required to plead around this defense. Moreover, Plaintiff avers that the issue of whether BJR applies to officers is not properly before this Court pursuant to a Rule 12(b)(6) motion.

As an initial matter, plaintiffs generally need not anticipate a defense. See Fed. R. Civ. P. 8(b)-(c); see also Gomez v. Toledo, 446 U.S. 635, 640 (1980) (holding the burden of pleading a defense rests with the defendant). Where the complaint’s allegations, however, reveal the existence of an affirmative defense, as Defendant argues here, plaintiffs must plead around the defense, by alleging specific facts that would avoid the apparent defense as Defendant argues. Doe II v. Myspace, Inc., 175 Cal. App. 4th 561, 566 (Ct. App. 2009) (citation and quotation omitted). “Absent such allegations, the complaint is subject to demurrer for failure to state a cause of action . . . .” Id. at 566 (citation omitted); Berg & Berg Enter., LLC v. Boyle, et al., 178 Cal. App. 4th 1020, 1046 (Ct. App. 2009) (“[T]he failure to sufficiently plead facts to rebut the business judgment rule or establish its exceptions may be raised on demurrer, as whether sufficient facts have been so pleaded is a question of law.”) (citations omitted). Thus,
if BJR applies to corporate officers under California law, the Complaint must include facts pleading around the defense. The Court holds, however, that Plaintiff was not required to plead around BJR because BJR does not apply to corporate decisions of officers in California.

At first blush, Defendant’s argument that BJR applies to both corporate directors as well as officers seems viable. Many California courts, when mentioning BJR, have repeatedly lumped officers and directors together without distinction, albeit in dicta. In addition, and not surprisingly, the distinction as to whether BJR applies to both corporate officers and directors has been the subject of much academic debate as the parties in this case suggest. Despite the confusion and debate, the Court must disagree with Defendant’s contention.

To begin, common law BJR “has two components - one which immunizes directors from personal liability if they act in accordance with its requirements, and another which insulates from court intervention those management decisions which are made by directors in good faith in what the directors believe is the organization’s best interest.” Berg & Berg Enter., LLC, 178 Cal. App. 4th at 1045 (citations and quotations omitted.) California courts traditionally have applied common law BJR to shield from scrutiny qualifying decisions made by a corporation’s board of directors. See, e.g., Lamden v. La Jolla Shores Clubdominium Homeowners Ass’n, 21 Cal. 4th 249, 259 (1999) (emphasis added). Detracting from its traditional application, Defendant proposes that common law BJR apply to corporate officers as well as directors. Defendant’s proposition, however, seems unprecedented as the Court’s research reveals no judicial decision in California applying common law BJR to corporate officers.

Rather, one decision by the California Court of Appeal has held that judicial deference afforded under BJR should not apply to interested directors who effectively were acting as officers. Gaillard v. Natomas, Co., 208 Cal. App. 3d 1250, 1265 (Ct. App. 1989) (“[Interested directors] were not ‘perform[ing] the duties of a director’ as specified in section 309, but were acting as officer employees of the corporation. The
judicial deference afforded under the business judgment rule therefore should not apply.”
(citation and quotations omitted). The Court of Appeal further articulated that “an
officer-director might be liable for particular conduct because of his capacity as an
officer, whereas the other directors would not. This result is in accord with the premise
of the business judgment rule that courts should defer to the business judgment of
disinterested directors who presumably are acting in the best interests of the corporation.”
Gaillard, 208 Cal. App. 3d at 1265. Still, Defendant contends that the broader “second
component” of common law BJR encompassing the general judicial policy of deference
to business decisions should apply to officers. The Court, nevertheless, finds that no
authority exists supporting such a proposition.2

In addition, California’s statutory BJR does not extend its protection to corporate
officers. California Corporations Code § 3093 (“§ 309”), which codifies California’s
common law BJR, expressly pertain to directors’ duties and liabilities and does not
mention “officer” anywhere in its text. Consequently, the California legislature, without
mistake, omitted officers in codifying BJR, and this Court cannot infer otherwise. See
Troppman v. Valverde, 40 Cal. 4th 1121, 1135 n.10 (2007) (Courts are “not to insert what
has been omitted, or to omit what has been inserted . . . .”) (citing Cal. Code Civ. Proc.
§ 1858; Cal. Teachers Ass’n v. Governing Bd. of Rialto Unified Sch. Dist., 14 Cal. 4th
627, 633 (1997)).

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2 Defendant cites cases that do not support his contention that common law BJR applies to
corporate officers. See Berg & Berg Enter., 178 Cal. App. 4th at 1045 (applying BJR to a director); Lee
Ass’n, 42 Cal. 3d 490, 508-09 (1986) (holding that third party tort claims against corporate directors
and officers are governed by the common law “ordinary prudent person” standard); PMC, Inc. v.
Kadisha, 78 Cal. App. 4th 1368, 1386-87 (Ct. App. 2000) (applying tort and agency principles in
determining liability pursuant to third party intentional tort claims); FDIC v. Castetter, 184 F.3d at 1044
(applying BJR to a director).

3 Corporations Code § 309, subdivision (a) provides that “[a] director shall perform the duties
of a director . . . in good faith, in a manner such director believes to be in the best interests of the
corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily
prudent person in a like position would use under similar circumstances.” A director “who performs the
duties of a director in accordance with” this subdivision, as well as other subdivisions that permit
reliance on information provided by others under certain circumstances not relevant here, “shall have
no liability based upon any alleged failure to discharge the person’s obligations as a director.” Cal.
Corp. Code § 309(c).
Likewise, the legislative committee’s comments show that it was the drafters’ intent not to include officers when applying BJR’s standard of care to directors. See San Diego Cnty. Emps. Ret. Ass’n v. Superior Court, 196 Cal. App. 4th 1228, 1237 (Ct. App. 2011) (“A court’s overriding purpose in construing a statute is to ascertain legislative intent... a court looks first to the words of the statute and gives them their usual and ordinary meaning.”) (citations and quotations omitted); see also Pacific Gas & Elec. Co. v. Workers’ Comp. Appeals Bd., 114 Cal. App. 4th 1174, 1180 (Ct. App. 2004) (“Both the legislative history of the statute and the wider historical circumstances of its enactment may be considered in ascertaining the legislative intent.”) (citation omitted).

Specifically, with respect to the standard of care, the legislative comments state, in part: “[I]t is the intent of the draftsmen, by combining the requirement of good faith within the standard of care, to incorporate the familiar concept that, these criteria being satisfied, a director should not be liable for an honest mistake of business judgment.” See Cal. Corp. Code § 309 (Legislative Committee Comment) (quotation omitted). With respect to this standard of care, officers were expressly excluded. See id. (“The standard of care does not include officers.”). The draftsmen reason: “Although a non-director officer may have a duty of care similar to that of a director [ ], his ability to rely on factual information, reports or statements may, depending upon the circumstances of the particular case, be more limited than in the case of a director in view of the greater obligation he may have to be familiar with the affairs of the corporation.” Id. In other words, when the California legislature had the opportunity to codify common law BJR, it purposely excluded its application to corporate officers.

In light of the apparent lack of authority and the California legislature’s expressed intent not to include corporate officers in codifying common law BJR, this Court holds that BJR does not protect officers’ corporate decisions. Accordingly, to the extent Defendant argues that Plaintiff’s Complaint should be dismissed for failure to plead around BJR, the Court DENIES Defendant’s Motion.

Furthermore, the Court finds unavailing Defendant’s argument that Plaintiff’s
allegations pertain to Defendant’s capacity as Indymac’s director as opposed to his role as CEO. It is axiomatic that Plaintiff is the master of the Complaint. See, e.g., Lincoln Property Co. v. Roche, 546 U.S. 81, 90 (2005) (citation omitted) ( “In general, the plaintiff is the master of the complaint and has the option of naming only those parties the plaintiff chooses to sue, subject only to the rules of joinder [of] necessary parties.”). Here, Plaintiff alleges sufficiently that Defendant’s conduct and actions were undertaken in his capacity as an officer. Whether Plaintiff can ultimately prove these allegations is not before this Court at this time. Accordingly, to the extent Defendant’s Motion is based on this argument, the Court DENIES Defendant’s Motion.

V. CONCLUSION

Based on the foregoing, the Court DENIES Defendant’s Motion to Dismiss in its entirety.

IT IS SO ORDERED.

December 13, 2011

[Signature]

HON. OTIS D. WRIGHT, II
UNITED STATES DISTRICT JUDGE
COMPLAINT

Plaintiff, the United States Securities and Exchange Commission (the “Commission”) for its Complaint alleges as follows:

SUMMARY OF ALLEGATIONS

1. This action arises out of a series of materially false and misleading public disclosures by the Federal National Mortgage Association (“Fannie Mae” or the “Company”) and certain of its former senior executives concerning the Company’s exposure to subprime mortgage and reduced documentation Alt-A loans. Eager to promote the impression that Fannie Mae had limited exposure to subprime and Alt-A loans during a period of heightened investor interest in the credit risks associated with these loans, Fannie Mae and its executives misled investors into believing that the Company had far less exposure to these riskier mortgages than in fact existed.

(collectively, "Defendants"), made or substantially assisted others in making materially false and misleading statements regarding Fannie Mae’s exposure to subprime and Alt-A loans.

3. For example, in a February 2007 public filing, Fannie Mae described subprime loans as loans “made to borrowers with weaker credit histories” and reported that 0.2%, or approximately $4.8 billion, of its Single Family credit book of business as of December 31, 2006, consisted of subprime mortgage loans or structured Fannie Mae Mortgage Backed Securities (“MBS”) backed by subprime mortgage loans.

4. Fannie Mae did not disclose to investors that in calculating the Company’s reported exposure to subprime loans, Fannie Mae did not include loan products specifically targeted by the Company towards borrowers with weaker credit histories, including Expanded Approval (“EA”) loans. As of December 31, 2006, the amount of EA loans owned or securitized in the Company’s single-family credit business was approximately $43.3 billion, yet none of these loans were included in the Company’s disclosed subprime exposure.

5. Fannie Mae’s exclusion of loans such as EA from its subprime disclosures was particularly misleading because EA loans were exactly the type of loans that investors would reasonably believe Fannie Mae included when calculating its exposure to subprime loans. In fact, the Company identified EA as its “most significant initiative to serve credit impaired borrowers” in response to regulatory requests for information on its subprime loans. In addition, all of the Defendants knew that EA loans had higher average serious delinquency rates, higher credit losses, and lower average credit scores than the loans Fannie Mae included when calculating its disclosed subprime loan exposure.

6. In a November 2007 public filing, Fannie Mae described subprime loans as a loan to a borrower with a “weaker credit profile than that of a prime borrower,” classified mortgage
loans as “subprime” if the mortgage loans were originated by a “specialty” subprime lender or a “subprime division of a large lender,” and again represented that only 0.2%, or approximately $4.8 billion, of its Single Family credit book of business consisted of subprime mortgage loans or structured Fannie Mae MBS backed by subprime mortgage loans as of both March 31, 2007, and June 30, 2007.

7. Fannie Mae did not tell investors that in calculating the Company’s exposure to subprime loans reported in this filing, Fannie Mae again did not include at least $43 billion of EA loans, included loans from only fifteen loan originators of the approximately 210 lenders listed on the HUD Subprime Lender list, and did not even have the capacity to track whether loans were originated by a subprime division of a large lender.

8. Fannie Mae made similarly misleading disclosures concerning its exposure to subprime loans in public filings throughout the Relevant Period. The result of these disclosures was to mislead investors into seriously underestimating Fannie Mae’s exposure to subprime loans.

9. Similarly, Fannie Mae misled investors concerning its exposure to Alt-A loans with reduced or alternative documentation requirements. Fannie Mae did not disclose the total percentage of its Single Family mortgage guarantee business consisting of reduced documentation loans as reflected in its own internal reporting, which Defendants routinely received throughout the Relevant Period.

10. Instead, in its public disclosures, Fannie Mae described Alt-A loans as loans with lower or alternative documentation requirements, and then further stated that it classified loans as “Alt-A if the lenders that deliver the mortgage loans to us have classified the loans as Alt-A based on documentation or other product features.”
11. Based on this reporting construct, for example, in a May 2007 filing, Fannie Mae publicly reported that approximately 11% of its total Single Family mortgage credit book of business as of March 31, 2007, consisted of Alt-A mortgage loans or Fannie Mae mortgage securities backed by Alt-A mortgage loans. This filing materially underreported the extent of Fannie Mae’s total exposure to low documentation loans, which was approximately 17.9% as of March 31, 2007, based on Fannie Mae’s own internal records.

12. Fannie Mae also did not disclose to investors that certain reduced documentation loans it received from lenders were not included in the calculation of Fannie Mae’s publicly disclosed Alt-A loan exposure if the reduced documentation requirements were internally designated as Lender-Selected. Despite this exclusion, during the Relevant Period, Lender-Selected Reduced Documentation Loans had a serious delinquency rate that was substantially higher than Fannie Mae’s full documentation loans with a similar credit risk profile. Further, Fannie Mae did not tell investors that the Company itself provided lenders—in advance—with the coding designations for Alt-A versus Lender-Selected.

13. The result of these disclosures was to mislead investors into materially underestimating Fannie Mae’s exposure to reduced documentation loans. Fannie Mae made similarly misleading disclosures concerning its exposure to reduced documentation loans in public filings throughout the Relevant Period.

14. Mudd, Lund and Dallavecchia each knew, based on reports and internal data they received on a regular basis, that the Company’s reported exposure to subprime and Alt-A loans was inaccurate. The misleading statements describing subprime and Alt-A loans occurred in periodic and other filings with the Commission, and public settings, including investor and analyst calls and media interviews. Mudd, Lund and Dallavecchia reviewed and approved each
of the false public filings. Mudd and Dallavecchia each made public statements falsely claiming that the Company's exposure to subprime loans was minimal.

15. By engaging in the misconduct described herein, Mudd violated and aided and abetted the violation of the antifraud and reporting provisions of the federal securities laws; Dallavecchia violated the antifraud provisions and aided and abetted the violation of the antifraud and reporting provisions of the federal securities laws; and Lund aided and abetted violations of the antifraud and reporting provisions of the federal securities laws. The Commission seeks injunctive relief, disgorgement of profits, prejudgment interest, civil penalties and other appropriate and necessary equitable relief from both defendants.

JURISDICTION AND VENUE

16. The Court has jurisdiction over this action pursuant to Sections 20(b) and 22(a) of the Securities Act [15 U.S.C. §§ 77t(b) and 77v(a)] and Sections 21(d), 21(e) and 27 of the Exchange Act [15 U.S.C. §§ 78u(d), 78u(e), and 78aa)], and 28 U.S.C. § 1331.

17. Venue is proper in the Court pursuant to Section 22(a) of the Securities Act, [15 U.S.C. §77v(a)], and Section 27 of the Exchange Act [15 U.S.C. § 78aa] because certain of the acts, practices, transactions and courses of business constituting the violations alleged herein occurred within this judicial district.

18. Defendants Mudd, Dallavecchia and Lund directly or indirectly made use of the means or instrumentalities of interstate commerce, the mails, and the facilities of a national securities exchange in connection with the transactions, acts, practices and courses of business alleged in this Complaint.
DEFENDANTS


20. Enrico Dallavecchia, age 50, was Chief Risk Officer ("CRO") of Fannie Mae from June 2006 until August 2008 when he was removed by the Board along with two other executives. As CRO, Dallavecchia sub-certified all of Fannie Mae’s Annual Forms 10-K and quarterly Forms 10-Q. He also reviewed and approved Fannie Mae’s Forms 12b-25 dated February 27, 2007 and May 9, 2007. Dallavecchia is a resident of Potomac, Maryland.

21. Thomas Lund, age 53, was a Fannie Mae employee since 1995 who served as Executive Vice-President ("EVP") of Fannie Mae’s Single Family Credit Guarantee ("Single Family") business from July 2005 until June 2009. As EVP of the Single Family business, Lund sub-certified all of Fannie Mae’s Annual Forms 10-K and quarterly Forms 10-Q. He also reviewed and approved Fannie Mae’s Forms 12b-25 dated February 27, 2007, and May 9, 2007. Lund is a resident of Cabin John, Maryland.
RELEVANT ENTITY

22. **Fannie Mae** was, at all times relevant to this Complaint, a shareholder-owned Government Sponsored Enterprise ("GSE") established by the U.S. Congress in 1938 to support liquidity, stability and affordability in the secondary mortgage market, where existing mortgage-related assets are purchased and sold. Fannie Mae provides market liquidity by securitizing mortgage loans originated by lenders in the primary mortgage market into Fannie Mae MBS, and purchasing mortgage loans and mortgage-related securities in the secondary market for Fannie Mae's mortgage portfolio. By law, securities issued by Fannie Mae are "exempted securities." Accordingly, registration statements with respect to Fannie Mae's offerings are not filed with the Commission.

23. In March 2003, Fannie Mae voluntarily registered its common stock with the SEC under Section 12(g) of the Exchange Act and has, since then, been required to file periodic and current reports with the SEC, including annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K.

24. Throughout the Relevant Period, Fannie Mae's common stock traded publicly on the New York Stock Exchange ("NYSE"). Its principal place of business was and is in Washington, D.C.


26. On August 8, 2008, Fannie Mae announced a net loss of $2.3 billion. Fannie Mae stated that it was no longer certain that it would have enough capital to carry it through its losses. At this time, the Company announced that the main cause for its increased credit losses was the
deterioration in the credit performance of a small number of higher risk loan products, including Alt-A loans. As of the third quarter of 2008, more than 70% of Fannie Mae’s credit losses were caused by its subprime and Alt-A loans.

27. On September 6, 2008, FHFA placed Fannie Mae into conservatorship and, as conservator, FHFA succeeded to all the rights, titles, powers and privileges of Fannie Mae, its shareholders, and the officers or directors of Fannie Mae with respect to the Company and its assets.

BACKGROUND

Fannie Mae Single Family Mortgage Guarantee Business

28. Fannie Mae’s Single Family mortgage credit book of business was $2.34 trillion in 2006, $2.65 trillion in 2007, and $2.8 trillion in September 2008 when the Company was placed into Conservatorship.

29. During the Relevant Period, Fannie Mae operated three business segments—(i) Single Family; (ii) Multi-Family; and, (iii) Capital Markets.

30. Fannie Mae’s primary business segment is the Single Family business, which works with lender customers to securitize Single Family mortgage loans (relating to properties with four or fewer residential units) into Fannie Mae MBS and to facilitate the purchase of Single Family mortgage loans for Fannie Mae’s portfolio. Revenues in Fannie Mae’s Single Family business are derived primarily from fees received as compensation for guaranteeing the timely payment of principal and interest on mortgage loans underlying Fannie Mae’s Single Family MBS. During the Relevant Period, the Single Family business comprised approximately 51%, 64% and 54% of Fannie Mae’s net revenues in each of 2006, 2007, and 2008, respectively.

31. Fannie Mae’s Single Family business principally acquired loans through one of two channels: (i) the Lender (or flow) channel, which obtained loans from lenders on a going-
forward or contractual basis through agreements to purchase loans from lenders before those
loans were originated based on certain terms and conditions; and, (ii) the Investor (or bulk)
channel, which acquired from lenders loans that had already been originated based on data files
for those loans that were provided by lenders to Fannie Mae for review prior to purchase.

32. Fannie Mae’s Single Family business had a proprietary automated underwriting
system called Desktop Underwriter ("DU"). DU was used by the Single Family business to
assess the primary risk factors of a loan in order to measure that loan’s default risk. Customers
of Fannie Mae also used DU to originate and underwrite loans so those customers would know—
in advance—whether any given loan was eligible for sale to Fannie Mae. When DU provided a
Fannie Mae customer with an “approve” for a loan application, that customer knew that Fannie
Mae would agree to acquire that loan and waive certain warrants and representations so long as
the loan is originated in accordance with information originally submitted via DU.

33. At various times during the Relevant Period, Fannie Mae adjusted and
recalibrated the risk assessment models within its DU system. For instance, in 2006, in
connection with its Say Yes strategy to regain market share, Fannie Mae employed a “DU Bump”
wherein eligibility parameters were expanded to provide more “approve” messages in DU for
larger volumes of loans with lower FICO scores and higher LTVs than previously permitted. By
adjusting and recalibrating the risk assessment models within its DU system, Fannie Mae took on
increasingly risky loans during the Relevant Period.

34. While many mortgage originators used Fannie Mae’s DU system as part of the
underwriting process, many large mortgage lenders also had their own automated origination and
underwriting platforms. For instance, during the Relevant Period, Countrywide Financial
Corporation's (Countrywide) proprietary underwriting system was called Clues, and Freddie Mac had a system similar to DU that was called Loan Prospector.

35. Not all loans acquired by Fannie Mae were underwritten using DU. During the Relevant Period, Fannie Mae acquired and securitized mortgage loans that were underwritten through other automated underwriting systems or simply by agreed-upon standards in a manual process. For instance, Fannie Mae acquired loans under Countrywide Financials Fast and Easy loan program that were underwritten using Countrywide's Clues system. Similarly, most of the My Community Mortgage ("MCM") loans Fannie Mae acquired during the Relevant Period were manually underwritten by loan officers and mortgage brokers at various companies nationwide and not evaluated using DU.

Mudd's Role at Fannie Mae and his Disclosure Responsibilities

36. As COO and then CEO from 2000 until September 2008, Mudd oversaw all three Fannie Mae business units, including the Single Family business. Additionally, during the Relevant Period Mudd was a member of the Board of Directors, the Audit Committee, a regular attendee at the Board’s Risk Policy and Capital Committee meetings, held regular weekly meetings with his direct reports the business units, and attended quarterly business unit briefings. Mudd regularly read, reviewed and marked-up draft periodic filings and met with individuals who provided sub-certifications prior to certifying Forms 10-K and Forms 10-Q.

37. As CEO, and based on his prior role as COO, Mudd possessed detailed operational knowledge concerning Fannie Mae's subprime and reduced documentation loan exposure. Further, during the Relevant Period, Mudd routinely received acquisition, delinquency and credit loss data concerning subprime and Alt-A loans. Mudd certified filings and made
public statements describing Fannie Mae’s subprime and reduced documentation loan exposure knowing that those public statements were false and misleading.

38. With regard to subprime-quality and reduced documentation loans, he received at least quarterly risk briefings on the Single Family business in which data showing Fannie Mae’s total subprime and reduced documentation loan exposure was presented. Additionally, Mudd met weekly with his direct reports, who, among other things, informed him about Single Family loan acquisitions, trends and status with respect to market share targets.

39. Mudd was well aware of the Company’s increased acquisition of reduced documentation loans—indeed, Mudd himself directed the company to pursue that market. For instance, in an April 26, 2006, Credit Risk meeting following a presentation on reduced documentation loans and their risks by the Single Family credit officer (who noted low documentation loans were riskier), Mudd stated that “the market is moving to low documentation and we need to actively pursue the keys to this market.”

40. Mudd oversaw Fannie Mae’s 2006 market share increase during which the Single Family business grew its market share from 20% of total mortgage loan originations to 25% by acquiring more subprime and reduced documentation loans. In part as a result of Fannie Mae’s successful market share growth and timely filing of the company’s periodic reports, Mudd’s taxable compensation grew from $6.16 million in 2006 to $10.64 million in 2007.

41. Throughout the Relevant Period, in addition to wages earned, Mudd—like all Fannie Mae executives—received an Annual Incentive Plan (“AIP”) bonus that was tied to two things: (i) Company performance, measured by attaining corporate year-end goals; and, (ii) personal performance, measured by attaining individual year-end goals. The AIP program was designed to “put part of the participants’ total compensation package at risk, based on the
achievement of one-year goals for both the participant and the corporation” with individual performance driving the AIP payout each year, adjusted for corporate goal performance. The AIP bonus for a given year’s performance was paid out in the following fiscal year such that an AIP bonus for performance in 2006 was received in 2007.

42. In his 2006 year-end report to the Board, Mudd noted that the Single Family business increased its market share, in part by entering new markets “especially Alt-A and subprime,” that in response to filing the Company’s 2004 Form 10-K, “the market and ratings agency reactions generally were positive—there were no big surprises,” and that the Company’s stock price improved by more than 20%. Mudd’s 2006 taxable compensation was more than $6 million with approximately $2.5 million from his AIP bonus. In 2007, Fannie Mae’s corporate goals included growing revenue, which the Single Family business set about doing by increasing its book by 5.6% with a plan to acquire more Alt-A and subprime loans. In 2007, Mudd’s taxable compensation was more than $10 million—with $3.5 million from his AIP bonus alone. Mudd served as CEO for only eight full months in 2008, but his taxable compensation in 2008 was $7.4 million—with more than $2.2 million from his AIP bonus based on his personal performance for 2007.

43. Mudd was also well aware that investors were increasingly focused on subprime loans. In a February 6, 2007 memo to the Board of Directors of Fannie Mae, Mudd wrote that investors and analysts were “focused on our market share, subprime risk and our portfolio strategy.” As CEO of Fannie Mae, Mudd routinely interacted with investors and the media. During the Relevant Period, as investors and the media increasingly focused their attention on the credit risks associated with subprime and Alt-A mortgage loans, Mudd made numerous false and misleading statements that downplayed the Company’s exposure to such loans and provided
false assurance to the market that Fannie Mae was participating in a safer segment of the mortgage market. Indeed, Mudd created the false perception that Fannie Mae’s participation in high credit risk loans such as Alt-A and subprime was small and contained, and reinforced this false and misleading impression, telling investors that Fannie Mae was in the prime—not the subprime—market with a different, higher set of standards and underwriting.

44. Mudd was knowledgeable about the mortgage markets. While CEO of Fannie Mae, Mudd made numerous appearances before Congress to testify about the mortgage markets, the role of the GSEs and the subprime market. In that setting, Mudd repeatedly minimized Fannie Mae’s reported exposure, falsely claiming it was less than 2% of the Company’s book or that Fannie Mae held about zero percent subprime.

45. During the Relevant Period, Mudd received, reviewed and commented on (often in handwritten notes) multiple draft versions of each of Fannie Mae’s periodic and other filings with the Commission. Prior to certification, Mudd met—seriatim—with officers of the Company who had provided sub-certifications to discuss issues presented by upcoming public filings. Also, as a member of the Audit Committee at Fannie Mae and the Board of Directors, Mudd participated in final committee and board reviews of Fannie Mae’s Forms 10-K and Forms 10-Q during the Relevant Period prior to certifying.

Lund’s Role at Fannie Mae and his Disclosure Responsibilities

46. Lund served as an officer at Fannie Mae for fourteen years, from 1995 until his retirement in 2009, and was EVP of the Single Family business at Fannie Mae from 2005 forward. Lund was a member of the Executive Committee and was the senior-most executive in charge of the Single Family business. He received and provided regular reports on the actual
volumes of Single Family subprime and reduced documentation loan acquisitions, the associated
delinquency rates, and credit losses for all subprime-quality and reduced documentation loans.

47. Lund received Single Family acquisition data on at least a monthly basis detailing
acquisitions of reduced documentation and subprime-quality loans. As the senior executive in
charge of the Single Family business, Lund was knowledgeable about Fannie Mae’s loan
acquisitions and the performance of Fannie Mae’s high credit risk loan portfolio.

48. At Mudd’s weekly direct reports meetings, Lund provided Single Family business
overviews to the CEO and others. Lund also held weekly meetings with his direct reports. The
SVP for the Western Business Office of Fannie Mae routinely updated Lund on that region’s
then-most significant customers: Countrywide, IndyMac and WAMU.

49. Lund was also a member of Fannie Mae’s Disclosure Committee, which oversaw
the preparation of the Company’s periodic (and other) filings with the Commission. During the
Relevant Period, Lund was the only Single Family business executive that sat on Fannie Mae’s
Disclosure Committee and was, therefore, uniquely positioned to inform that Committee about
the Single Family loan portfolio. Fannie Mae attendance records from the Relevant Period
reflect that Lund routinely attended Disclosure Committee meetings where contemplated draft
filings with the Commission were reviewed and issues discussed.

50. During the Relevant Period, Lund also received and reviewed draft versions of
Fannie Mae’s periodic and other filings with the Commission before they were publicly filed.
While he knew the difference between the actual and the reported volumes of subprime and
reduced documentation loans, Lund did not ensure that investors were likewise informed.
Instead, he sub-certified as to the accuracy of the Company’s materially false and misleading
disclosures concerning its exposure to subprime and Alt-A loans, which were directly within his area of knowledge and responsibility.

51. During his tenure as EVP of the Single Family business, Lund oversaw Fannie Mae’s 2006 market share growth, and, in part as a result of its success and timely filing of the company’s periodic reports, Lund’s taxable compensation grew from $833,658 in 2006 to $1.9 million in 2007.

52. Throughout the Relevant Period, in addition to wages earned, Lund received an AIP bonus tied to attaining corporate and personal goals. In 2006, Fannie Mae’s corporate goals included filing its 2004 Form 10-K, hitting Single Family MBS issuance targets, increasing profitability in the Single Family business, and reintroducing the Company to investors. In 2006, owing to its Say Yes business strategy, the Single Family business exceeded its goal of increasing market share from 20% to 25.4%, and on a corporate level, the Company grew its stock price more than 20%—from just under $49 to over $60 per share. Lund’s 2006 taxable compensation was $833,658 with $792,960 from his AIP bonus. By contrast, in 2005, Lund’s wages totaled $497,285. This represented a 67% increase in compensation between 2005 and 2006.

_Dallavecchia’s Role at Fannie Mae and his Disclosure Responsibilities_

53. Enrico Dallavecchia served as Fannie Mae’s EVP and Chief Risk Officer from June 2006 through August 2008. In that position, Dallavecchia reported directly to Mudd and was responsible for credit, market, counterparty, and operational risk oversight for all business units within Fannie Mae, which included measuring, reporting, and monitoring Fannie Mae’s risk profile and formulating the Company’s risk policies. As the senior-most executive in charge of credit risk, Dallavecchia received and provided regular reports on the actual volumes of
subprime and reduced documentation loan acquisitions, the associated delinquency rates, and
credit losses for those loans at Fannie Mae.

54. Dallavecchia was also a member of Fannie Mae's Disclosure Committee, which
oversaw the preparation of the Company's periodic (and other) filings with the Commission.
During the Relevant Period, Dallavecchia was the only executive from the Chief Risk Office
who sat on Fannie Mae's Disclosure Committee. As CRO, Dallavecchia was uniquely
positioned to recognize and inform others about the overall credit risks presented by Fannie
Mae's loan portfolio.

55. Fannie Mae attendance records from the Relevant Period reflect that Dallavecchia
routinely attended Disclosure Committee meetings where contemplated draft filings with the
Commission were reviewed and issues discussed. Dallavecchia personally received and
reviewed draft versions of Fannie Mae's periodic and other filings with the Commission.
Dallavecchia sub-certified as to the accuracy of the Company's materially false and misleading
disclosures concerning its exposure to subprime and Alt-A loans, thereby substantially assisting
the Company's fraud.

56. Dallavecchia and the Single Family CRO team assisted in drafting the definition
of subprime contained in the February 27, 2007, Form 12b-25 in which Fannie Mae first
quantified its subprime exposure.

57. Dallavecchia occasionally led the Board's Risk, Policy and Capital Committee
meetings and attended Executive Committee meetings. In those roles, Dallavecchia received
information and data concerning Fannie Mae's total exposure to reduced documentation and
subprime loans.
58. As Fannie Mae’s CRO, Dallavecchia had credit risk oversight for Fannie Mae’s 2006 market share growth, and, in part as a result of its success and timely filing of the company’s periodic reports, Dallavecchia’s taxable compensation more than doubled from $617,886 for 7 months of service in 2006 to $2.68 million in 2007.

59. Throughout the Relevant Period, in addition to wages earned, Dallavecchia received an AIP bonus tied to attaining corporate and personal goals. When Dallavecchia began as Fannie Mae’s CRO, the then-Chairman of the Board of Directors noted in an address to Senior Management, “We have to think differently and creatively about risk ... Enrico Dallavecchia was not brought on-board to be a business dampener.” In 2006, Fannie Mae’s corporate goals included filing its 2004 Form 10-K, increasing its earnings per share, profitability, and subprime penetration while building a CRO function and implementing business unit risk officers. In his year-end 2006 self-assessment, Dallavecchia noted that the most significant achievement was his office playing a role “from both a risk perspective and also from a business perspective.” Dallavecchia further noted that his office “authored the Risk Section of the 2004 10-K.”

60. In 2007, Fannie Mae’s corporate goals included growing revenue and timely periodic filings with the Commission. In addition to Fannie Mae meeting most of its 2007 corporate goals with respect to growing revenue, Mudd’s year-end 2007 review of Dallavecchia noted that he completed the build out of the CRO structure, developed risk limits and did good work on the Board Risk Policy and Capital Committee. Dallavecchia’s 2007 taxable compensation was more than $2.6 million with $1.04 million from his AIP bonus.

61. One month prior to conservatorship, in August 2008, Dallavecchia was terminated as CRO. Accordingly, Dallavecchia served as CRO for only seven full months in 2008; his 2008 taxable compensation was $2.3 million with $923,780 from his AIP bonus.
OVERVIEW OF FANNIE MAE LOAN PROGRAMS

Fannie Mae’s Reduced Documentation Loan Programs

62. During the 1990s, Fannie Mae had limited market presence in Alt-A mortgage loans, which were not a large part of mortgage originations nationwide.

63. In July 1999, Fannie Mae and Countrywide Home Loans entered into an alliance agreement, which included a reduced documentation loan program called the “internet loan,” which was soon thereafter re-branded by Countrywide as the Fast and Easy loan. This loan program featured a streamlined documentation process, which allowed mortgage-loan applicants with a qualifying FICO credit score to be preapproved for a mortgage loan without providing documentation to verify income or assets.

64. The Fast and Easy loan program was popular. Fannie Mae executives referred to it as Countrywide’s “signature” or “flagship” mortgage product. By the mid-2000s, other mortgage lenders developed similar reduced documentation loan programs such as Mortgage Express and PaperSaver—many of which Fannie Mae acquired in ever-increasing volumes throughout the Relevant Period.

65. Alt-A loans proliferated in the marketplace, and during the Relevant Period Fannie Mae’s Single Family business pushed to increase its acquisitions of those Alt-A loans. By year-end 2006, 35% of Fannie Mae’s Single Family loan acquisitions were Alt-A loans. By year-end 2007, that number increased to 37%, and by June 30, 2008, 26% of its Single Family loan acquisitions were Alt-A loans.

Fannie Mae’s Subprime Loan Programs

66. Since the late 1990s, Fannie Mae acquired and guaranteed subprime mortgage loans described in Fannie Mae periodic filings during the Relevant Period as loans made to
“borrowers with weaker credit histories” or “weaker credit profile[s]” that “have a higher likelihood of default than prime loans” as part of the Company’s two primary programs for borrowers with weaker credit histories: Expanded Approval/Timely Payment Rewards (“EA”) and MyCommunityMortgage (“MCM”).

67. The credit risks posed by these programs were well understood by senior management at Fannie Mae. Mudd was familiar with the EA and MCM loan programs and the credit risks those loan programs entailed. Throughout the Relevant Period all the Defendants received reports, briefings and presentations containing acquisition volume, Serious Delinquency Rates (“SDQ Rates”) and credit loss data with respect to Fannie Mae’s EA and MCM loans. Throughout the Relevant Period, Mudd, Lund and Dallavecchia knew that EA loans were—on average—the highest credit risk loans on Fannie Mae’s book of business, and knew that EA loans contributed disproportionately to Fannie Mae’s credit losses.

68. Indeed, in May 2001, Mudd wrote a memo to the then-CEO noting that EA loans “are the highest default risk loans we have ever done.”

69. Traditionally, Fannie Mae treated EA loans as part of its subprime exposure. For example, a March 2002 Report prepared for the U.S. Department of Housing and Urban Development (“HUD”) with the participation of Fannie Mae, entitled “Subprime Markets, the Role of GSEs and Risk-Based Pricing,” stated under a section entitled ‘Agency Subprime Lending Products’ that:

The agencies are increasing their presence in the subprime market by rolling-out new subprime mortgage products through updated versions of their automated underwriting systems. Fannie Mae seller/servicers now offer loan products to three groups of credit-impaired borrowers under two new programs. Fannie Mae’s Expanded Approval program allows lenders to approve borrowers who would have been formerly classified as ‘Refer with Caution’ ... by Fannie Mae’s Desktop Underwriter (DU). ... The Expanded Approval products are recent innovations, and, according to Fannie Mae representatives, account for a
relatively small portion of that GSE’s book of business ... At most, according to a Fannie Mae stock analyst, these subprime loan purchases will account for no more than five percent of that GSE’s purchase volumes. (Emphasis added).

70. Similarly, in its annual exam process in 2004 and 2005, Fannie Mae’s then-primary regulator, the Office of Federal Housing Enterprise Oversight’s (“OFHEO”) asked for information on Fannie Mae’s total Single Family subprime loan exposure, specifically requesting: “[t]he volume of loans purchased in 2004 [and 2005] defined as CE structured subprime ... or sub-prime as otherwise defined.” In March of 2005 and April of 2006, respectively, Fannie Mae responded by providing OFHEO with information on mortgage loan purchases and mortgage-backed securities under the EA program, describing the EA program as, “our most significant initiative to serve credit-impaired borrowers.”

71. Moreover, before December 2006, various internal Fannie Mae reports, including reports to the Board, identified subprime loans as including: (i) investor channel subprime loans acquired as part of its Subprime NBI; (ii) A- Deal loans that pre-date December 2005; and, (iii) EA loans.

Fannie Mae Excluded EA and MCM Loans from its Subprime Disclosure

72. When Fannie Mae first reported its quantitative exposure to subprime loans in a filing with the Commission on February 27, 2007, the Company broadly defined subprime as loans to “borrowers with weaker credit histories.” EA and MCM loans fell squarely within this definition, but were not included in the accompanying quantification of Fannie Mae’s subprime exposure.

73. Instead, the quantification consisted primarily of private label securities it held that were marketed as being backed by subprime loans, certain “A-” loans that the company acquired prior to 2005, and certain loans that had been acquired through a limited new business
initiative beginning in 2006. Fannie Mae's subprime quantification did not include significant numbers of other loans that fell within its published subprime definition of loans to "borrowers with weaker credit histories."

74. Throughout the Relevant Period, EA loans had, on average, higher SDQ rates than the loans Fannie Mae used in calculating its disclosed subprime exposure. Senior management at Fannie Mae, including the Defendants, were aware of this fact, as SDQ rates were tracked and regularly included in reports and other internal presentations. For example, in a meeting of the Risk Policy and Capital Committee ("RPCC") of Fannie Mae's Board, the CRO reported that as of July 2007 Fannie Mae's SDQ rates for EA were 5.57% (the highest on its book); by contrast, the SDQ rate of its disclosed subprime loans were 4.95%.

75. Throughout the Relevant Period, the credit risk associated with Fannie Mae's EA and MCM acquisitions was reported to and tracked by senior management, including Defendants, in terms of acquisition volume, delinquencies, and credit losses—alongside those loans that were included when quantifying its disclosed "subprime" exposure in its public filings. EA and MCM loans were routinely included in reports tracking Fannie Mae's high risk loan products (which ranged from three to five or more loan types during the Relevant Period) that were received by the Defendants.

76. Also during the Relevant Period, senior executives, including the Defendants, were provided with credit loss data that showed that the greatest amount of credit losses attributable to any one loan type or product on Fannie Mae's Single Family book were attributable to the EA product. For instance, in an October 26, 2007, Disclosure Committee report, it is noted that EA loans were responsible for $188.9 million in losses and MCM loans
were responsible for $16 million in losses—compared to $5.5 million in losses for the loan population Fannie Mae disclosed as its subprime exposure.

77. As a portion of Fannie Mae’s book of business, EA loans increased in volume between 2006 and 2008 from $43.3 billion to $58.3 billion, totaling approximately 2% of the company’s book of business during the Relevant Period. MCM loans, which were intended for low-to-moderate income borrowers, accounted for between 0.3% and 1.5% of Fannie Mae’s book of business over the same period. None of these loans were included in Fannie Mae’s calculation of its publicly disclosed subprime exposure.

FANNIE MAE'S DISCLOSURES

Overview

78. Since 2003 in its annual Form 10-K filings, Fannie Mae included a table of credit risk characteristics for Single Family loans ("Credit Risk Tables"). Those Credit Risk Tables contain information describing risk characteristics such as original LTV, Product Type, Property Type, Occupancy Type, FICO Credit Score bands, Loan Purpose, Geographic Concentration, and Origination Year. The tables did not include any statement or representation as to whether Fannie Mae held subprime and Alt-A loans.

79. During the Relevant Period, Fannie Mae also provided narrative disclosures in its periodic filings concerning the company’s expectation of credit losses, delinquencies, market environment and economic factors that could impact the company’s business. These narrative disclosures repeatedly contained materially false and misleading statements and representations regarding Fannie Mae’s Alt-A and subprime exposure.

80. During part of the Relevant Period, Fannie Mae also filed supplemental Form 8-Ks filed simultaneously with various Forms 10-K and Forms 10-Q that contained credit characteristic information concerning its Single Family book of business, along with a purported
tabular description of Fannie Mae's subprime and Alt-A holdings. None of the information contained in those supplement Form 8-Ks provided investors with an accurate description of the Company's subprime or Alt-A holdings. Although Fannie Mae claimed to provide additional information to investors, labeling a portion of loans "subprime" and "Alt-A" in a disclosure table, those tables included only a fraction of the loans that met Fannie Mae's own public definition of "subprime" or "Alt-A" in the quantification under each category. These supplemental disclosures deliberately gave investors false comfort that the Company's exposure to subprime and Alt-A loans was dramatically smaller than it, in fact, was.

**Fannie Mae's Initial Quantification of Subprime Exposure Was False and Misleading**

81. By February 2007, following S&P's downgrade of high-profile subprime lender, New Century Financial Corporation, and other indicia of subprime market turmoil—including HSBC Holdings PLC's announcement that the U.S. subprime market was unstable—investors were increasingly focused on subprime loans and the risks associated with these loans.

82. In a February 6, 2007 memo to the Board of Directors of Fannie Mae, Mudd wrote that investors and analysts were "focused on our market share, subprime risk and our portfolio strategy." With this backdrop, Fannie Mae's Disclosure Committee, which included Lund and Dallavecchia as members, decided to include a quantitative disclosure of Fannie Mae's exposure to subprime loans in the Company's public filings.

83. According to an internal e-mail sent to both Lund and Dallavecchia, "Enrico [Dallavecchia]'s team has been tasked with developing a definition of 'sub-prime,' as well as providing the numbers for the 12b-25."
84. On February 23, 2007 in a call with investors Mudd stated: “Subprime mortgages are those offered to borrowers with damaged credit” and Fannie Mae’s “subprime investment constitutes well below 2 percent of our book.”

85. Four days later on February 27, 2007, in a Form 12b-25 filing with the Commission, the Company disclosed the following regarding Fannie Mae’s subprime exposure:

Although there is no uniform definition for sub-prime ... loans across the mortgage industry... sub-prime loans typically are made to borrowers with weaker credit histories ... We estimate that approximately 0.2% of our single-family mortgage credit book of business as of December 31, 2006 consisted of sub-prime mortgage loans or structured Fannie Mae MBS backed by sub-prime mortgage loans ... We estimate that approximately 2% of our single-family mortgage credit book of business as of December 31, 2006 consisted of private-label mortgage-related securities backed by sub-prime mortgage loans and, to a lesser extent, resecuritizations of private-label mortgage-related securities backed by sub-prime mortgage loans. (Emphasis added.)

86. The percentage of subprime loans disclosed by Fannie Mae did not include a material number of subprime-quality loans in the Fannie Mae Single Family mortgage credit book of business as of December 31, 2006, made to “borrowers with weaker credit histories.” In particular, the percentage of subprime loans disclosed by Fannie Mae did not include the EA and MCM loans, which were the very types of loans that investors (and analysts) believed were the company’s primary subprime exposure.

87. Fannie Mae’s exposure to EA loans in its Single Family mortgage credit book of business was approximately $43.3 billion as of December 31, 2006—approximately 10 times greater than the 0.2% ($4.8 billion) disclosed as “sub-prime mortgage loans or structured Fannie Mae MBS back by subprime loans” as of December 31, 2006.

88. The February 27, 2007, disclosure falsely stated that Fannie Mae’s total exposure to loans made to borrowers with weaker credit histories (subprime) was 2.2% of its total
mortgage credit book of business, when in fact its exposure was at least 4.64% (as of December 31, 2006).

89. Nothing in Fannie Mae’s public disclosures alerted investors that it held a much larger volume of loans that matched the Company’s description of subprime loans but were not included in the reported subprime number.

90. Although Fannie Mae excluded EA from its subprime reporting, Fannie Mae’s EA loans had, on average throughout the Relevant Period, SDQ rates higher than those loans Fannie Mae actually included in calculating its disclosed exposure to subprime loans. As of January 2007, EA loans had an SDQ rate of 5.69%; disclosed Subprime loans (as-quantified in Fannie Mae’s filings) had an SDQ rate of 4.82%.

91. EA and MCM loans accounted for a higher percentage of Single Family credit losses (20.4%) at year-end 2006 than loans Fannie reported as its subprime exposure, which at the time were responsible for no credit losses.

92. Mudd, Lund and Dallavecchia each reviewed and approved the February 27, 2007, Form 12b-25 statement before it was released by the Company, knowing its quantified subprime disclosure excluded EA and MCM loans.

_Dallavecchia’s False and Misleading Statement_  

93. That same day, February 27, 2007, Dallavecchia spoke directly to investors on a conference call and explained:

In our filing today, we also indicate that we have increased our participation in subprime product in 2006. Our purchases have been prudent and have been made when we concluded that they would contribute to our mission objectives or they would gener a profitable return. Given our view of the subprime market generally, let me offers [sic] some insight into our approach to this segment and the exposure to the risk. The first point, as per our filing, is that our exposure is modest. Approximately 0.2% of our single-family credit book of business consisted of subprime loans or Fannie Mae MBS backed by subprime loans ... to
conclude my thoughts on credit risk, I anticipate our credit losses will trend upward as a result of the general softening of the housing market ... At the same time, I would advise that you consider our exposure in light of the strength of the risk characteristics I have described and the immaterial size of our participation in the subprime market. (Emphasis added.)

94. Despite knowledge that the Company had exposure to approximately $43.3 billion worth of EA loans and $13.8 billion in MCM loans as of December 31, 2006, which fell squarely within Fannie Mae’s publicly stated definition of subprime, Dallavecchia falsely represented that only “0.2% of [Fannie Mae’s] Single Family credit book of business consisted of subprime loans,”

95. Moreover, Dallavecchia further misled investors regarding Fannie Mae’s subprime exposure by emphasizing that Fannie Mae’s subprime was “modest,” “prudent” and “immaterial.” He gave the public these assurances knowing Fannie Mae’s exposure to EA loans was at least ten times greater than “0.2% of [Fannie Mae’s] single-family credit book of business.” His purpose was clear. As Dallavecchia explained in an internal email on February 23, 2007, in preparing for the investor call, “I am trying to say that if you look at our guarantee book of business we have an insignificant exposure in subprime loans.”

Mudd’s False and Misleading Testimony Before Congress

96. On March 15, 2007, Mudd appeared before the House Financial Services Committee and gave testimony in a hearing on Legislative Proposals on GSE Reform. Mudd was asked: “And you have not engaged in the subprime market. You hadn’t gone there to a great extent is that right?” In response, Mudd testified:

The answer for Fannie Mae on behalf of subprime is that it’s important to remember there is subprime and there is predatory. Subprime simply means ... that you have a credit blemish, and we think those people are part of the market. It’s less than 2 percent of our book. It’s 80 percent insured. It’s highly subordinated. We’ve been in it very carefully, consistent with some very strong anti-predatory lending guidelines we have.
97. At the time that Mudd gave this testimony, he knew that Fannie Mae EA loans were designed to provide loans to borrowers with weaker credit histories, i.e., “credit blemish[ed]” borrowers, and that the quantification of Fannie Mae’s subprime holding as “less than 2 percent of our book” did not include EA or MCM loans. The following month, on April 17, 2007, Mudd again appeared before the Committee on Financial Services to provide testimony in a hearing on solutions to the subprime market turmoil. Mudd again testified: “Subprime’ is, after all, simply the description of a borrower who doesn’t have perfect credit.” He provided a broad description of Fannie Mae’s efforts to reach “borrower[s] who do[n’t] have perfect credit”:

We see it as part of our mission and our charter to make safe mortgages available to people who don’t have perfect credit. In the past several years, for example, we have designed mortgage options to give borrowers with blemished credit access to high-quality, low-cost, non-predatory loans. We also set conservative underwriting standards for loans we finance to ensure the homebuyers can afford their loans over the long term . . . we continued our careful entry into the subprime market, by and large supporting lenders, products and practices that met our standards, and which helped us meet our HUD affordable housing requirements.

98. Having broadly defined “subprime” and described Fannie Mae’s outreach to the market for borrowers without perfect credit, Mudd testified as to the amount of subprime held by Fannie Mae: “Today, our exposure remains relatively minimal — less than 2.5 percent of our book of business can be defined as subprime.”

99. Mudd knew EA loans were loans specifically designed for “people who don’t have perfect credit” —his own definition for subprime—and that the 2.5 percent figure he used did not include billions of dollars of EA and MCM loans. As such, his statement was knowingly false and misleading when made.

_Fannie Mae’s False and Misleading Subprime Disclosures in its 2005 10-K Filing_
100. In May 2007, Fannie Mae filed its 2005 Form 10-K, in which it supplemented its prior public definition of subprime. In addition to asserting that “subprime” generally refers to loans made to borrowers “with a weaker credit profile” and “borrowers [who] have a higher likelihood of default,” Fannie Mae now disclosed that it classified loans as subprime if the loans were originated from a specialty subprime lender.

101. On May 2, 2007, Fannie Mae filed its 2005 Form 10-K and stated:

“Subprime mortgage” generally refers to a mortgage loan made to a borrower with a weaker credit profile than that of a prime borrower. As a result of the weaker credit profile, subprime borrowers have a higher likelihood of default than prime borrowers. Subprime mortgage loans are often originated by lenders specializing in this type of business, using processes unique to subprime loans. In reporting our subprime exposure, we have classified mortgage loans as subprime if the mortgage loans are originated by one of these specialty lenders or, for the original or resecuritized private-label, mortgage-related securities that we hold in our portfolio, if the securities were labeled as subprime when sold ... We also estimate that subprime loans represented approximately 2.2% of our single-family mortgage credit book of business as of December 31, 2006, of which approximately 0.2% consisted of subprime mortgage loans or structured Fannie Mae MBS backed by subprime mortgage loans and approximately 2% consisted of private-label mortgage-related securities backed by subprime mortgage loans and, to a lesser extent, resecuritizations of private-label mortgage-related securities backed by subprime mortgage loans.

102. Fannie Mae’s reporting of its subprime exposure omitted approximately $43.3 billion worth of EA loans and $13.8 billion in MCM loans in Fannie Mae’s Single Family mortgage credit book of business as of December 31, 2006—approximately 12 times greater than the 0.2% ($4.8 billion) disclosed as “subprime mortgage loans or structured Fannie Mae MBS back by subprime loans” as of December 31, 2006.

103. Nothing in Fannie Mae’s public disclosures alerted investors that this much larger volume of loans matched the Company’s description of subprime loans but were not included in the reported quantitative number.
104. In addition, while Fannie Mae stated that it classified loans as subprime if those loans were originated by specialty subprime lenders, that statement was materially false and misleading as well. Since 1993, the U.S. Department of Housing and Urban Development ("HUD") posted a publicly available HUD Subprime Lender list based on loan data and interviews with lenders themselves. Companies in the mortgage industry rely on the HUD Subprime Lender list as a proxy for identifying subprime lenders. Internal Fannie Mae documents reflect that its personnel, including Lund, were aware of the HUD Subprime Lender list as an accepted source for subprime-lender identification. During the Relevant Period, the HUD Subprime Lender list included approximately 210 lenders.

105. The Company failed to disclose, however, that, when calculating Fannie Mae's subprime exposure, only certain loans that had been originated by 15 lenders were included. Fannie Mae purchased and guaranteed loans from many other lenders on the HUD list, but they were not included when calculating the Company's subprime exposure. Fannie Mae disclosed neither that it was restricting its definition of "specialty lender" to 15 lenders on the HUD list, nor the names of those lenders on the HUD list that it included in its calculations. In fact, Fannie Mae acquired loans from many other specialty lenders on the HUD Subprime Lender list, and EA loans were originated by lenders on the HUD list.

106. Although EA was left out of Fannie Mae's subprime reporting, it was well-known within Fannie Mae that EA was generally considered subprime in the marketplace. For example, on April 5, 2007, the SVP of business and strategic development sent an email to a group of Fannie Mae executives including Lund and Dallavecchia, stating "mcm and ea are much deeper risks that we take and many (if not all) in the market call EA subprime. They are growing very
fast. Within a month, Fannie Mae filed its next public statement concerning its subprime exposure, and again omitted its exposure to EA and MCM loans.

107. On May 9, 2007, Fannie Mae filed a Form 12b-25 with the Commission, which repeated the disclosure contained in the May 2, 2007 filing.

108. As it had previously, Fannie Mae’s reporting of its subprime disclosure in this May 9, 2007 filing omitted approximately $43.3 billion worth of EA loans and $13.8 billion in MCM loans in Fannie Mae’s Single Family mortgage credit book of business as of December 31, 2006. That undisclosed subprime exposure was approximately 12 times greater than the 0.2% ($4.8 billion) disclosed as “subprime mortgage loans or structured Fannie Mae MBS back by subprime loans” as of December 31, 2006.

109. Mudd, Lund and Dallavecchia had each reviewed and approved the Form 12b-25 dated May 9 2007 that was released by the Company.

Fannie Mae’s False and Misleading Subprime Disclosures for Year-End 2006

110. In early August 2007, as Fannie Mae prepared a draft Form 8-K Credit Supplement to be filed simultaneous with its upcoming 2006 Form 10-K, Mudd personally requested additional basic data concerning the Company’s credit book in a draft version of the Form 8-K. The additional data Mudd received from the CRO office on August 5, 2007, included details on the total volume of EA, MCM, disclosed subprime, and Alt-A loans Fannie Mae had on its book of business. This draft included SDQ data that clearly showed EA loans had a higher rate of delinquency (5.38%) than the Company’s disclosed subprime loans (4.8%).

111. The data provided to Mudd also included data on FICO scores that demonstrated that the credit quality of EA loans was worse than the credit quality of the loans that Fannie Mae disclosed as its subprime exposure. Specifically, the document disclosed that 53% of EA loans
had FICO scores below 620; whereas 47% of Fannie Mae’s disclosed subprime had FICO scores below 620. Further, 26% of EA had FICO scores below 580 while 23% of disclosed subprime loans had FICO scores that low.

112. On August 3, 2007, as members of the Disclosure Committee, Dallavecchia and Lund both received the same draft credit supplement sent to Mudd. This information concerning EA and MCM was not ultimately made public.

113. Fannie Mae issued its 2006 Form 10-K less than two weeks after each of the defendants received the draft 8-K disclosure comparing EA and disclosed subprime, and documenting that EA loans had a higher serious delinquency rate than disclosed subprime and that EA loans had a weaker credit profile than disclosed subprime. The public filing again defined “subprime” as “loans to borrowers with riskier credit profiles.” Nevertheless, EA and MCM loans were not included when quantifying Fannie Mae’s subprime exposure; nor was it disclosed that there were “loans to borrowers with riskier credit profiles” that were excluded from Fannie Mae’s subprime reporting.

114. On August 16, 2007 Fannie Mae filed its 2006 Form 10-K and stated:

In recent years, we have increased our acquisitions of loans to borrowers with riskier credit profiles, referred to as subprime loans by the industry. Subprime mortgage loans that we acquire are generally originated by lenders specializing in this type of business, using processes unique to subprime loans. Based on data published by National Mortgage News and our internal economic analysis of the mortgage market, subprime mortgage loan originations have increased sharply in recent years, rising to a record high of approximately 24% of single-family mortgage loan originations in the first quarter of 2006 ... Our acquisitions of subprime mortgage loans have been significantly less than the overall market’s share. We estimate that approximately 0.2% of our total single-family mortgage credit book of business as of December 31, 2006 consisted of subprime mortgage loans or structured Fannie Mae MBS backed by subprime mortgage loans. We have also invested in highly rated private-label mortgage-related securities that are backed by ... subprime mortgage loans ... We estimate that ... private-label mortgage-related securities backed by subprime mortgage loans, including
resecuritizations, accounted for approximately ... 2% ... of our single-family mortgage credit book of business as of June 30, 2007.

115. Fannie Mae's Single Family mortgage credit book of business consisted of approximately $43.3 billion worth of EA loans and $13.8 billion worth of MCM loans as of December 31, 2006 — more than 12 times greater than the 0.2% ($4.8 billion) disclosed as "subprime mortgage loans or structured Fannie Mae MBS back by subprime loans" as of December 31, 2006.

116. Nothing in Fannie Mae's public disclosures alerted investors that this much larger volume of loans matched the Company's description of subprime loans but were not included in the reported quantitative number.

117. Mudd certified and Lund and Dallavecchia each sub-certified the 2006 Form 10-K even though they knew that the statements regarding the Company's subprime exposure were materially misleading.

Fannie Mae's False and Misleading Subprime Disclosures for First, Second and Third Quarters of 2007

118. In preparing to review the upcoming Fannie Mae filing, a Disclosure Committee Analytical Report was sent on October 26, 2007, to several individuals, including Mudd, Dallavecchia and Lund. The report presented data on Single Family's "[h]igher risk products," including EA, MCM, and disclosed subprime. The data documented that, in the two periods addressed in the document, year-to-date as of September 2006 and year-to-date as of September 2007, Fannie Mae's credit losses from EA and MCM far outweighed losses compared to the loans reported as the company's subprime exposure. As of September 2006, Fannie Mae had $80.6 million in losses from EA and $1.7 million in losses from MCM, compared to no losses from loans disclosed as subprime. As of September 2007, Fannie Mae had $188.9 million in
losses from EA, and $16 million in losses from MCM, compared to $5.5 million in losses from loans disclosed as subprime. Fannie Mae’s credit losses from EA in 2006 and 2007 were overwhelmingly greater than any losses it experienced related to its disclosed subprime holdings during the same period. A key observation in the Report showed that the Company’s highest risk products (which included EA and MCM loans) “comprise less than 15% of the Single Family book but accounted for 57% of the $440MM” increase in credit losses.

119. Within two weeks, on November 9, 2007, Fannie Mae filed its Forms 10-Q for the first, second and third quarters of 2007. Even though each of the Defendants knew that EA and MCM loans fit Fannie Mae’s public definition of subprime loans and were a source of credit losses far greater than losses triggered by the loans that were disclosed as subprime, EA or MCM loans were not included in the quantification of subprime. The Company stated in its first quarter Form 10-Q:

A subprime mortgage loan generally refers to a mortgage loan made to a borrower with a weaker credit profile than that of a prime borrower. As a result of the weaker credit profile, subprime borrowers have a higher likelihood of default than prime borrowers. Subprime mortgage loans are typically originated by lenders specializing in this type of business or by subprime divisions of large lenders, using processes unique to subprime loans. In reporting our subprime exposure, we have classified mortgage loans as subprime if the mortgage loans are originated by one of these specialty lenders or a subprime division of a large lender. … Approximately 0.2% of our total single-family mortgage credit book of business as of March 31, 2007 consisted of subprime mortgage loans or Fannie Mae MBS backed by subprime mortgage loans. This percentage increased to approximately 0.3% as of September 30, 2007. Less than 1% of our single-family business volume for the nine months ended September 30, 2007 consisted of subprime mortgage loans or Fannie Mae MBS backed by subprime mortgage loans. (Emphasis added.)

120. The Company’s subprime disclosures in its second and third quarter Forms 10-Q were comparable.
121. The quantified subprime exposure omitted at least $43 billion worth of EA loans that were part of Fannie Mae’s Single Family mortgage credit book of business and $17.6 billion in MCM loans as of March 31, 2007—approximately 12 times greater than the 0.2% ($4.8 billion) disclosed as “subprime mortgage loans or structured Fannie Mae MBS back by subprime loans” as of March 31, 2007.

122. Nothing in Fannie Mae’s public disclosures alerted investors to this much larger volume of loans that matched the Company’s description of subprime loans but were not included in the reported subprime exposure.

123. The November 9, 2007, Form 10-Q filings supplemented its prior public definition of subprime. In addition to stating that it classified “mortgage loans as subprime if the mortgage loans are originated by one of these specialty lenders,” it also stated that it classified loans as subprime if the loans are originated by “a subprime division of a large lender.”

124. This statement in the November 9, 2007 Form 10-Q was false. In reality, Fannie Mae never tracked loans from the subprime divisions of large lenders and, accordingly, the Company never included any of those subprime loans in its reported subprime exposure—despite its explicit claim that it did so.

125. Since at least 2003, Mudd was aware that subprime divisions of major lenders were originating and selling EA loans to Fannie Mae. Nevertheless, the Company never included any EA loans in its subprime reporting.

126. In February 2007, Mudd traveled to meet with Fannie Mae’s then-largest customer, Countrywide. At the meeting, Mudd was briefed by the President and COO of Countrywide Home Loans about the volume of loans Fannie Mae acquired from that customer’s subprime lending division (Full Spectrum Lending), which between 2004 and 2006 totaled
$14.23 billion worth of loans. The presentation explicitly referred to Countrywide’s subprime lending division customers as subprime “Fallen Angels.”

127. In the Relevant Period alone, Fannie Mae acquired loans totaling approximately $28.5 billion from Countrywide’s subprime division—the subprime division of a large lender. That number is far greater than the amount of “sub-prime mortgage loans or structured Fannie Mae MBS back by subprime mortgage loans” that Fannie Mae publicly disclosed to investors at any point during the Relevant Period.

128. Disclosing loans acquired from Countrywide’s subprime division alone would have more than doubled the disclosed subprime exposure in Fannie Mae’s Single Family guarantee portfolio. However, those loans were not included in the Company’s reported subprime exposure.

129. During the Relevant Period, Fannie Mae purchased or securitized loans from subprime divisions of other large lenders including Citigroup, JPMorgan and GMAC.

130. Lund’s direct reports knew and informed him that subprime divisions of large lenders sold loans to Fannie Mae—including Citi’s Argent/Ameriquest, Countrywide’s Full Spectrum Lending, and First Franklin’s Flagstar bank.

131. On November 9, 2007, for the quarter ended September 30, 2007, Fannie Mae also filed a “credit supplement” on Form 8-K with the Commission. The document contained a summary description of certain credit risk characteristics of its Single Family book of business in chart form. Included in this chart were separate columns identifying Fannie Mae’s subprime holdings and designating that 0.3% of its Single Family holdings were subprime loans. This supplemental disclosure did not inform investors of the additional subprime exposure from EA and MCM loans, or loans originated by the subprime divisions of large lenders. Fannie Mae
continued to issue credit supplements that were similarly false and misleading throughout the Relevant Period.

**Mudd’s False and Misleading Subprime Statements to the Media**

132. On December 2, 2007, Mudd spoke about Fannie Mae’s subprime holdings in a newspaper interview published in the San Francisco Gate.

Q: We know you very well for the fact that you have well-underwritten loans, fully amortizing, and that you either keep these loans in portfolio or guarantee them. So how are you having involvement with these subprime loans at all?

A: I’ll give you two pieces to understand it. The notion that there is a delineation between a lower prime loan and a high subprime loan are incorrect. There’s a FICO score, there’s an LTV (loan to value) and a bunch of other factors. We have about 2 percent of our broker’s business in total that meets our definition of what would be a subprime loan, not a predatory loan, but typically a loan to an individual that has had a credit blemish in the past. We made a decision a few years ago that there were lots of creditworthy individuals who had a credit blemish which would have previously either disqualified them from a prime loan, or condemn them to a subprime lender. They were probably eligible for what we call affordability product. So we have about 2 percent of that business on our books, and that is how our involvement happened.

133. Mudd made these claims when he knew they were false and misleading. At the time that he made this statement, Mudd knew that the “2 percent” figure did not include billions of dollars in EA or MCM loans held by Fannie Mae. Mudd also knew that those undisclosed loans were specifically designed for “credit blemish[ed]” borrowers and that the figure could not reflect loans originated by the subprime division of large lenders, which by then the Company claimed to include in its reported subprime exposure.

**Fannie Mae’s False and Misleading Subprime Disclosures for Year-End 2007**

134. In February 27, 2008, Fannie Mae issued its 2007 Form 10-K, which was identical to prior disclosures but further included the following statement:

Subprime mortgage loans, whether held in our portfolio or backing Fannie Mae MBS, represented less than 1% of our single-family business volume in each of 2007, 2006 and 2005. We estimate that subprime mortgage loans held in our
portfolio or subprime mortgage loans backing Fannie Mae MBS, excluding resecuritized private-label mortgage-related securities backed by subprime mortgage loans, represented approximately 0.3% of our total single-family mortgage credit book of business as of December 31, 2007, compared with 0.2% and 0.1% as of December 31, 2006 and 2005, respectively.

135. Approximately $55.6 billion worth of Fannie Mae’s Single Family mortgage credit book of business consisted of EA loans as of December 31, 2007, and $38.8 billion in MCM loans—approximately 11 times greater than the 0.3% ($8.3 billion) disclosed as “subprime mortgage loans held in our portfolio or subprime mortgage loans backing Fannie Mae MBS” as of December 31, 2007.

136. Nothing in Fannie Mae’s public disclosures alerted investors that this much larger volume of loans matched the Company’s description of subprime loans but were not included in the reported quantitative number.

137. As of January 31, 2008, the serious delinquency rate of EA was 7.14%—performance that was worse than the disclosed subprime serious delinquency rate of 6.21% for the same period. By February 2008, it was clear from reports provided to all three defendants that credit losses from EA loans were “disproportionate to the amount of the book they constitute.”

Fannie Mae’s False and Misleading first and second quarter 2008 filings

138. On May 6, 2008, Fannie Mae filed its Form 10-Q first quarter 2008 and stated:

Subprime mortgage loans, whether held in our portfolio or backing Fannie Mae MBS represented less than 1% of our single-family business volume for the first quarter of 2008 and 2007. We estimate that subprime mortgage loans held in our portfolio or subprime mortgage loans backing Fannie Mae MBS, excluding private-label mortgage-related securities backed by subprime mortgage loans, represented approximately 0.3% of our total single-family mortgage credit book of business as of both March 31, 2008 and December 31, 2007. (Emphasis added.)
139. Approximately $101 billion worth of Fannie Mae's Single Family mortgage credit book of business of March 31, 2008, consisted of undisclosed loans that fell within the company’s description of subprime, and approximately $94.4 billion worth of Fannie Mae's Single Family mortgage credit book of business consisted of undisclosed loans as of December 31, 2007—approximately 12 times greater than the 0.3% ($8 billion as of March 31, 2008 and $8.3 billion as of December 31, 2007) disclosed as “subprime mortgage loans held in our portfolio or subprime mortgage loans backing Fannie Mae MBS” as of December 31, 2007.

140. Nothing in Fannie Mae’s public disclosures alerted investors that this much larger volume of loans matched the Company’s description of subprime loans, but were not included in the reported quantitative number.

141. By July 2008, Dallavecchia was emailing Mudd directly to highlight that EA and MCM were generating approximately 20% of the Company’s credit losses.

142. As of the beginning of August 2008, EA and MCM were classified in internal Fannie Mae documents as two of Fannie Mae’s top three highest-risk loan products and Fannie Mae made plans to eliminate the EA loan program as part of an attempt to improve the overall credit quality of its Single Family book of business.

143. This was not disclosed. Instead, on August 8, 2008, Fannie Mae filed its Form 10-Q for the second quarter 2008 and explained:

Subprime mortgage loans, whether held in our portfolio or backing Fannie Mae MBS represented less than 1% of our single-family business volume for the first six months of 2008 and 2007. We estimate that subprime mortgage loans held in our portfolio or subprime mortgage loans backing Fannie Mae MBS, excluding resecuritized private-label mortgage-related securities backed by subprime mortgage loans, represented approximately 0.3% of our total single-family mortgage credit book of business as of both June 30, 2008 and December 31, 2007.
144. Approximately $60 billion worth of Fannie Mae’s Single Family mortgage credit book of business consisted of EA loans and $41.7 billion in MCM loans as of June 30, 2008—approximately 12 times greater than the 0.3% ($8 billion) disclosed as “subprime mortgage loans held in our portfolio or subprime mortgage loans backing Fannie Mae MBS” as of both June 30, 2008 and December 31, 2007.

145. Nothing in Fannie Mae’s public disclosures alerted investors to the fact this much larger volume of loans matched the Company’s description of subprime loans but were not included in the reported quantitative number.

**Mudd Publicly Declares that Fannie Mae has Zero Subprime**

146. On August 20, 2008, Mudd falsely stated in a radio interview: Fannie Mae has “about zero percent” exposure to subprime loans, and “[s]ubprime to Fannie Mae means a loan to a borrower that has had a credit problem in the past.” When Mudd made this statement, he knew that Fannie Mae had substantial exposure to loans made to borrowers who have had a credit problem in the past.

**Post-conservatorship Fannie Mae Acknowledges Additional Subprime Holdings**

147. After Fannie Mae had been placed into conservatorship on September 6, 2008, the Company made a disclosure that highlights the misleading nature of the Company’s prior subprime reports. At the time this disclosure was made, neither Mudd nor Dallavecchia were at Fannie Mae and Lund, who remained EVP of the Single Family business until June 2009, was no longer a member of the Disclosure Committee.

148. On November 10, 2008, Fannie Mae filed its Form 10-Q for the third quarter and stated:
We have classified mortgage loans as subprime if the mortgage loan is originated by a lender specializing in subprime business or by subprime divisions of large lenders. We apply these classification criteria in order to determine our ... subprime loan exposures; however, we have other loans with some features that are similar to ... subprime loans that we have not classified as ... subprime because they do not meet our classification criteria. (Emphasis added).

149. In this statement, for the first time the Company publicly acknowledged what Mudd, Lund and Dallavecchia had known throughout the Relevant Period; namely, that Fannie Mae held loans squarely within the public definition of subprime that it had not included in calculating its publicly disclosed exposure to subprime loans.

150. Based on the facts alleged above, Mudd, Lund and Dallavecchia, knew or were reckless in not knowing that Fannie Mae’s statements disclosing its subprime holdings, and as to Mudd and Dallavecchia, their respective statements regarding Fannie Mae’s subprime holdings, were false and misleading.

FANNIE MAE’S ALT-A DISCLOSURE FRAUD

Fannie Mae Increases Market Share By Acquiring Reduced Documentation Alt-A Loans

151. Fannie Mae acquired increasing amounts of reduced documentation loans. Prior to 2000, Fannie Mae had a limited market presence in purchasing reduced documentation loans, and those loans were not a large part of mortgage originations nationwide. This changed during the 2000s, and by 2007, reduced documentation loans were surging in popularity, representing approximately 40% of mortgage loan originations nationwide.

152. Traditionally, Fannie Mae’s MBS dominated the nationwide mortgage-related securities market. However, by 2005, private label competition for mortgage-backed securities overtook Fannie Mae’s MBS market dominance; as a result, Fannie Mae’s nationwide share of mortgage loan originations fell from 40% in 2004 to 20% in 2005.
153. In response, at the end of 2005, Fannie Mae’s board of directors instructed the Single Family business to adjust its business plan to gain back market share. The goal was to increase Single Family’s purchases from 20% of total mortgage loan originations to at least 25% by the end of 2006. In an April 2006 meeting, Mudd directed the Single Family business to acquire more reduced documentation loans specifically, saying: “the market is moving to low documentation and we need to actively pursue the keys to this market.”

154. Fannie Mae’s push to increase its reduced documentation loans was dramatic. At the end of 2004, reduced documentation loans constituted 17.8% of Fannie Mae’s Single Family loan acquisitions: by year-end 2005 that number was 20.2%, and by year-end 2006, 27.8% of Fannie Mae’s Single Family loan acquisitions were reduced documentation loans. This represented a nearly 40% increase from 2005 and a greater than 50% increase from 2004.

*Fannie Mae Internally Tracked Its Loans With Low Or Alternative Documentation Requirements As Reduced Documentation Loans*

155. As described in internal Company records, documentation level is a key credit risk characteristic of a loan. Because Alt-A loans do not require that a borrower fully document their income, assets and/or employment, Alt-A loans have a greater risk of default than fully documented loans. Fannie Mae executives—including Mudd, Lund and Dallavecchia—regularly monitored the total reduced documentation loan acquisition trends at the Company and the attendant credit risk those loans presented via internal reports.

156. Mudd, for example, was well aware of the Company’s increased acquisition of reduced documentation loans. An April 26, 2006 CEO credit risk briefing stated that of all loans acquired by Fannie Mae’s Single Family business, 20.2% were reduced documentation loans at year-end 2005, and this number increased to 23.5% of acquisitions by February 2006. That same report noted that credit risks (such as reduced documentation) are a strong predictor of serious
delinquency within the first year of a loan’s acquisition and therefore present significant credit risk.

157. Similarly, at the beginning of his tenure as CRO of Fannie Mae in June 2006, Dallavecchia was briefed on Fannie Mae’s increasing stake in reduced documentation loans. Dallavecchia received a credit risk briefing that explained: Fannie Mae’s Single Family business has seen an increase in “potentially riskier products like ... low documentation loans ... [and] Alt-A loans as a percent of total acquisitions increased from 11.5% in 2002 to 20.2% in 2005.” That same presentation described this increase as an acquisition “trend” and noted Fannie Mae’s Single Family plan for an “Alt-A push. Goal of $60B in 2006.”

158. As a member of the Disclosure Committee, throughout the fall of 2006, Dallavecchia received draft versions of Fannie Mae’s 2004 Form 10-K, which contained detailed acquisition data concerning reduced documentation mortgages, including quantitative exposure data that showed reduced documentation mortgages “represented approximately 18%, 20% and 24% of our single-family acquisitions in 2004, 2005, and the first half of 2006.”

159. Likewise, throughout the Relevant Period, as EVP of the Single Family business, Lund was aware of Fannie Mae’s increasing exposure to Alt-A loans. He received monthly reports that presented Fannie Mae’s total reduced documentation loan exposure, which between 2006 and 2008 ranged from 13% to 21% of the Single Family mortgage book of business. Those loan acquisition reports were sometimes called the “Tom Lund Report.”

160. During the Relevant Period, Lund’s Single Family officers—from his Single Family Credit Risk officers to Product Management and Development executives—routinely prepared presentations and reports concerning not only Fannie Mae’s increasing acquisitions of reduced documentation loans, but also the credit risks associated with those loans, including their
expected and actual SDQ rates. As the head of the Single-Family business, Lund had access to data and information prepared by his officers, as well as Early Warning reports—all of which conveyed, as described by his staff: "Low doc is more likely to default than full doc."
161. In its public filings, when it publicly disclosed the amount of reduced or alternative documentation loans it held, the Company did not report all of the reduced documentation loans that it tracked internally as one of seven key credit risks.

162. Each of the Defendants knew that approximately half of the reduced documentation loans in the Single Family book were not included when the Company reported its Alt-A loans.

163. When the Company internally tracked its reduced documentation loans it included loans that it referred to as “Special Lender Programs” or Lender-Selected loans. These were loans in which the lender ostensibly initiated the reduced documentation option for processing the loan. The Company also tracked “Other Low/No Doc loans,” which are Borrower-Selected loans, or loans in which borrowers specifically requested loans for which minimal documentation was required.

164. When the Company reported its Alt-A holdings it failed to disclose all its reduced documentation loans: it disclosed Borrower-Selected loans but did not report its Lender-Selected loans. This limited disclosure misrepresented the extent of Fannie Mae’s total exposure to reduced documentation loans.

165. On average throughout the Relevant Period, Lender-Selected Reduced Documentation Loans—the undisclosed Alt-A loans—had SDQ rates that were 1.4 times higher than full documentation loans with otherwise similar credit risks. Moreover, during the Relevant Period, certain types of Lender-Selected Reduced Documentation Loans that Fannie Mae acquired, such as Countrywide’s Fast and Easy loans, had SDQ rates that were 2 times higher than full documentation loans with otherwise similar credit risks.
166. Fannie Mae's Alt-A disclosure misrepresented the extent of its reduced documentation high risk holdings as evidenced by the undisclosed loans from a single source of Lender-Selected reduced documentation loans. At year-end 2006, Fannie Mae had $102.5 billion worth of *Fast and Easy* loans alone on its Single Family book of business, which grew to $129.2 billion by year-end 2007, and by the end of the third quarter of 2008, Fannie Mae had $133.4 billion worth of *Fast and Easy* loans on its Single Family book of business. None of these loans, or other similar Lender-Selected reduced documentation loans, were ever disclosed to investors when the Company quantified its Alt-A exposure.

167. This single unreported Alt-A product from one customer—Countrywide—accounted for 4.63% of Fannie Mae's 2006 Single Family business, 5.10% in 2007 and 4.94% as of September 2008. As one of Lund’s officers stated in a presentation: “CHL [Countrywide] sells whatever it can through Fast & Easy.”

**Fannie Mae Failed To Disclose That The Company Directed Lenders When To Classify Loans as Alt-A**

168. Fannie Mae stated that it classified loans as “Alt-A if the lender that delivers the mortgage loans to us has classified the loans as Alt-A based on documentation or other product features.” This reporting materially understated the extent of Fannie Mae’s total exposure to reduced documentation loans.

169. Fannie Mae did not disclose that the Company directed lenders that delivered the mortgage loans to Fannie Mae’s lender channel whether to label reduced documentation loans as Alt-A or not. The Alt-A classification, in practice, came from Fannie Mae and was executed by the originating lenders; the lenders did not make the coding determination.

170. Fannie Mae had contractual agreements with lenders that included instructions on when to code reduced documentation loans for delivery through its Lender Channel as Alt-A.
Occasionally, when a customer delivered loans to Fannie Mae’s Lender channel with an Alt-A code that Fannie Mae had not prescribed for delivery for that loan type, Fannie Mae would instruct the customer to re-code its loans to remove the Alt-A code prior to accepting delivery.

171. Fannie Mae determined whether the lender classified the loan as Alt-A rather than accepting an Alt-A classification as designated by a lender.

**Fannie Mae Issues a Series of False and Misleading Disclosures on Alt-A**

172. In its 2004 Form 10-K, which was filed on December 6, 2006, the Company disclosed that it had increased its holdings of reduced documentation loans, but did not quantify those holdings:

> We also have increased the proportion of reduced documentation loans that we purchase ... we began to increase our participation in these product types where we concluded that it would be economically advantageous or that it would contribute to our mission objectives ... In addition, there has been an increasing industry trend towards streamlining the mortgage loan underwriting process by reducing the documentation requirements for borrowers. Reduced documentation loans in some cases present higher credit risk than loans underwritten with full standard documentation.

173. In its discussion of Alt-A, Fannie Mae did not disclose that the amount of “loans that are underwritten with lower or alternative documentation” in the Single Family mortgage credit book of business was $390 billion as of September 30, 2006, or the fact that by June 30, 2006, approximately 24% of Fannie Mae’s Single Family loan acquisitions were reduced documentation loans.

174. As Fannie Mae prepared to file its 2005 Form 10-K in February 2007, Single Family officers working on the credit risk disclosures voiced concern: “Given Alt-A is an increasing as part of our business [sic] strategy and volume and this is the 2005 disclosure it seems to warrant more than a fairly benign reference, as is the case in the 2004 disclosure ... The decision now may very well be not to include numbers for this segment and just disclose an
increasing trend in words, but by the time we are done with 2006 we need to reflect the reality of the business.”

175. During this time period, senior management at Fannie Mae recognized that investors wanted to know the Company’s Alt-A exposure. In April 2007, the director of Investor Relations at Fannie Mae wrote an email acknowledging, “In anticipation of IR’s 2005 10-K briefing with Dan and Bob tomorrow, we would like to get your direction on how management should address questions related to FNMs exposure to Alt-A product … we expect the question to be asked and need to plan for it.” (Emphasis added).

Fannie Mae’s False and Misleading Alt-Disclosures in its May 9, 2007 Form 12b-25 Filing

176. On May 9, 2007, for the first time, Fannie Mae disclosed a quantification of its Alt-A holdings in its Form 12b-25 filing. The Company defined Alt-A as loans with “lower or alternative documentation” and disclosed that it held 11% of Alt-A in its Single Family mortgage credit book of business. Fannie Mae stated:

Although there is no uniform definition of Alt-A … [Alt-A] loans generally are loans that are underwritten with lower or alternative documentation than a full documentation mortgage loan and that also may include other alternative features … In reporting our Alt-A exposure, we have classified mortgage loans as Alt-A if the lenders that deliver the mortgage loans to us have classified the loans as Alt-A based on documentation or other product features, or, for the original or resecuritized private-label, mortgage-related securities that we hold in our portfolio, if the securities were labeled as Alt-A when sold. We estimate that approximately 11% of our total single-family mortgage credit book of business as of both March 31, 2007 and December 31, 2006 consisted of Alt-A mortgage loans or structured Fannie Mae MBS backed by Alt-A mortgage loans … As described below in the discussion of our Capital Markets group, we also have invested in highly rated private-label mortgage-related securities backed by Alt-A loans. We estimate that approximately 1% of our total single-family mortgage credit book of business consisted of private-label mortgage-related securities backed by Alt-A mortgage loans as of both March 31, 2007 and December 31, 2006. (Emphasis added.)
177. The amount of Alt-A Fannie Mae publicly disclosed did not include the “lower or alternative documentation loans” that were internally referred to as Lender-Selected reduced document loans. Yet nothing in Fannie Mae’s public disclosures alerted investors to the fact that a much larger volume of loans that matched the Company’s description of its Alt-A holdings were excluded from the amount of Alt-A that the Company disclosed.

178. Fannie Mae’s total exposure to loans with “lower or alternative documentation” (Alt-A) was actually 20.7% and 20.1% of its total Single Family mortgage credit book of business at March 31, 2007, and December 31, 2006, respectively, not 11% as disclosed. Fannie Mae’s reporting of its Alt-A mortgage loans omitted approximately $219 billion and $201 billion worth of Fannie Mae’s Single Family mortgage credit book of business which consisted of reduced documentation loans as of March 31, 2007, and December 31, 2006, almost equal to the volume of Single Family loans ($263 billion and $257 billion) that were disclosed as Alt-A.

**Fannie Mae’s False and Misleading Alt-A Disclosures in its 2006 Form 10-K**

179. In June 2007, Lund’s Single Family personnel prepared Single Family Credit Committee presentation materials, which acknowledged that, for internal Fannie Mae calculations, Fannie Mae’s undisclosed Alt-A loan programs were treated as reduced documentation loans, not full document loans.

180. Even though senior management, including Mudd, Lund and Dallavecchia, recognized that Fannie Mae had an increasing volume of reduced documentation loans that performed as poorly as some loans disclosed as Alt-A, none of these loans were disclosed. On August 16, 2007, in its 2006 Form 10-K, the Company stated:

> “Alt-A mortgage” generally refers to a loan that can be underwritten with lower or alternative documentation than a full documentation mortgage loan but may also include other alternative product features. As a result, Alt-A mortgage loans generally have a higher risk of default than non-Alt-A mortgage loans. In
reporting our Alt-A exposure, we have classified mortgage loans as Alt-A if the
lenders that deliver the mortgage loans to us have classified the loans as Alt-A
based on documentation or other product features, or, for the original or
resecuritized private-label, mortgage-related securities that we hold in our
portfolio, if the securities were labeled as Alt-A when sold ... We estimate that
approximately 11% of our total single-family mortgage credit book of business as
of December 31, 2006 consisted of Alt-A mortgage loans or structured Fannie
Mae MBS backed by Alt-A mortgage loans. This percentage increased to
approximately 12% as of June 30, 2007 ... We estimate that private label
mortgage-related securities backed by Alt-A loans ... accounted for
approximately 1% (and 2% respectively) ... of our single-family mortgage credit

181. At the time of this disclosure, Fannie Mae’s total exposure to loans with “lower or
alternative documentation” (Alt-A) was actually 22% of its total Single Family mortgage credit
book of business, not 12% as disclosed. Fannie Mae’s reporting of its Alt-A omitted
approximately $238 billion worth of Fannie Mae’s Single Family mortgage credit book of
business, which consisted of reduced document loans as of June 30, 2007—almost equal to the
$296 billion that was disclosed as Alt-A.

Fannie Mae’s False and Misleading Alt-A Disclosures in its first, second
and third quarter 2007 10-Qs

182. By October 2007, reduced documentation loans comprised 29.1% of Fannie
Mae’s Single Family loan acquisition volume and 22% of the Single Family mortgage credit

183. Nevertheless, on November 9, 2007, in its 2007 Forms 10-Q for the first quarter,
the Company disclosed:

As of March 31, 2007, we estimate that approximately 11% of our total single-
family mortgage credit book of business consisted of Alt-A mortgage loans or
Fannie Mae MBS backed by Alt-A mortgage loans. This percentage increased to
approximately 12% as of September 30, 2007 ... As of March 31, 2007, we held
in our investment portfolio approximately $34.5 billion in private-label mortgage-
related securities backed by Alt-A mortgage loans.
184. On that same day, November 9, 2007, Fannie Mae also filed its 2007 Forms 10-Q for the second and third quarter, the Alt-A disclosures for which were comparable to the 2007 Form 10-Q for the first quarter.

185. Fannie Mae’s total exposure to loans with “lower or alternative documentation” (Alt-A) was actually 22% of its total Single Family mortgage credit book of business, not 12% as disclosed. Fannie Mae’s reporting of its Alt-A omitted approximately $267 billion worth of Fannie Mae’s Single Family mortgage credit book of business which consisted of reduced document loans as of September 30, 2007—almost equal to the $306 billion that was disclosed as Alt-A.

186. On November 9, 2007, for the quarter ended September 30, 2007, Fannie Mae also filed a Form 8-K credit supplement with the Commission. The document contained a summary description of certain credit risk characteristics of its Single Family book of business in chart form. Included in this chart was a separate column identifying Fannie Mae’s Alt-A holdings, and designating that 12.5% of its Single Family mortgage credit book of business were Alt-A loans. Nowhere in this supplemental disclosure was there any statement to suggest that Single Family holdings included billions of dollars of additional reduced documentation loans that were not reflected in the 12.5% figure. Fannie Mae continued to issue credit supplements that were similarly misleading throughout the Relevant Period.

**Fannie Mae’s False and Misleading Disclosure in its Year-End 2007 10-K Filing**

187. On February 27, 2008, in its 2007 Form 10-K, the Company repeated its prior statement on Alt-A and updated its reporting as follows:

Alt-A mortgage loans, whether held in our portfolio or backing Fannie Mae MBS, represented approximately 16% of our single-family business volume in 2007, compared with approximately 22% and 16% in 2006 and 2005, respectively.
188. Fannie Mae’s total volume of loans with “lower or alternative documentation” (Alt-A) was actually 37% of its Single Family acquisitions, not 16% as disclosed.

189. On May 6, 2008, in its 2008 Form 10-Q for the first quarter, the Company stated:

Alt-A mortgage loans, whether held in our portfolio or backing Fannie Mae MBS represented approximately 4% of our single-family business volume for the first quarter of 2008, compared with approximately 23% for the first quarter of 2007. Alt-A mortgage loans held in our portfolio or Alt-A mortgage loans backing Fannie Mae MBS, excluding resecuritized private-label mortgage-related securities backed by Alt-A mortgage loans, represented approximately 11% of our total single-family mortgage credit book of business as of March 31, 2008, compared with approximately 12% as of December 31, 2007.

190. Fannie Mae’s total exposure to loans with “lower or alternative documentation” (Alt-A) was actually 22% of its total Single Family mortgage credit book of business, not 11% as disclosed. Fannie Mae’s reporting of its Alt-A loans omitted approximately $323 billion worth of mortgage loans in Fannie Mae’s Single Family mortgage credit book of business that consisted of reduced document loans as of March 31, 2008—more than the $300 billion that was disclosed as Alt-A.

191. As of December 2007, 23% of Fannie Mae’s Single Family mortgage credit book of business consisted of reduced documentation loans, not the 11% reported in the public filing.

192. Approximately two and a half months after the 2008 Form 10-Q filing, in July 29, 2008, Lund held a staff meeting which addressed issues related to reduced documentation loans. Countrywide’s *Fast and Easy* program—a Lender-Selected loan program whose loans were tracked as a reduced document high risk loan internally but excluded from Fannie Mae’s public disclosure of its Alt-A exposure—was specifically discussed in the presentation. The briefing addressed that these loans performed as poorly as some loans that were disclosed as Alt-A.
Despite this knowledge, *Fast and Easy* loans were not disclosed as part of Fannie Mae’s Alt-A exposure, and Lund continued to sub-certify Fannie Mae’s public statements.

193. By August 2008, and before the filing of its 2008 Form 10-Q for the second quarter, Fannie Mae was planning to eliminate its high risk products, including Alt-A. The Company still did not disclose its total Alt-A loans.

194. On August 8, 2008, in its 2008 Form 10-Q for the second quarter, its final filing before conservatorship, the Company stated:

> Alt-A mortgage loans, whether held in our portfolio or backing Fannie Mae MBS represented approximately 4% of our single-family business volume for the first six months of 2008, compared with approximately 22% for the first six months of 2007 ... Alt-A mortgage loans held in our portfolio or Alt-A mortgage loans backing Fannie Mae MBS, excluding resecuritized private-label mortgage-related securities backed by Alt-A mortgage loans, represented approximately 11% of our total single-family mortgage credit book of business as of June 30, 2008, compared with approximately 12% as of December 31, 2007.

195. Fannie Mae’s total exposure to loans with “lower or alternative documentation” (Alt-A) was actually 23% of its total Single Family mortgage credit book of business, not 11% as disclosed. Fannie Mae’s reporting of its Alt-A omitted approximately $341 billion worth of Fannie Mae’s Single Family mortgage credit book of business which consisted of reduced documentation loans as of June 30, 2008—more than the $306 billion that was disclosed as Alt-A to investors on August 8, 2008.

*Post-conservatorship Fannie Mae Acknowledges Additional Alt-A Holdings*

196. In its first periodic filing post-conservatorship, Fannie Mae made a disclosure that highlights the misleading nature of the Company’s prior Alt-A disclosures. At the time this disclosure was made neither Mudd nor Dallavecchia were at Fannie Mae, and Lund, who remained EVP of the Single Family business, was no longer a member of the Disclosure Committee. The Company explained:
We have classified mortgage loans as Alt-A if the lender that delivers the mortgage to us has classified the loans as Alt-A based on documentation or other features ... We apply these classification criteria in order to determine our Alt-A ... loan exposure[ ]; however, we have other loans with some features that are similar to Alt-A ... that we have not classified as Alt-A ... because they do not meet our classification criteria. (Emphasis added.)

197. In this statement for the first time the Company publicly acknowledged what Mudd, Lund and Dallavecchia had known throughout the Relevant Period, that it held loans that matched its public definition of Alt-A, but had not included them when reporting its Alt-A exposure:

198. Based on the facts alleged above, Mudd, Lund and Dallavecchia, knew or were reckless in not knowing that Fannie Mae’s statements reporting Alt-A were false and misleading.

FIRST CLAIM FOR RELIEF
VIOLATION OF SECTION 10(b) OF THE EXCHANGE ACT AND RULE 10b-5(b)
(MUDD)

1. Paragraphs 1 through 198 are realleged and incorporated by reference as if set forth fully herein.

2. Mudd directly or indirectly, by use of the means or instrumentalities of interstate commerce, or by use of the mails, or of the facilities of a national securities exchange, in connection with the purchase or sale of Fannie Mae securities, knowingly or recklessly, has made untrue statements of material facts or omitted to state material facts necessary in order to make statement made, in the light of the circumstances under which they were made, not misleading.

3. By reason of the foregoing, Mudd directly or indirectly has violated, and unless enjoined will again violate, Section 10(b) of the Exchange Act (15 U.S.C. § 78j(b)) and Rules 10b-5(b) thereunder (17 C.F.R. § 240.10b-5(b)).
SECOND CLAIM FOR RELIEF
VIOLATION OF SECTION 17(a)(2) OF THE SECURITIES ACT
(MUDD AND DALLAVECCHIA)

4. Paragraphs 1 through 198 are realleged and incorporated by reference as if set forth fully herein.

5. Mudd and Dallavecchia, directly or indirectly, in the offer and sale of Fannie Mae securities, by use of the means and instruments of transportation and communication in interstate commerce and by use of the mails, knowingly, recklessly or negligently have obtained money or property by means of untrue statements of material fact or omissions to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

6. By reason the foregoing, Mudd and Dallavecchia have violated, and unless enjoined will again violate, Sections 17(a)(2) of the Securities Act (15 U.S.C. § 77q(a)(2)).

THIRD CLAIM FOR RELIEF
AIDING AND ABETTING VIOLATIONS OF SECTION 10(b) OF THE EXCHANGE ACT
AND RULE 10b-5(b)
(MUDD, DALLAVECCHIA AND LUND)

7. Paragraphs 1 through 198 are realleged and incorporated by reference as if set forth fully herein.

8. Fannie Mae and Mudd, directly or indirectly, by use of the means or instrumentalities of interstate commerce, or by use of the mails, or of the facilities of a national securities exchange, in connection with the purchase or sale of Fannie Mae securities, knowingly or recklessly, has made untrue statements of material facts or omitted to state material facts necessary in order to make statement made, in the light of the circumstances under which they were made, not misleading.
9. Mudd, Dallavecchia and Lund acted knowingly or recklessly and provided substantial assistance to and thereby aided and abetted Fannie Mae in its violations of Exchange Act Section 10(b) and Rule 10b-5(b); [17 C.F.R. § 240.10b-5(b)]; therefore, each is liable pursuant to Exchange Act Section 20(e) [15 U.S.C. § 78t(e)].

10. Dallavecchia and Lund acted knowingly or recklessly and provided substantial assistance to and thereby aided and abetted Mudd in his violations of Exchange Act Section 10(b) and Rule 10b-5(b); [17 C.F.R. § 240.10b-5(b)]; therefore, each is liable pursuant to Exchange Act Section 20(e) [15 U.S.C. § 78t(e)].

11. Unless restrained and enjoined, Mudd, Dallavecchia and Lund will continue to aid and abet violations of Section 10(b) of the Exchange Act (15 U.S.C. § 78j(b)) and Rules 10b-5(b) thereunder (17 C.F.R. § 240.10b-5(b)).

FOURTH CLAIM FOR RELIEF
VIOLATION OF EXCHANGE ACT RULE 13A-14(A)

(MUDD)

12. Paragraphs 1 through 198 are realleged and incorporated by reference as if set forth fully herein.

13. On December 6, 2006, May 2, 2007, August 16, 2007, and February 27, 2008, Mudd signed false certifications of Fannie Mae Forms 10-K, and on November 9, 2007, May 6, 2008, and August 8, 2008, Mudd signed false certifications of Fannie Mae Forms 10-Q. Each of those Forms 10-K and Forms 10-Q certifications Mudd made were pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 and Rule 13a-14(a) promulgated thereunder. His certifications falsely stated that: he had reviewed each report; based upon his knowledge, the reports did not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not
misleading; and based upon his knowledge, the financial statements and information contained in each report fairly present in all material respects the financial condition, results of operations and cash flows of the registrant.

14. By reason of the foregoing, Mudd violated, and unless restrained and enjoined will continue to violate, Exchange Act Rule 13a-14(a) (17 C.F.R. § 240.13a-14) promulgated under Section 302 of the Sarbanes-Oxley Act of 2002.

FIFTH CLAIM FOR RELIEF

AIDING AND ABETTING VIOLATIONS OF SECTION 13(A) OF THE EXCHANGE ACT AND RULES 12B-20, 13A-1 AND 13A-13 (MUFF, DALLA VECCHIA AND LUND)

15. Paragraphs 1 through 198 are realleged and incorporated by reference as if set forth fully herein.

16. Section 13(a) of the Exchange Act and Rule 13a-1 and Rule 13a-13 thereunder requires issuers of registered securities to file with the Commission factually accurate current and quarterly reports. Exchange Act Rule 12b-20 provides that in addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading.


18. By reason of the foregoing, Mudd, Dallavecchia and Lund acted knowingly or recklessly and provided substantial assistance to and thereby aided and abetted Fannie Mae's violations of Section 13(a) of the Exchange Act (15 U.S.C. § 78m(a)) and Exchange Act Rules 12b-20, 13a-1 and 13a-13 (17 C.F.R. §§ 240.12b-20, 240.13a-1, and 240.13a-13); therefore, each is liable pursuant to Exchange Act Section 20(e) [15 U.S.C. § 78t(e)].
PRAYER FOR RELIEF

WHEREFORE, the Commission respectfully requests that this Court:


(b) Permanently restrain and enjoin defendant Dallavecchia from violating Section 17(a)(2) of the Securities Act, aiding and abetting Fannie Mae’s and Mudd’s violations of Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5, and aiding and abetting Fannie Mae’s violation of Section 13(a) of the Exchange Act and Exchange Act Rules 12b-20, 13a-1 and 13a-13.

(c) Permanently restrain and enjoin defendant Lund from aiding and abetting Fannie Mae’s and Mudd’s violations of Section 10(b) and Rule 10b-5, aiding and abetting Fannie Mae’s violation of Section 13(a) of the Exchange Act and Exchange Act Rules 12b-20, 13a-1 and 13a-13.

(d) Order defendants Mudd, Dallavecchia and Lund to pay disgorgement, together with prejudgment interest;

(f) Permanently bar defendants Mudd, Dallavecchia and Lund, pursuant to Section 20(e) of the Securities Act [15 U.S.C. § 77t(e)] and Section 21(d)(2) of the Exchange Act (15 U.S.C. § 78u(d)(2)), from acting as an officer or director of any issuer that has a class of securities registered under Section 12 of the Exchange Act (15 U.S.C. § 78l) or that is required to file reports pursuant to Section 15(d) of the Exchange Act (15 U.S.C. § 78o(d)); and
(g) Grant such other relief as this Court may deem necessary and proper.

Dated: December 16, 2011

Washington, D.C.

Respectfully Submitted,

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

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COMPLAINT

Plaintiff U.S. Securities and Exchange Commission (the “Commission”), alleges for its Complaint as follows:

SUMMARY OF ALLEGATIONS

1. This action arises out of a series of materially false and misleading public disclosures by the Federal Home Loan Mortgage Corporation (“Freddie Mac” or the “Company”) and certain of its senior executives relating to the exposure of Freddie Mac’s largest business segment – Single Family Guarantee – to subprime mortgage loans.

2. Between March 23, 2007, and August 6, 2008 (the “Relevant Period”), a period of heightened investor interest in the credit risks associated with subprime loans, Freddie Mac and defendants Richard F. Syron (“Syron”), Patricia L. Cook (“Cook”), and Donald J. Bisenius (“Bisenius”) misled investors into believing that the Company had far less exposure to these riskier mortgages than in fact existed. To that end, at various times, each made or substantially assisted Freddie Mac and each other in making materially false and misleading statements that
claimed in substance that Freddie Mac had little or no exposure to subprime loans in its Single Family Guarantee business.

3. While Freddie Mac disclosed during the Relevant Period that the exposure of its Single Family Guarantee business to subprime loans was between $2 billion and $6 billion, or between 0.1 percent and 0.2 percent, of Freddie Mac’s Single Family Guarantee portfolio — its exposure to subprime was materially greater. As of December 31, 2006, Freddie Mac’s Single Family Guarantee business was exposed to approximately $141 billion (or 10 percent of the portfolio) in loans the Company internally referred to as “subprime,” “otherwise subprime” or “subprime-like” and its exposure grew to approximately $244 billion (or 14 percent of the portfolio) by June 30, 2008, as the Company sought to win back lost market share by increasing its acquisition of such loans.

4. Syron had ultimate authority over the subprime disclosures in Freddie Mac’s Information Statements and supplements to the Information Statements published between March 23, 2007 and May 14, 2008, and in its Form 10-Q filed with the Commission on August 6, 2008, and also in speeches he gave or public statements he made in 2007 and 2008. Cook spoke at an investor conference on May 17, 2007, in which she told investors that Freddie Mac had “basically no subprime exposure” and she provided substantial assistance to Syron and Freddie Mac in making subprime disclosures in the Information Statements and supplements and a Form 10-Q by certifying to the accuracy of the disclosures, which related to her area of responsibility. Bisenius also certified to the accuracy of the subprime disclosures in certain Information Statements and supplements published during the Relevant Period and the Form 10-Q and thus substantially assisted Syron and Freddie Mac in making the misleading statements in these documents; he also substantially assisted Syron and Cook in making oral misstatements.
about subprime by failing to correct statements in their prepared speeches that he knew misstated the Company's subprime exposure. Each defendant made, or substantially assisted others in the making of, these misleading subprime disclosures at a time when each knew, or was reckless in not knowing, that the Company was increasing its acquisition of higher-risk loans that it internally referred to as “subprime,” “otherwise subprime” or “subprime-like.”

5. By this conduct, Syron and Cook violated, and Syron, Cook and Bisenius aided and abetted violations of, the antifraud and reporting provisions of the federal securities laws.

JURISDICTION AND VENUE

6. This Court has jurisdiction over this action pursuant to Section 22(a) of the Securities Act of 1933 (the “Securities Act”) [15 U.S.C. § 77v(a)] and Sections 21(d), 21(e), and 27 of the Securities Exchange Act of 1934 (the “Exchange Act”) [15 U.S.C. §§ 78u(d), 78u(e), and 78aa] and 28 U.S.C. § 1331.


8. In connection with the transactions, acts, practices and courses of business alleged in this Complaint, Syron, Cook and Bisenius have directly or indirectly made use of the means or instrumentalities of interstate commerce, of the mails, or of the facilities of a national securities exchange in connection with the transactions, acts, practices, and courses of business alleged in this Complaint.
9. **Freddie Mac** was, at all times relevant to this Complaint, a shareholder-owned Government Sponsored Enterprise ("GSE") established by the U.S. Congress on July 24, 1970, with the passage of the Federal Home Loan Mortgage Corporation Act (the "FHLMC Act"), to provide a continuous flow of funds for residential mortgages. Freddie Mac performed this function by buying and guaranteeing residential mortgage loans and mortgage-related securities, which it financed by issuing mortgage-related securities, debt securities and equity securities. Under the FHLMC Act, the Company's securities were "exempt securities," meaning they were exempt from the registration and disclosure requirements of the federal securities laws. On July 18, 2008, Freddie Mac voluntarily registered its common and preferred stock under Section 12(g) of the Exchange Act by filing a Form 10 registration statement with the Commission. Prior to July 18, 2008, Freddie Mac publicly disseminated annual and quarterly reports of its financial condition and results of operations in Information Statements and Information Statement Supplements, which were virtually identical in presentation to annual and quarterly reports filed with the Commission by registrants. Since July 18, 2008, Freddie Mac has been subject to the reporting requirements of the federal securities laws. During the Relevant Period, Freddie Mac's common stock was actively traded on the New York Stock Exchange under the ticker symbol "FRE." Its principal place of business was, and is, in McLean, Virginia.

10. Freddie Mac manages its business through three reportable segments: (i) Single Family Guarantee ("Single Family"), (ii) Investments, and (iii) Multifamily.

11. Single Family is Freddie Mac's primary business segment. During the Relevant Period, Freddie Mac reported that the size of its Single Family business was $1.4 trillion as of December 31, 2006, $1.7 trillion as of December 31, 2007 and $1.8 trillion as of June 30, 2008.
12. Through its Single Family business, Freddie Mac purchases residential mortgages and mortgage-related securities in the secondary mortgage market and securitizes them as Freddie Mac mortgage-backed securities, known as Participation Certificates ("PCs"). Freddie Mac guarantees the payment of principal and interest on the mortgage loans that underlie these PCs in exchange for guarantee fees.

13. During the Relevant Period, Freddie Mac completed at least four preferred stock offerings, raising approximately $7.5 billion: (i) pursuant to an Offering Circular dated April 10, 2007, it issued $500 million worth of 5.66 percent non-cumulative perpetual preferred stock, (ii) pursuant to an Offering Circular dated July 17, 2007, it issued $500 million worth of 6.02 percent non-cumulative perpetual preferred stock, (iii) pursuant to an Offering Circular dated September 25, 2007, it issued $500 million of 6.55 percent non-cumulative perpetual preferred stock and (iv) pursuant to an Offering Circular dated November 29, 2007, it issued $6 billion fixed-to-floating rate non-cumulative perpetual preferred stock. Additionally, in mid-2008, Freddie Mac executives attempted to make at least one additional preferred stock offering in the amount of $5.5 billion. Throughout the Relevant Period, Freddie Mac also routinely issued debt securities.

14. On September 6, 2008, following mounting losses, Freddie Mac’s primary regulator, the FHFA, placed it into conservatorship. On September 7, 2008, FHFA, as conservator, adopted a resolution eliminating the par value of Freddie Mac’s common stock, increasing the number of shares of Freddie Mac common stock authorized for issuance to four billion, preventing Freddie Mac from making any payment to purchase or redeem its capital stock or pay any dividends to holders of Freddie Mac’s common stock, and limiting the voting rights of holders of Freddie Mac’s common stock.
DEFENDANTS

15. Richard F. Syron, age 68, was Chairman of the Board of Directors ("Chairman") and Chief Executive Officer ("CEO") of Freddie Mac from December 2003 until September 7, 2008, when Freddie Mac's regulator, the Federal Housing Finance Agency ("FHFA"), placed it into conservatorship. Syron’s compensation grew from approximately $14.7 million in 2006 to $18.3 million in 2007 – tied, in part, to the "Touch More Loans" initiative discussed further below in Paragraph 45 and to quarterly financial reporting. Syron formally ceased to be an employee of Freddie Mac on November 7, 2008, and was deemed to have resigned from the Board of Directors, effective as of that date. Syron is a resident of Massachusetts.

16. As Chairman and CEO of Freddie Mac, Syron oversaw all three of Freddie Mac’s reportable segments, including Single Family. As Chairman, Syron was a regular attendee at Board meetings and Board committee meetings, including the Board’s Mission, Sourcing and Technology Committee meetings. As CEO, he chaired a team that he personally selected from the upper echelons of executive management called the “SET” or “Senior Executive Team,” which met periodically to consider Freddie Mac’s strategic direction. Syron also regularly attended monthly meetings of the Enterprise Risk Management Committee (the "ERMC"), which was a committee comprised of executives and senior management from Freddie Mac’s three reportable segments that considered the status of credit, market and operational risks, among others, to the Freddie Mac enterprise. Syron received monthly materials from the ERMC that apprised him of the credit, market and operational risks, among others, to the Freddie Mac enterprise. Syron also attended meetings of the ERMC.

17. Syron had extensive knowledge and experience in housing market-related issues. He wrote a dissertation about the housing market and served in various leadership positions at
both the Federal Reserve Bank of Boston and the Federal Home Loan Bank of Boston, including President and CEO. Syron was knowledgeable about the housing market and mortgage-related risks, and familiar with the views held by other market participants.

18. Syron regularly received and reviewed drafts of the Freddie Mac Information Statements and Annual Reports to Stockholders ("Information Statements") and supplements to the Information Statements ("Information Statement Supplements") and, once Freddie Mac became an SEC-reporting company, drafts of Freddie Mac's first Form 10-Q. Syron certified Freddie Mac’s Information Statements and Supplements published between March 23, 2007 and May 14, 2008, and Freddie Mac’s Form 10-Q filed with the Commission on August 6, 2008.

19. Patricia L. Cook, age 58, was an officer of Freddie Mac and held several titles, including Executive Vice President ("EVP") of Investments and Capital Markets and Chief Business Officer ("CBO"), from August 2004 through September 26, 2008. Cook’s compensation was $4.9 million in 2006 and $4.8 million in 2007 – tied, in part, to the Touch More Loans strategy discussed below in Paragraph 45 and to quarterly financial reporting. Cook formally ceased to be an employee of the Company on November 17, 2008, approximately two months after the Company announced certain management and organizational changes, including the elimination of her position. Cook is a resident of Washington, D.C.

20. As EVP of Investments and Capital Markets and as CBO, Cook oversaw Single Family. Cook attended Board meetings and Board committee meetings, including the Board’s Mission, Sourcing and Technology Committee meetings. Cook was one of the senior executives who served on Syron’s SET. She also attended or, on occasion, sent representatives on her behalf, to the monthly ERMC meetings. She received materials from the ERMC that apprised her of the credit, market and operational risks, among others, to the Freddie Mac enterprise. As
the senior executive in charge of the Single Family business, Cook was knowledgeable about
Freddie Mac's acquisitions and the performance of Freddie Mac's high risk loan portfolio,
including certain loans the Company internally considered to be subprime.

21. The Touch More Loans strategy, discussed below in Paragraph 45, also played a
role in Cook's compensation. In 2006, Cook's target bonus was $2 million and her target long-
term equity award for performance was $2.4 million. Cook received a bonus of $2.3 million, or
$300,000 in excess of her target, and a long-term equity award equating to $2.763 million, or
$363,000 greater than her target, in part due to Cook's Touch More Loans strategy. In 2007,
Cook received a bonus of $1.4 million dollars plus a supplemental bonus of $200,000 with a
three-year vesting schedule, again in part because of Touch More Loans.

22. Cook was responsible for ensuring that Single Family's public disclosures were
accurate. Cook was considered an expert on credit risk within Freddie Mac. Furthermore,
during the Relevant Period, the Disclosure Committee consulted Cook at least once regarding the
Company's public disclosures concerning subprime.

23. Cook signed sub-certifications directed to Syron and other senior executives for
each Freddie Mac Information Statement and Information Statement Supplement published
between March 23, 2007 and May 14, 2008, and for Freddie Mac's Form 10-Q filed with the
Commission on August 6, 2008. Each of Cook's sub-certifications covered the Company's
subprime disclosures.

24. Donald J. Bisnius, age 53, was employed by Freddie Mac from 1992 through
April 1, 2011, and held a number of titles, including Senior Vice President ("SVP") of Credit
Policy and Portfolio Management from November 2003 to April 2008, SVP of Single Family
Credit Guarantee from May 2008 to May 2009 and, most recently, EVP of Single Family Credit Guarantee. Bisenius is a resident of Virginia.

25. In 2007 and 2008, Bisenius reported directly to Cook and was the senior-most officer for credit risk in Single Family during the periods covered by the Information Statement and Information Statement Supplements for the periods ended December 31, 2006, March 31 and June 30, 2007, the Information Statement Supplement for the period ended March 31, 2008, and the Form 10-Q for the period ended June 30, 2008. As the senior-most officer for credit risk in Single Family, Bisenius was recognized within Freddie Mac as an expert on single-family mortgages and on credit risk and was responsible for developing credit policies for Freddie Mac’s guarantee of loans.

26. Between approximately March 2007 and April 2008, Bisenius also focused on certain “special projects,” including a “Model Subprime Offering” discussed below in Paragraph 61, aimed at borrowers previously serviced by lenders who self-identified as subprime originators.

28. As described below, in or about June 2006, Freddie Mac began to quantify in its public disclosures the approximate amount of exposure to subprime loans in the Single Family guarantee business. During the Relevant Period, Freddie Mac provided various such estimates – ranging between $2 and $6 billion, or 0.1 to 0.2 percent of its Single Family guarantee business. In fact, during this period, Single Family had exposure to between approximately $140 billion and $244 billion of loans that Freddie Mac internally recognized were “subprime,” “otherwise subprime” or “subprime-like.” The misleading statements identified herein all relate to attempts by Freddie Mac and its senior executives, including defendants, to minimize and mislead investors concerning the exposure of Freddie Mac’s Single Family guarantee business to subprime loans.

29. Beginning with its Information Statement for the fiscal year ended December 31, 2003 (the “2003 Information Statement”), and continuing through the Relevant Period, Freddie Mac published tables of credit risk characteristics for Single Family loans (the “Credit Risk Tables”). Those Credit Risk Tables contain information describing risk characteristics such as original loan-to-value (“LTV”) ratio bands, product type, property type, occupancy type, FICO credit score bands, loan purpose, geographic concentration, and origination year. The Credit Risk Tables did not quantify or otherwise provide estimates of Freddie Mac’s exposure to subprime loans.

30. In or about March 2007, as investor interest in the credit risk associated with subprime loans continued to increase, Freddie Mac began to provide narrative disclosure describing and estimating the exposure of its Single Family guarantee business to subprime loans.
loans. These disclosures contained blatantly false and misleading statements for the reasons described below.

Since the 1990s, Freddie Mac Internally Categorized Loans As Subprime Or Subprime-Like As Part Of Its Loan Acquisition Programs And In Connection With Monitoring The Risk Of Its Portfolios

31. As part of its loan acquisition and securitization process in the Single Family credit guarantee portfolio, Freddie Mac provided mortgage loan originators with a series of mortgage underwriting standards and/or automated underwriting software tools, including, since at least 1995, its proprietary automated underwriting system ("AUS") called "Loan Prospector."

32. Loan Prospector generated a credit risk classification for each loan and was used to determine the terms on which a loan could be sold to Freddie Mac, including whether a loan could be sold to Freddie Mac without certain representations and warranties or without additional cost.

33. During the Relevant Period, Loan Prospector generated a score that estimated the risk of default for each loan. The scores, in turn, were grouped into six bands or "grades," which roughly corresponded to the level of anticipated risk: A+, A1, A2, A3, C1 or C2. These grades were visible to Freddie Mac but not to mortgage loan originators or the public. Loans falling into the first four grades (A+, A1, A2 and A3) were designated "Accept Loans." Loans falling into the bottom two grades (C1 and C2) were designated "Caution Loans."

34. A loan designated as an Accept Loan permitted automated underwriting, reduced documentation and generally did not require originators to make special representations and warranties regarding the credit quality of the loan because Loan Prospector had already determined the loan was creditworthy.

35. By contrast, Loan Prospector's designation of a loan as a Caution Loan meant that the system had identified concerns about the loan's creditworthiness. Originators were required
manually to underwrite Caution Loans, produce additional documentation regarding the borrower’s creditworthiness, and make special representations and warranties regarding the credit quality of the loan. Caution Loans had multiple higher risk characteristics, such as high LTV ratios, borrowers with lower FICO scores, unusual property types or high debt-to-income ratios, and were recognized within Freddie Mac as loans that had a high risk of default relative to Accept Loans. Internally at Freddie Mac, Caution Loans were considered to be equivalent to subprime.

36. On October 8, 1997, Freddie Mac publicly announced the roll-out of its “A-minus Program” at the Mortgage Bankers Association’s annual meeting in New York. “A-minus” was a term commonly used in the marketplace to refer to subprime loans. The next day, the *American Banker* published an article reporting on Freddie Mac’s announcement and observed that “Freddie Mac is diving into subprime lending, ending months of speculation over how deeply the agency would go into the burgeoning market.” Under the A-minus Program, Caution Loans that received a score of C1 in Loan Prospector could be sold to Freddie Mac on the same terms as an Accept Loan with the payment of an additional fee by the seller. As noted by the *American Banker* article, the A-minus Program was publicly perceived as expanding Freddie Mac’s exposure to subprime loans.

37. Sales and marketing materials prepared for Single Family as part of the roll-out of the A-minus Program advised the Company’s sales force that “Freddie Mac is expanding the range of loans it will purchase, including many loans in the A-minus sector of the market. Now lenders can use Loan Prospector to provide less costly, more efficient financing to borrowers with weaker credit.” In describing the A-minus sector of the housing market, the sales and
marketing materials stated that "A-minus loans account for approximately 50 percent of subprime loans."

38. In or about November 1998, in connection with the A-minus Program, Freddie Mac revised its Credit Policy Book as it related to the broader credit risk parameters and processes under which Freddie Mac was willing to guarantee loans in Single Family. The memorandum authorizing these revisions described mortgages eligible for the A-minus Program as "[m]ortgages that generally comprise the first and second tier of subprime lender risk grades" and "mortgages generally includ[ing] 54% to 56% of the subprime market." Mortgage loans that received a C1 rating in Loan Prospector were described as having a credit quality of "A-minus," and those that received a C2 rating in Loan Prospector were described as having a credit quality of "subprime." Bisenius signed and approved the revisions to the Credit Policy Book.

39. In or about 1999, at the request of Bisenius, Freddie Mac developed an econometric model called "Segmentor," which enhanced Loan Prospector’s ability to identify subprime loans prior to Freddie Mac guaranteeing those loans. The model scored mortgage loans on a variety of credit risk characteristics, such as debt ratio, FICO’s, and time since most recent foreclosure, and generated a "subprime score." If the Segmentor "subprime score" fell below certain thresholds or had certain characteristics such as a high debt-to-income ratio, the loan received an automatic rating of C1 or C2 in Loan Prospector.

40. Loan Prospector developed and evolved over time, but, the internal view that Caution Loans (C1 and C2) were synonymous with subprime or were "subprime-like" did not change.

41. Freddie Mac’s exposure to Caution Loans up through the Relevant Period steadily rose. As of the end of 2004, Freddie Mac guaranteed the principal and interest on Caution Loans
in the amount of approximately $70 billion. From the first quarter of 2005 through the second quarter of 2008, Freddie Mac increased its total exposure to Caution Loans from approximately $73 billion to $233 billion, with the largest annual increase between the fourth quarter of 2006 (approximately $138 billion) and the fourth quarter of 2007 (approximately $216 billion). While Caution Loans were internally referred to as subprime, they were not disclosed publicly as part of the Company’s Single Family subprime exposure.

_Freddie Mac Acquires Increasingly Risky Loans to Maintain Market Share_

42. In or about the early 2000s, Freddie Mac and the Federal National Mortgage Association ("Fannie Mae") began to lose market share in mortgage loan securitizations to new competitors, including Wall Street banks. Mortgage originations had shifted from traditional fixed-rate loans to higher risk loan products with features such as adjustable rates ("ARMs"), interest-only payments, and reduced documentation requirements.

43. By 2005, the Freddie Mac and Fannie Mae combined share of the market for mortgage securitizations had fallen to approximately 42 percent from a high of nearly 60 percent in 2000. Within that shrinking GSE share of the market, Freddie Mac also had been steadily losing market share to Fannie Mae. Freddie Mac responded to this loss of market share by broadening its credit risk parameters to purchase and guarantee increasingly risky mortgages in its Single Family guarantee portfolio between approximately 2004 and 2007.

44. For example, in or about late 2004, despite contrary advice from the Company’s senior credit risk experts, Syron authorized Freddie Mac’s continued purchases of a particularly risky type of mortgage commonly referred to in the industry as a "No Income, No Asset" loan or "NINA." NINAs were widely considered to be particularly risky because they did not require any verification of a borrower’s income or assets. Freddie Mac’s senior credit risk officers
advocated to Syron that the Company stop guaranteeing NINA mortgages, in part, because of the high risk of default associated with such mortgages within their first year and because of perceived reputation risk to the Company. Syron rejected the advice, in part due to his desire to improve Freddie Mac’s market share.

45. Another example of increased risk taking occurred in or about 2005, when the Company embarked on a business strategy called Touch More Loans. Touch More Loans was designed to gain back lost market share by granting exceptions to Freddie Mac’s existing credit policy to permit the acquisition and guarantee of riskier loans that were being originated in the marketplace. Cook led the Touch More Loans strategy.

46. Coinciding with the introduction of Touch More Loans, the Company embarked on two additional initiatives to expand market share:

a. First, in February 2005, Freddie Mac introduced a new residential mortgage product called Home Possible, which was geared to low-to-moderate income borrowers (such as teachers, law enforcement personnel, healthcare workers and the military) and permitted lower down payments or higher loan-to-value ratios, among other higher credit risk characteristics, than had previously been allowed. Loans acquired through Home Possible were internally considered to be “subprime-like.”

b. Second, on August 17, 2005, Freddie Mac internally issued a policy statement authorizing increased guarantees of a Fannie Mae proprietary product called “Expanded Approval” (or “EA”) loans. As of December 2004, Freddie Mac guaranteed the principal and interest on EA loans in the approximate amount of $69 million. From the first quarter of 2005 through the second quarter of 2008, Freddie Mac increased its total exposure to EA loans from approximately $1 billion to $11 billion (with the largest increase of
approximately $8 billion coming between the fourth quarter of 2006 and the fourth quarter of 2007). EA loans were considered to have, at best, credit risk equivalent to A-minus loans and were internally described in this policy statement as (1) "appear[ing] to be subprime in nature[,]" and (2) "high risk . . . since performance compares to subprime products." In fact, on August 20, 2007, in an email that was sent to Cook and others, Bisenius described EA loans as "clearly subprime.”

47. From 2005 forward, Freddie Mac also substantially increased its exposure to loans from a subprime lending division of Countrywide Financial Corporation ("Countrywide") known as Full Spectrum Lending. Between 1999 and 2004, Freddie Mac acquired loans from Countrywide’s Full Spectrum Lending division in the aggregate amount of approximately $279 million. From 2005 through 2008, Freddie Mac acquired approximately $12 billion of Full Spectrum Lending loans (with the largest increase between 2006 (approximately $3 billion) and 2007 (approximately $6 billion)).

48. The approximate aggregate amount (in billions of U.S. dollars), measured by unpaid principal balance, of C1, C2 and EA loans in Single Family at the end of the following periods was as follows:

<table>
<thead>
<tr>
<th>Period</th>
<th>EA</th>
<th>C1</th>
<th>C2</th>
<th>Total C1 and C2</th>
<th>Total C1, C2 and EA</th>
<th>Total Single-Family Guarantee Portfolio</th>
<th>% Total C1, C2 and EA of Total Single-Family Guarantee Portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>1Q05</td>
<td>$1</td>
<td>$39</td>
<td>$35</td>
<td>$74</td>
<td>$75</td>
<td>$1,220</td>
<td>6%</td>
</tr>
<tr>
<td>Period</td>
<td>EA</td>
<td>C1</td>
<td>C2</td>
<td>Total C1, C2 and C2</td>
<td>Total C1, C2 and EA</td>
<td>Total Single-Family Guarantee Portfolio</td>
<td>% Total C1, C2 and EA of Total Single-Family Guarantee Portfolio</td>
</tr>
<tr>
<td>--------</td>
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<td>------</td>
<td>---------------------</td>
<td>---------------------</td>
<td>----------------------------------------</td>
<td>---------------------------------------------------------------</td>
</tr>
<tr>
<td>2Q05</td>
<td>$1</td>
<td>$42</td>
<td>$37</td>
<td>$79</td>
<td>$80</td>
<td>$1,244</td>
<td>6%</td>
</tr>
<tr>
<td>3Q05</td>
<td>$1</td>
<td>$47</td>
<td>$39</td>
<td>$86</td>
<td>$87</td>
<td>$1,274</td>
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<td>$2</td>
<td>$53</td>
<td>$42</td>
<td>$95</td>
<td>$97</td>
<td>$1,318</td>
<td>7%</td>
</tr>
<tr>
<td>1Q06</td>
<td>$2</td>
<td>$60</td>
<td>$47</td>
<td>$107</td>
<td>$109</td>
<td>$1,360</td>
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</tr>
<tr>
<td>2Q06</td>
<td>$2</td>
<td>$64</td>
<td>$50</td>
<td>$114</td>
<td>$116</td>
<td>$1,387</td>
<td>8%</td>
</tr>
<tr>
<td>3Q06</td>
<td>$2</td>
<td>$71</td>
<td>$54</td>
<td>$125</td>
<td>$127</td>
<td>$1,428</td>
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</tr>
<tr>
<td>4Q06</td>
<td>$3</td>
<td>$78</td>
<td>$60</td>
<td>$138</td>
<td>$141</td>
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<td>$89</td>
<td>$67</td>
<td>$156</td>
<td>$160</td>
<td>$1,528</td>
<td>10%</td>
</tr>
<tr>
<td>2Q07</td>
<td>$6</td>
<td>$100</td>
<td>$77</td>
<td>$177</td>
<td>$183</td>
<td>$1,586</td>
<td>12%</td>
</tr>
<tr>
<td>3Q07</td>
<td>$8</td>
<td>$110</td>
<td>$88</td>
<td>$198</td>
<td>$206</td>
<td>$1,642</td>
<td>13%</td>
</tr>
<tr>
<td>4Q07</td>
<td>$11</td>
<td>$118</td>
<td>$98</td>
<td>$216</td>
<td>$227</td>
<td>$1,692</td>
<td>13%</td>
</tr>
<tr>
<td>1Q08</td>
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<td>$123</td>
<td>$104</td>
<td>$227</td>
<td>$238</td>
<td>$1,739</td>
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</tr>
<tr>
<td>2Q08</td>
<td>$11</td>
<td>$127</td>
<td>$106</td>
<td>$233</td>
<td>$244</td>
<td>$1,784</td>
<td>14%</td>
</tr>
</tbody>
</table>
49. Beginning in or about 2004, in addition to purchasing and guaranteeing the payment of principal and interest on loans that had been underwritten using Loan Prospector, Freddie Mac increasingly purchased and guaranteed mortgage loans underwritten through other proprietary AUSs. For example, Freddie Mac purchased and guaranteed mortgage loans underwritten using AUSs such as Fannie Mae’s Desktop Underwriter and Countrywide’s CLUES.

50. To assess the relative risk of mortgages underwritten through other AUSs, Freddie Mac used an internal modeling system called LP Emulator to approximate how the loans would have scored under Loan Prospector. LP Emulator used the same scoring metric as Loan Prospector – Accept Loans (A+, A1, A2 and A3) and Caution Loans (C1 and C2) – but, LP Emulator was run on a loan after Freddie Mac had agreed to guarantee the loan. Using LP Emulator, Freddie Mac could identify a loan that would have been designated as a Caution Loan if underwritten through Loan Prospector, but had instead been guaranteed on terms equivalent to an Accept Loan after being underwritten through another AUS. Loans falling into this category were deemed to have a “defect.” Beginning in 2004, Freddie Mac tracked the “defect rate” of loans acquired through other AUSs.

51. In the second quarter of 2003, before Freddie Mac increased its purchases through AUSs other than Loan Prospector, Freddie Mac’s aggregate defect rate was approximately 1 percent. Freddie Mac’s purchase and guarantee of mortgages underwritten through other AUSs increased to the point where it was acquiring fewer loans through Loan Prospector (approximately 27 percent) than through Fannie Mae’s Desktop Underwriter (approximately 31 percent). The defect rate rose dramatically, and in August 2007, the aggregate defect rate
reached a historical high of approximately 22 percent. Approximately 22 percent of the loans Freddie Mac purchased and guaranteed that were underwritten through other AUSs therefore met the Freddie Mac internal definition of subprime.

**Defendants Were Aware of Subprime Exposure in Single Family**

52. On May 25, 2006, Cook attended a meeting of the Board’s Finance and Capital Deployment Committee. Prior to that meeting, she received a memorandum authored by the Company’s then-Chief Enterprise Risk Officer, highlighting for her and the other attendees that “[t]he credit parameters of new single-family purchases continue to decline. In order to support our business strategies to increase customer focus, build market share and meet affordable goals, we continue to expand credit policies and increase purchases of higher-risk products.”

53. Six days later, on May 31, 2006, Syron and Cook attended a meeting of the Board’s Mission, Sourcing and Technology Committee, where it was highlighted that the Touch More Loans strategy had resulted in significantly greater credit risk to the Company. Specifically, a presentation made by a senior credit risk officer stated that, pursuant to Touch More Loans, Freddie Mac was “expanding our appetite” for, among other things, risk layering of lower FICOs, higher LTV’s, other AUSs, and other high-risk loans. To the extent it was not already clear to them prior to the meeting, Syron and Cook also were informed that the Company was loosening its underwriting standards through its implementation of the Touch More Loans strategy by, among other things, increasing exceptions to the Company’s existing credit policy—exceptions that had almost tripled between 2004 and 2005, from 286 in 2004 to 770 in 2005.

54. On November 30, 2006, Bisenius’ staff informed him that loans sold to Freddie Mac through Fannie Mae’s Desktop Underwriter were contributing disproportionately to the Company’s increasing defect rate and included loans that were equivalent to subprime. Specifically, Bisenius’ staff told him and others that loans from Fannie Mae’s Desktop
Underwriter “have a much higher percent of defect loans, loans that are subprime-like, loans that have very low FICOs” in referring to loans that contributed to the increasing “defect rate” at the Company.

55. On December 7, 2006, Syron and Cook attended a meeting of the Mission, Sourcing and Technology Committee of the Board of Directors. Attached to a presentation prepared for that meeting was a glossary of terms, the purpose of which was to inform the Board of how management used certain terms. The glossary defined “Subprime Mortgages” as follows:

There is no longer a clear-cut distinction between prime and subprime mortgages as the mortgage market has evolved to provide for mortgage credit to a full range of borrowers with a variety of products and processes. Subprime mortgages generally are mortgages that involve elevated credit risk. Whereas prime loans are typically made to borrowers who have a strong credit history and can demonstrate a capacity to repay their loans, subprime loans are typically made to borrowers who have a blemished or weak credit history and/or a weaker capacity to repay.

Ultimately, during the Relevant Period, the Company’s public subprime disclosures were inconsistent with how management characterized its use of the term “subprime” for its own Board members.

56. Beginning on or about January 18, 2007, Freddie Mac’s ERMC began to report on Freddie Mac’s exposure to subprime loans. Attendees of the January 18 ERMC meeting – including Syron and Cook – were told that “[l]oan level risk grades are blurred as capital retreats in [the] subprime market, increasing the likelihood that we are already purchasing subprime loans under existing acquisition programs.” Accordingly, this presentation reinforced to attendees of this meeting that it was likely that Freddie Mac already was purchasing loans with credit risk characteristics similar to loans originated by self-identified subprime originators, and that market participants would consider to be subprime loans. The ERMC met monthly after this
and Syron and Cook generally attended ERMC meetings. Going forward, the ERMC reports consistently contained this same warning. Syron typically received the ERMC reports in advance of the meetings and generally reviewed them prior to the meetings.

57. On February 6 and 7, 2007, Syron gathered his Senior Executive Team for a two-day offsite planning meeting in Florida to discuss Freddie Mac’s strategic direction. Cook attended as a member of the SET, as did Bisenius (who was invited even though he was not formally a member of the SET). At least one presentation was devoted to Freddie Mac’s role in the subprime market. That presentation highlighted for attendees the following regarding Freddie Mac’s exposure to subprime:

- Freddie Mac “already purchase[s] subprime-like loans . . . but with considerably lower fees[,]” which attendees generally understood meant that Freddie Mac was purchasing loans with credit risk and expected default rates similar to the loans originated by a small handful of institutions that self-identified as subprime originators.
- The “[w]orst 10% of [the Single Family] Flow Business” – which comprised approximately 70 percent of Single Family purchases in 2006 – were “subprime-like loans.”
- Freddie Mac was purchasing greater percentages of “risk layer[ed]” loans, defined as loans consisting of total LTV greater than 90 percent and FICO scores less than 680, which was “leading to more ‘Cautions’” and a higher “[d]efect rate.”
- “‘Caution’ loans have greater default costs . . . resulting in higher expected losses[.]”
58. On February 17, 2007, Syron received and responded to an email from Bisenius regarding a new “Subprime Project.” Bisenius told Syron and others that an expanded role in the subprime market only made sense if Freddie Mac was adequately compensated for the risk, and reminded Syron and others that there were certain categories of loans, including “free cautions,” that the Company already purchased and did not receive adequate compensation for the risk.

59. On March 2 and 3, 2007, Syron, Cook and Bisenius attended a two-day Board of Directors meeting, a significant portion of which was dedicated to the Company’s strategic direction in subprime. Cook was one of the presenters at the Board meeting and she, along with the then-Chief Operating Officer, presented similar information to the Board as contained in the February 6 and 7 offsite meeting. Specifically, Cook and the then-Chief Operating Officer led a discussion at the meeting concerning a slide in which the “worst 10% of [Freddie Mac’s] Flow Business” was listed as an example of “subprime-like loans” the Company already purchased, and in which they conveyed:

- “We already purchase subprime-like loans to help achieve our HUD goals . . . but we receive considerably lower fees than subprime loans would fetch in the market.”
- “Some of our current purchases have subprime-like risk[.]”
- “[F]ixed-rate subprime doesn’t look all that different than the bottom of our purchases, with returns five to six times as great, not universal for all subprime.”

60. In addition to receiving at least the SET and Board materials referred to above in Paragraphs 57 and 59 which highlighted, among other things, that a material portion of the Single Family business was “subprime-like,” and monthly ERMC reports which repeatedly warned of the increasing risk that Freddie Mac was buying subprime loans (and showed data
suggesting that the credit risk of the principal and interest of loans to be securitized by Freddie Mac was increasing to historic proportions), Syron also was aware at least as early as February 17, 2007 of Freddie Mac’s efforts to develop a model subprime offering targeted at customers of self-identified subprime originators.

61. By at least early April 2007, Bisenius transitioned into a new role at Freddie Mac, where he was placed in charge of developing a Model Subprime Offering that was later publicly known as a product called “Freddie Mac SafeStep Mortgages,” to give subprime borrowers a more consumer-friendly mortgage option.

62. Although the Model Subprime Offering purportedly had been developed as an alternative to subprime products, Freddie Mac personnel, including Syron, Cook and Bisenius, recognized that it actually competed with existing programs that Freddie Mac had internally recognized as “subprime,” “otherwise subprime,” or “subprime-like.”

63. On April 12, 2007, Bisenius proposed abolishing Freddie Mac’s A-minus Program – which was long-recognized as subprime – “so as to not cannibalize [sic] our [Model Subprime Offering].”

64. By mid-April 2007, Bisenius also knew that the credit characteristics of loans to be guaranteed under the Model Subprime Offering were similar to those of other existing Freddie Mac programs in addition to the A-minus Program, such as Home Possible and Fannie Mae’s EA program, which he was well aware internally were perceived as programs that exposed Freddie Mac to subprime or subprime-like loans – as he had used those same descriptions for those programs.

65. Bisenius regularly briefed Cook on the Model Subprime Offering. Cook requested these briefings to discuss the role of the Company’s existing Single Family guarantee
programs relative to the Model Subprime Offering. At a briefing on April 20, 2007, highlighted that there were “alignment” issues between the Model Subprime Offering loans and Freddie Mac’s existing loan programs.

66. On May 16, 2007, Bisenius sent an e-mail commenting on a set of recommendations regarding certain of Freddie Mac’s current offerings as related to the Model Subprime Offering. In the email, Bisenius observed that the recommendations did not “address DU approves or Proprietary AUS approves that we think are subprime (ie., [sic] they would score Caution in LP) and therefore might compete with our model offering.”

67. On June 7, 2007, Cook and Bisenius attended a meeting of the Board’s Mission, Sourcing and Technology Committee, where it was conveyed that:

- Certain higher risk loans sold to Freddie Mac through other AUSs were equivalent to subprime.

- Freddie Mac-securitized loans obtained through Fannie Mae’s Desktop Underwriter had a “higher share of low FICO loans and subprime-like loans” relative to other AUS loans.

- Loans sold to Freddie Mac through Countrywide’s CLUES were “particularly volatile” and, in particular, of those loans sourced through CLUES that were later scored by Freddie Mac’s LP Emulator as “Caution,” (called “defect loans” for their contributions to the “defect rate”), a high proportion of such loans were “subprime in nature.”

68. On or about June 11, 2007, Cook and others received an “Executive Summary” sponsored by Bisenius, that stated that the Model Subprime Offering would compete with existing loans the Company acquired and guaranteed such as “[Freddie Mac’s] affordable
offerings like Home Possible and [Fannie Mae's] MyCommunityMortgage, as well as our LP Loan Prospector A-minus offering and [Fannie Mae's] newly revamped EA program.” The Executive Summary also highlighted that “[s]ubprime mortgages are not considered unique in the industry. An analysis of Freddie Mac’s existing products indicates our current A-minus offering has credit risk and product parameters (business terms) that match, and in some cases, are broader than those outlined in the proposed model Subprime offering.” Cook attended the meeting of the New Products Committee where this Executive Summary was discussed.

69. At the September 25, 2007 ERMC meeting, both Syron and Cook were told that the defect rate of purchases, which had been steadily rising, had increased from approximately 13 percent at the end of June 2007, to 19 percent in July 2007, to approximately 22 percent in August 2007. The presentation highlighted for Syron and Cook that principal drivers of the defect rate were low FICOs and high LTVs. Syron and Cook were presented with similar facts at the October 23, 2007 ERMC meeting.

70. Additionally, on September 26, 2007, Cook received a memorandum describing how the Model Subprime Offering would be positioned for marketing purposes. The memorandum noted that the Model Subprime Offering was consistent with Freddie Mac’s “longer term corporate ‘touch more loans’ strategy to expand into adjacent markets” and that the offering would replace Freddie Mac’s A-minus loan program.

71. On November 27, 2007, the ERMC distributed a packet of materials to Syron and Cook, among others. Although no meeting took place, the materials further informed Syron and Cook of the stresses on Single Family as a result of Freddie Mac’s acquisition of riskier loans. Specifically, the materials highlighted that the “2007 book performance is worse than in 2006, both exhibiting much higher serious delinquency rates than other book years;” that expected
default costs for October 2007 "are 76% higher than in 2006," and that the defect rate had risen to approximately 20 percent.

72. On December 18, 2007, Syron and Cook attended an ERMC meeting, which highlighted for them the deterioration of credit quality for the largest portion of Freddie Mac's Single Family guarantee portfolio. According to the report used at that meeting, the defect rate for the third quarter of 2007 had increased to approximately 20 percent, up from approximately 16 percent in the second quarter of 2007 and approximately 13 percent in the first quarter of 2007. Similar facts were highlighted for Syron and Cook at meetings of the ERMC on January 23, 2008.

73. On January 23, 2008, Syron and Cook attended another ERMC meeting, during which they were told that the defect rate on the largest part of the business was at approximately 20 percent in November, still at historically high levels. Syron and Cook also were told that EA loans accounted for approximately 19 percent of expected default costs in Single Family. Similar trends were highlighted for Syron and Cook at ERMC meetings on February 19, 2008, March 25, 2008 and April 29, 2008.

**Syron, Cook and Bisenius Were Responsible for Freddie Mac's Disclosures**

74. Syron, Cook and Bisenius each made, or aided and abetted Freddie Mac or each other in making, false and misleading credit risk disclosures regarding subprime loans in the Company's Single Family guarantee portfolio as a result of their authority over, or knowing and substantial assistance in, such disclosures.

September 30, 2007 (the “3Q07 Information Statement Supplement”), the Information Statement and Annual Report to Stockholders for the Fiscal Year Ended December 31, 2007 (the “2007 Information Statement”), the Financial Report for the Three Months Ended March 31, 2008 (the “1Q08 Information Statement Supplement”), and the Form 10-Q for the Quarterly Period Ended June 30, 2008 (the “2Q08 Form 10-Q”). The certifications stated, among other things:

- "Based on my knowledge, this [Report] does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this [Report].”

- "Based on my knowledge, the consolidated financial statements, and other financial information included in this [Report], fairly present in all material respects the financial condition, results of operations and cash flows of Freddie Mac as of, and for, the periods presented in this [Report].”

76. Cook sub-certified the 2006 Information Statement, the 2Q07 Information Statement Supplement, the 3Q07 Information Statement Supplement, the 2007 Information Statement, the 1Q08 Information Statement Supplement, and 2Q08 Form 10-Q. Bisenius sub-certified the 2006 Information Statement, the 2Q07 Information Statement Supplement and the 2Q08 Form 10-Q. Those sub-certifications stated, among other things:

- "Based upon my role and responsibilities, I have reviewed the appropriate sections of the [Report].”

- "I have consulted with such members of my staff and others whom I thought should be consulted in connection with my execution of this attestation.”

- "Based upon my role and responsibilities, but limited in all respects to the matters that come to my attention in fulfilling my responsibilities as [CBO (Cook) or SVP for Credit Policy (Bisenius)], I hereby certify to the best of my knowledge and belief that:”

- "The [Report] does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, to not be misleading.”

- "The financial statements and other financial information included in the [Report] fairly present, in all material respects, the financial condition and results of
operations, and cash flows of the Company as of and for the periods presented in the [Report].”

77. Cook and Bisenius each sub-certified to the accuracy of Freddie Mac’s subprime disclosures in those Information Statements and Information Statement Supplements described above in Paragraph 76 based upon their respective roles and responsibilities at the Company.

78. As EVP for Investments and Capital Markets and CBO, during the Relevant Period, Cook specifically had responsibility over the Company’s Single Family business, including the Company’s subprime loan exposure as it related to the credit risks associated with that business.

79. As SVP of Credit Policy and Portfolio Management and SVP of Single Family Credit Guarantee, during a portion of the Relevant Period, Bisenius had direct responsibility over the credit risks, including subprime loan exposure, associated with the Single Family business. During that portion of the Relevant Period that Bisenius was working on “special projects” for Cook, including the Model Subprime Offering, Bisenius continued to carry on certain responsibilities as the SVP for Credit Policy and Portfolio Management, and sub-certified to those Information Statements and Information Statement Supplements described above in Paragraph 76. In addition to sub-certifying these disclosures, Bisenius served on the Disclosure Committee that considered the 2Q08 Form 10-Q.

80. Given their respective roles and responsibilities and the importance of the sub-certifications to the Company’s disclosure process, Cook and Bisenius substantially assisted in the making of the Company’s false and misleading statements by validating the accuracy of the Company’s subprime disclosures, which they knew or were reckless in not knowing were false.
Freddie Mac's Subprime Disclosures

81. On June 28, 2006, in its Information Statement and Annual Report to Stockholders for the fiscal year end December 31, 2005 (the “2005 Information Statement”), Freddie Mac publicly quantified for the first time the exposure of its Single Family portfolio to subprime loans. The Company represented that: “At December 31, 2005 and 2004, we guaranteed $2.3 billion and $4.5 billion of securities backed by subprime mortgages which constituted less than one percent of our Total mortgage portfolio, respectively.”

82. The Company also noted that it participated in the subprime segment in two other ways: (i) “our Retained portfolio makes investments in non-Freddie Mac mortgage-related securities that were originated in this market segment” and (ii) “we made investments through our Retained Portfolio in some of the structured securities we issue with underlying collateral that is subprime.”

83. During the Relevant Period, Freddie Mac continued to make public disclosure of its Single Family subprime exposure. However, the disclosures during the Relevant Period were consistently materially false and misleading.

Year-End 2006

84. On March 23, 2007, in its 2006 Information Statement, Freddie Mac disclosed the following regarding its subprime exposure in Single Family:

Participants in the mortgage market often characterize loans based upon their overall credit quality at the time of origination, generally considering them to be prime or subprime. There is no universally accepted definition of subprime. The subprime segment of the mortgage market primarily serves borrowers with poorer credit payment histories and such loans typically have a mix of credit characteristics that indicate a higher likelihood of default and higher loss severities than prime loans. Such characteristics might include a combination of high loan-to-value ratios, low FICO scores or originations using lower underwriting standards such as limited or no documentation of a borrower’s income. The
subprime market helps certain borrowers by increasing the availability of mortgage credit.

While we do not characterize the single-family loans underlying the PCs and Structured Securities in our credit guarantee portfolio as either prime or subprime, we believe that, based on lender-type, underwriting practice and product structure, the number of loans underlying these securities that are subprime is not significant. Also included in our credit guarantee portfolio are Structured Securities backed by non-agency mortgage-related securities where the underlying collateral was identified as being subprime by the original issuer. At December 31, 2006 and 2005, the Structured Securities backed by subprime mortgages constituted approximately 0.1 percent and 0.2 percent, respectively of our credit guarantee portfolio.

The 2006 Information Statement also disclosed that Freddie Mac held, at December 31, 2006 and 2005, in its Retained Portfolio – which is distinct from the Single Family guarantee portfolio – “approximately $124 billion and $139 billion, respectively, of non-agency mortgage-related securities backed by subprime loans.”

85. The statement in the 2006 Information Statement that Freddie Mac’s subprime exposure in Single Family was “not significant” was materially false and misleading because it communicated the misleading impression that after considering a mix of credit risk characteristics to assess its exposure to subprime loans, Freddie Mac determined that its Single Family guarantee portfolio had no significant exposure.

86. Contrary to its disclosure, at December 31, 2006, Freddie Mac’s single-family credit guarantee portfolio consisted of approximately $141 billion of C1, C2 and EA loans – loans that Single Family internally described as “subprime,” “otherwise subprime” or “subprime-like loans” – which represented approximately 10 percent of Freddie Mac’s single-family credit guarantee portfolio.

87. Syron certified, and Cook and Bisenius each signed sub-certifications, for the 2006 Information Statement even though they knew, or were reckless in not knowing, that the
disclosure regarding exposure to subprime loans contained in the 2006 Information Statement was materially false and misleading.

88. The disclosures contained in Freddie Mac’s 2006 Information Statement were incorporated by reference into, among other things, Freddie Mac’s April 10, 2007 Offering Circular, pursuant to which Freddie Mac issued $500 million of 5.66 percent non-cumulative perpetual preferred stock.

_Syron Makes a Materially False and Misleading Statement Regarding Freddie Mac’s Exposure to Subprime Loans on an Earnings Conference Call_

89. The same day that Freddie Mac published the 2006 Information Statement, the Company’s senior executives held an earnings conference call. Syron and others participated in the call. On the call, Syron had the following question-and-answer exchange with a research analyst:

Q: “Seems like over the last couple of years that subprime market has really replaced the FHA product. You and to some degree Fannie Mae both have abstained from those higher LTV products....”

A: “Fortunately, at least speaking for ourselves as a GSE, we as you know weren’t involved in underwriting much of that business any of that business directly. Having said all of that ... we are working fairly intensely right now on how we can develop products in the subprime space that are both shareholder and consumer friendly ... we’re doing it on a pretty accelerated basis.”

90. Syron’s statement that, with respect to the subprime market, Freddie Mac was not “involved in underwriting much of that business any of that business directly” was materially false and misleading. Furthermore, his answer reinforced the already misleading impression that Freddie Mac did not participate in the “subprime space,” but was exploring ways to develop products for that market.
Syron and Cook Make Materially False and Misleading Statements Regarding Single Family's Exposure to Subprime in Speeches at Investor Conferences

91. Less than two months after the 2006 Information Statement was issued, Syron and Cook each spoke at separate investor conferences and reiterated the misleading assertion that Single Family's exposure to subprime loans was not significant.

92. On May 14, 2007, Syron spoke in New York at the UBS Global Financial Services Conference (the "UBS Conference") and stated: "As we discussed in the past, at the end of 2006, Freddie had basically no subprime exposure in our guarantee business, and about $124 billion of AAA rated subprime exposure in our retained portfolio."

93. Three days later, on May 17, 2007; Cook gave a speech at the Lehman Brothers 10th Annual Financial Services Conference (the "Lehman Conference") in London and stated: "As we discussed in the past, at the end of 2006, Freddie had basically no subprime exposure in our guarantee business, and about $124 billion of AAA rated subprime exposure in our retained portfolio."

94. Each of Syron's statement at the UBS Conference quoted in Paragraph 92 and Cook's statement at the Lehman Conference quoted in Paragraph 93 was materially false and misleading because the statements reinforced the misleading impression that Freddie Mac had little or no exposure to subprime loans in its Single Family guarantee business and was not in the "subprime space."

95. Prior to these speeches, Syron and Cook both knew or were reckless in not knowing that it was false and misleading to claim the Company "had basically no subprime exposure.” The then-head of External Reporting and others at Freddie Mac recognized that this statement was inaccurate.
96. Prior to Syron and Cook giving these speeches, Freddie Mac’s then-head of External Reporting reviewed a draft of Syron’s speech and warned Bisenius, among others, that it would be false to state that Freddie Mac has basically no exposure to subprime:

We need to be careful how we word this. Certainly our portfolio includes loans that under some definitions would be considered subprime. . . . We should reconsider making as sweeping a statement as we have “basically no subprime exposure.”

97. Bisenius did not respond to the concern raised by the then-head of External Reporting or otherwise seek to correct the speeches before they were given. He reported to Cook at the time.

First and Second Quarters of 2007

98. On June 14, 2007, Freddie Mac published its financial report for the three months ended March 31, 2007 (the “1Q07 Information Statement Supplement”), which appended, among other things, a June 14 press release in which Syron suggested that Freddie Mac was just starting to become exposed to subprime: “I’m particularly proud that our company took a leadership role in the subprime mortgage market, announcing new underwriting standards and products and committing to purchase up to $20 billion mortgages to support subprime borrowers.”

99. Freddie Mac did not quantify its subprime exposure in its 1Q07 Information Statement Supplement but incorporated by reference the misleading subprime disclosure contained in its 2006 Information Statement.

100. The disclosures contained in Freddie Mac’s 2006 Information Statement and its 1Q07 Information Statement Supplement were incorporated by reference into, among other things, Freddie Mac’s July 17, 2007 Offering Circular, pursuant to which Freddie Mac issued $500 million of 6.02 percent non-cumulative perpetual preferred stock.
101. On August 30, 2007, Freddie Mac published its 2Q07 Information Statement Supplement, which purported to disclose Freddie Mac’s total Single Family exposure to subprime:

Participants in the mortgage market often characterize single-family loans based upon their overall credit quality at the time of origination, generally considering them to be prime or subprime. There is no universally accepted definition of subprime. The subprime segment of the mortgage market primarily serves borrowers with poorer credit payment histories and such loans typically have a mix of credit characteristics that indicate a higher likelihood of default and higher loss severities than prime loans. Such characteristics might include a combination of high loan-to-value ratios, low credit scores or originations using lower underwriting standards such as limited or no documentation of a borrower’s income. The subprime market helps certain borrowers by broadening the availability of mortgage credit.

We estimate that approximately $2 billion, or 0.1 percent, and $3 billion, or 0.2 percent, of loans underlying our single-family mortgage portfolio, at June 30, 2007 and December 31, 2006, respectively, were classified as subprime mortgage loans.

The 2Q07 Information Statement Supplement also disclosed that, at June 30, 2007 and December 31, 2006, Freddie Mac held in its Retained Portfolio – which is distinct from the Single Family guarantee portfolio – “approximately $119 billion and $124 billion, respectively, of non-agency mortgage-related securities backed by subprime loans.”

102. The statement in Freddie Mac’s 2Q07 Information Statement Supplement concerning Single Family’s exposure to subprime in it guarantee portfolio was materially false and misleading. It communicated the misleading impression that, after considering a mix of credit risk characteristics to assess its exposure to subprime loans, Freddie Mac determined that its Single Family guarantee portfolio included only $2 billion, or 0.1 percent, of subprime loans as of June 30, 2007.
103. Contrary to its disclosure, as of June 30, 2007, Freddie Mac’s Single Family guarantee portfolio consisted of more than $182 billion of C1, C2 and EA loans – loans internally described as “subprime,” “otherwise subprime” or “subprime-like loans” – which represented approximately 11 percent of the Single Family credit guarantee portfolio.

104. In July 2007, in between the publication of Freddie Mac’s 1Q07 and 2Q07 Information Statement Supplements, Cook was involved in developing the Company’s definition of subprime for disclosure purposes.

105. Syron certified and Cook and Bisenius each sub-certified the 2Q07 Information Statement Supplement even though they knew or were reckless in not knowing that the Statement was materially false and misleading.

106. The disclosures contained in Freddie Mac’s 2006 Information Statement and its 2Q07 Information Statement Supplements were incorporated by reference into, among other things, Freddie Mac’s September 25, 2007 Offering Circular, pursuant to which Freddie Mac issued $500 million of 6.55 percent non-cumulative perpetual preferred stock.

Third Quarter of 2007

107. On November 20, 2007, Freddie Mac published its 3Q07 Information Statement Supplement, which purported to disclose Freddie Mac’s total Single Family exposure to subprime:

Participants in the mortgage market often characterize single-family loans based upon their overall credit quality at the time of origination, generally considering them to be prime or subprime. There is no universally accepted definition of subprime. The subprime segment of the mortgage market primarily serves borrowers with poorer credit payment histories and such loans typically have a mix of credit characteristics that indicate a higher likelihood of default and higher loss severities than prime loans. Such characteristics might include a combination of high loan-to-value ratios, low credit scores or originations using lower underwriting standards such as limited or no documentation of a
borrower's income. The subprime market helps certain borrowers by broadening the availability of mortgage credit.

We estimate that approximately $5 billion and $3 billion of loans underlying our Structured Transactions at September 30, 2007 and December 31, 2006, respectively, were classified as subprime mortgage loans.

The 3Q07 Information Statement Supplement also disclosed that, at September 30, 2007 and December 31, 2006, Freddie Mac held in its Retained Portfolio – which is distinct from the Single Family guarantee portfolio – “approximately $105 billion and $124 billion, respectively, of non-agency mortgage-related securities backed by subprime loans.”

108. The statement in Freddie Mac’s 3Q07 Information Statement Supplement concerning Single Family’s exposure to subprime in its guarantee portfolio was materially false and misleading. It communicated the misleading impression that, after considering a mix of credit risk characteristics to assess its exposure to subprime loans, Freddie Mac had determined that its Single Family guarantee portfolio included only $5 billion of subprime loans as of September 30, 2007.

109. Contrary to its disclosure, Freddie Mac’s Single Family credit guarantee portfolio had exposure to approximately $206 billion of C1, C2 and EA loans – loans internally described as “subprime,” “otherwise subprime” or “subprime-like loans” – which represented approximately 13 percent of the Single Family credit guarantee portfolio as of September 30, 2007.

110. Syron certified and Cook sub-certified the 3Q07 Information Statement Supplement even though they knew or were reckless in not knowing that the Statement was materially false and misleading.

111. The disclosures contained in Freddie Mac’s 2006 Information Statement and its 3Q07 Information Statement Supplements were incorporated by reference into, among other
things, Freddie Mac’s November 29, 2007 Offering Circular, pursuant to which Freddie Mac issued $6 billion of fixed-to-floating rate non-cumulative perpetual preferred stock.

Syron Makes a False and Misleading Statement Regarding Single Family’s Exposure to Subprime at an Investor Conference

112. On December 11, 2007, Syron spoke at a Goldman Sachs & Co. Financial Services Conference (the “GS Conference”) in New York. At the GS Conference, Syron knowingly or recklessly made the false and misleading representation that Freddie Mac had not guaranteed any subprime loans in its Single Family guarantee business. He stated:

Finally, we feel that our credit position in the current guarantee book, actually, is very near the best of the entire industry. A very major reason for this is that we have very low exposures to alt A in risk-layered mortgage products in the guarantee business. We didn’t do any subprime business.... In terms of our insight into the subprime stuff, we didn’t buy any subprime loans. I mean, we bought some securities, which we can go through, and we think we’re fine in. We bought them for goal purposes. But we didn’t buy in guarantee, essentially any subprime loans. So we weren’t in that business.

113. Syron’s statement was materially false and misleading because his statement reinforced the misleading impression that Freddie Mac had little or no exposure to subprime loans in its Single Family guarantee business. Although Syron appears to have rationalized this false and misleading statement based on the fact that Single Family did not typically acquire loans from a small handful of institutions that self-identified as subprime originators, this rationale was not publicly disclosed and not shared with the audience as the basis for his sweeping public statement. In fact, as set forth above, at the time of Syron’s statement, the Freddie Mac Single Family guarantee business consisted of approximately $206 billion of exposure to loans that Freddie Mac internally recognized were “subprime,” “otherwise subprime” or “subprime-like.”
Year-End 2007

114. On February 28, 2008, Freddie Mac published its 2007 Information Statement, which purported to disclose Freddie Mac’s total Single Family exposure to subprime:

Participants in the mortgage market often characterize single-family loans based upon their overall credit quality at the time of origination, generally considering them to be prime or subprime. There is no universally accepted definition of subprime. The subprime segment of the mortgage market primarily serves borrowers with poorer credit payment histories and such loans typically have a mix of credit characteristics that indicate a higher likelihood of default and higher loss severities than prime loans. Such characteristics might include a combination of high LTV ratios, low credit scores or originations using lower underwriting standards such as limited or no documentation of a borrower’s income. The subprime market helps certain borrowers by broadening the availability of mortgage credit.

While we have not historically characterized the single-family loans underlying our PCs and Structured Securities as either prime or subprime, we do monitor the amount of loans we have guaranteed with characteristics that indicate a higher degree of credit risk. See “Mortgage Portfolio Characteristics — Higher Risk Combinations” for further information. We estimate that approximately $6 billion and $3 billion of loans underlying our Structured Transactions at December 31, 2007 and 2006, respectively, were classified as subprime mortgage loans.

The 2007 Information Statement Supplement also disclosed that, as of December 31, 2007 and December 31, 2006, Freddie Mac held in its Retained Portfolio — which is distinct from the Single Family guarantee portfolio — “approximately $110 billion and $122 billion, respectively, of non-agency mortgage-related securities backed by subprime loans.” Additionally, Freddie Mac announced that, to date, it had made purchase commitments of $207 million of mortgages on primary residence, single-family properties, pursuant to the commitment it announced in April 2007 to purchase up to $20 billion in fixed-rate and hybrid ARM products and also purchases of $43 billion of mortgages to borrowers that otherwise might have been limited to subprime products.
115. The statement in Freddie Mac’s 2007 Information Statement concerning Single Family’s subprime exposure in its guarantee portfolio was materially false and misleading because it communicated the misleading impression that, after considering a mix of credit risk characteristics to assess its exposure to subprime loans, Freddie Mac had determined that its Single Family guarantee portfolio included only $6 billion of exposure to subprime loans as of December 31, 2007.

116. Contrary to its disclosure, Freddie Mac was exposed in its Single Family guarantee business to approximately $226 billion of C1, C2 and EA loans – loans internally described as “subprime,” “otherwise subprime” or “subprime-like loans” – which represented approximately 13 percent of Freddie Mac’s Single Family credit guarantee portfolio as of December 31, 2007.

117. Syron certified and Cook sub-certified the 2007 Information Statement even though they knew or were reckless in not knowing that the Statement was materially false and misleading.

First Quarter of 2008

118. On May 14, 2008, Freddie Mac published its 1Q08 Information Statement Supplement, purported to assure investors that it monitors the subprime loans it guarantees and purported to disclose Freddie Mac’s exposure to subprime loans underlying Structured Transactions:

Participants in the mortgage market often characterize single-family loans based upon their overall credit quality at the time of origination, generally considering them to be prime or subprime. There is no universally accepted definition of subprime. The subprime segment of the mortgage market primarily serves borrowers with poorer credit payment histories and such loans typically have a mix of credit characteristics that indicate a higher likelihood of default and higher loss severities than prime loans.
Such characteristics might include a combination of high LTV ratios, low credit scores or originations using lower underwriting standards such as limited or no documentation of a borrower's income. The subprime market helps certain borrowers by broadening the availability of mortgage credit. While we have not historically characterized the single-family loans underlying our PCs and Structured Securities as either prime or subprime, we do monitor the amount of loans we have guaranteed with characteristics that indicate a higher degree of credit risk (see "Higher Risk Combinations" for further information). In addition, we estimate that approximately $4 billion of security collateral underlying our Structured Transactions at both March 31, 2008 and December 31, 2007 were classified as subprime.

The 1Q08 Information Statement Supplement also disclosed that, as of March 31, 2008 and December 31, 2007, Freddie Mac held in its Retained Portfolio – which is distinct from the Single Family guarantee portfolio – “approximately $93 billion and $101 billion, respectively, of non-agency mortgage-related securities backed by subprime loans.”

119. The statement in Freddie Mac’s 1Q08 Information Statement Supplement concerning Single Family’s exposure to subprime in its guarantee portfolio was materially false and misleading because it communicated the misleading impression that, after considering a mix of credit risk characteristics to assess its exposure to subprime loans, Freddie Mac had determined that its total Single Family exposure to subprime loans was only $4 billion, or the amount of its Structured Transactions as of March 31, 2008. In fact, at the time, Freddie Mac was exposed to approximately $239 billion of C1, C2 and EA loans – loans that were internally referred to as “subprime,” “otherwise subprime” or “subprime-like loans” – which represented approximately 14 percent of Freddie Mac’s Single Family credit guarantee portfolio.

120. Syron certified and Cook sub-certified the 1Q08 Information Statement Supplement even though they knew or were reckless in not knowing that the Statement was materially misleading.
Second Quarter of 2008

121. On August 6, 2008, Freddie Mac filed with the Commission its 2Q08 Form 10-Q, which was the first periodic report it filed following its registration with the Commission. The 2Q08 Form 10-Q disclosed the following regarding Freddie Mac's subprime exposure:

Participants in the mortgage market often characterize single-family loans based upon their overall credit quality at the time of origination, generally considering them to be prime or subprime. There is no universally accepted definition of subprime. The subprime segment of the mortgage market primarily serves borrowers with poorer credit payment histories and such loans typically have a mix of credit characteristics that indicate a higher likelihood of default and higher loss severities than prime loans. Such characteristics might include a combination of high LTV ratios, low credit scores or originations using lower underwriting standards such as limited or no documentation of a borrower's income. The subprime market helps certain borrowers by broadening the availability of mortgage credit. While we have not historically characterized the single-family loans underlying our PCs and Structured Securities as either prime or subprime, we do monitor the amount of loans we have guaranteed with characteristics that indicate a higher degree of credit risk (see "Higher Risk Combinations" for further information). In addition, we estimate that approximately $6 billion of security collateral underlying our Structured Transactions at both June 30, 2008 and December 31, 2007 were classified as subprime.

Although we do not categorize our single-family loans into prime or subprime, we recognize that certain of the mortgage loans in our retained portfolio exhibit higher risk characteristics. Total single-family loans include $1.3 billion at both June 30, 2008 and December 31, 2007, of loans with higher-risk characteristics, which we define as loans with original LTV ratios greater than 90% and borrower credit scores less than 620 at the time of loan origination.

The 2Q08 Form 10-Q also disclosed that, as of June 30, 2008 and December 31, 2007, Freddie Mac held in its Retained Portfolio – which is distinct from the Single Family guarantee portfolio
approximately $86 billion and $101 billion, respectively, of non-agency mortgage-related securities backed by subprime loans.”

122. The statement in Freddie Mac’s 2Q08 Form 10-Q concerning Single Family’s exposure to subprime in its guarantee portfolio was materially false and misleading. It communicated the misleading impression that, after considering a mix of credit risk characteristics to assess its exposure to subprime loans, Freddie Mac had determined that its Single Family exposure to subprime loans was only $6 billion, or the amount of its Structured Transactions, as of June 30, 2008. In fact, at June 30, 2008, Freddie Mac’s Single Family guarantee portfolio was exposed to approximately $244 billion of C1, C2 and EA loans – loans that were internally referred to as “subprime,” “otherwise subprime” or “subprime-like loans” – which represented approximately 14 percent of Freddie Mac’s Single Family credit guarantee portfolio.

123. Syron certified and Bisenius and Cook sub-certified to the 2Q08 Form 10-Q even though they knew or were reckless in not knowing that the Statement was materially false and misleading.

124. The chart below summarizes (in billions of U.S. dollars) the approximate exposure to subprime loans in the Freddie Mac Single Family guarantee business, as disclosed by Freddie Mac, compared to the Freddie Mac exposure to Caution Loans (C1 and C2) and EA loans – loans that were internally described as “subprime,” “otherwise subprime” or “subprime like” – during the same period:
<table>
<thead>
<tr>
<th>Period</th>
<th>Disclosed Subprime Exposure</th>
<th>% Disclosed Subprime Exposure of Total Single-Family Guarantee Portfolio</th>
<th>Total C1, C2 and EA</th>
<th>Total Single-Family Guarantee Portfolio</th>
<th>% Total C1, C2 and EA of Total Single-Family Guarantee Portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>4Q06</td>
<td>&quot;Not Significant&quot;</td>
<td>0.1%</td>
<td>$141</td>
<td>$1,467</td>
<td>10%</td>
</tr>
<tr>
<td>1Q07</td>
<td>N/A</td>
<td>0.1%</td>
<td>$159</td>
<td>$1,528</td>
<td>10%</td>
</tr>
<tr>
<td>2Q07</td>
<td>$2</td>
<td>0.1%</td>
<td>$182</td>
<td>$1,586</td>
<td>11%</td>
</tr>
<tr>
<td>3Q07</td>
<td>$5</td>
<td>N/A</td>
<td>$206</td>
<td>$1,642</td>
<td>13%</td>
</tr>
<tr>
<td>4Q07</td>
<td>$6</td>
<td>N/A</td>
<td>$226</td>
<td>$1,692</td>
<td>13%</td>
</tr>
<tr>
<td>1Q08</td>
<td>$4</td>
<td>N/A</td>
<td>$239</td>
<td>$1,739</td>
<td>14%</td>
</tr>
<tr>
<td>2Q08</td>
<td>$6</td>
<td>N/A</td>
<td>$244</td>
<td>$1,784</td>
<td>14%</td>
</tr>
</tbody>
</table>

**FIRST CLAIM FOR RELIEF**

**Violations of Section 10(b) of the Exchange Act and Rules 10b-5(b)**  
(Against Syron and Cook)

125. Paragraphs 1 through 124 are realleged and incorporated by reference as if set forth fully herein.

126. Syron and Cook, directly or indirectly, by use of the means or instrumentalities of interstate commerce, or by use of the mails, or of the facilities of a national securities exchange, in connection with the purchase or sale of Freddie Mac securities, knowingly or recklessly, made
untrue statements of material facts and omitted to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

127. By reason of the foregoing, Syron and Cook violated, and unless enjoined will again violate, Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and Rule 10b-5(b) thereunder [17 C.F.R. § 240.10b-5(b)].

SECOND CLAIM FOR RELIEF

Aiding and Abetting Violations of Section 10(b) of the Exchange Act and Rules 10b-5(b) (Against Syron, Cook and Bisenius)

128. Paragraphs 1 through 127 are realleged and incorporated by reference as if set forth fully herein.

129. Freddie Mac, directly or indirectly, by use of the means or instrumentalities of interstate commerce, or by use of the mails, or of the facilities of a national securities exchange, in connection with the purchase or sale of securities, knowingly or recklessly, made untrue statements of material facts and omitted to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

130. By reason of the foregoing, Syron knowingly or recklessly provided substantial assistance to and thereby aided and abetted Freddie Mac in its violations of Exchange Act Section 10(b) and Rule 10b-5(b) [17 C.F.R. § 240.10b-5(b)]; therefore, Syron is liable pursuant to Exchange Act Section 20(e) [15 U.S.C. § 78t(e)].

131. By reason of the foregoing, Cook knowingly or recklessly provided substantial assistance to Freddie Mac and/or Syron and thereby aided and abetted Freddie Mac and/or Syron in their violations of Exchange Act Section 10(b) and Rule 10b-5(b) [17 C.F.R. § 240.10b-5(b)]; therefore, Cook is liable pursuant to Exchange Act Section 20(e) [15 U.S.C. § 78t(e)].
132. By reason of the foregoing, Bisenius knowingly or recklessly provided substantial assistance to Freddie Mac, Syron and/or Cook and thereby aided and abetted Freddie Mac, Syron and/or Cook in their violations of Exchange Act Section 10(b) and Rule 10b-5(b) [17 C.F.R. § 240.10b-5(b)]; therefore, Bisenius is liable pursuant to Exchange Act Section 20(e) [15 U.S.C. § 78t(e)].

133. Unless restrained and enjoined, Syron, Cook and Bisenius will in the future aid and abet violations of Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and Rule 10b-5(b) thereunder [17 C.F.R. § 240.10b-5(b)].

THIRD CLAIM FOR RELIEF

Violations of Sections 17(a)(2) of the Securities Act (Against Syron and Cook)

134. Paragraphs 1 through 133 are realleged and incorporated by reference as if set forth fully herein.

135. Syron and Cook, directly or indirectly, in the offer and sale of Freddie Mac securities, by use of the means and instruments of transportation and communication in interstate commerce and by use of the mails, knowingly, recklessly, or negligently have obtained money or property by means of untrue statements of material fact or omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

136. By reason the foregoing, Syron and Cook violated, and unless enjoined will again violate, Section 17(a)(2) of the Securities Act [15 U.S.C. § 77q(a)(2)].
FOURTH CLAIM FOR RELIEF

Violation of Exchange Act Rule 13a-14
(Against Syron)

137. Paragraphs 1 through 136 are realleged and incorporated by reference as if set forth fully herein.

138. On August 6, 2008, Syron signed false certifications pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 and Rule 13a-14 promulgated thereunder, that were included in Freddie Mac’s Form 10-Q filed with the Commission on that date. His certification falsely stated that: he had reviewed each report; based upon his knowledge, the reports did not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading; and based upon his knowledge, the financial statements and information contained in each report fairly present in all material respects the financial condition, results of operations and cash flows of the issuer.


FIFTH CLAIM FOR RELIEF

Aiding and Abetting Violations of Section 13(a) of the Exchange Act and Rules 12b-20 and 13a-13
(Against Syron, Cook and Bisenius)

140. Paragraphs 1 through 139 are realleged and incorporated by reference as if set forth fully herein.

141. Section 13(a) of the Exchange Act and Rule 13a-13 thereunder require issuers of registered securities to file with the Commission factually accurate quarterly reports. Exchange
Act Rule 12b-20 provides that, in addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading.


143. By reason of the foregoing, Syron, Cook and Bisenius acted knowingly or recklessly provided substantial assistance to and thereby aided and abetted Freddie Mac’s violations of Section 13(a) of the Exchange Act [15 U.S.C. § 78m(a)] and Exchange Act Rules 12b-20 and 13a-13 [17 C.F.R. §§ 240.12b-20 and 240.13a-13]; therefore, each is liable pursuant to Exchange Act Section 20(e) [15 U.S.C. § 78t(e)].

**PRAYER FOR RELIEF**

WHEREFORE, the Commission respectfully requests that this Court:

(a) Permanently restrain and enjoin defendants Syron and Cook from violating or aiding and abetting violations of Section 17(a) of the Securities Act [15 U.S.C. § 77q(a)], Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and Rule 10b-5(b) thereunder [17 C.F.R. § 240.10b-5(b)], Section 13(a) of the Exchange Act [15 U.S.C. § 78m(a)] and Exchange Act Rules 12b-20 and 13a-13, and with respect to defendant Syron only, Exchange Act Rule 13a-14 [17 C.F.R. §§ 240.13a-13, and 240.13a-14];

(c) Order Syron, Cook and Bisenius to pay disgorgement, together with prejudgment interest;


(e) Permanently bar Syron, Cook and Bisenius, pursuant to Section 20(e) of the Securities Act [15 U.S.C. §77t(e)] and Section 21(d)(2) of the Exchange Act [15 U.S.C. § 78u(d)(2)], from acting as an officer or director of any issuer that has a class of securities registered under Section 12 of the Exchange Act [15 U.S.C. § 78l] or that is required to file reports pursuant to Section 15(d) of the Exchange Act [15 U.S.C. § 78o(d)]; and
(f) Grant such other relief as this Court may deem necessary and proper.

Dated: December 14, 2011
Washington, DC

Respectfully submitted,

[Signature]
Suzanne J. Romajask
Kevin P. O'Rourke

Of Counsel:
Stephen L. Cohen
Charles E. Cain
Giles T. Cohen
David S. Karp

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Counsel for Plaintiff
IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

LOUISIANA MUNICIPAL POLICE
EMPLOYEES’ RETIREMENT SYSTEM and
U.F.C.W. LOCAL 1776 & PARTICIPATING
EMPLOYERS PENSION FUND,

Plaintiffs,

v.

DAVID PYOTT, HERBERT W. BOYER, LOUIS
J. LAVINGNE, GAVIN S. HERBERT,
STEPHEN J. RYAN, LEONARD D.
SCHAEFFER, MICHAEL R. GALLAGHER,
ROBERT ALEXANDER INGRAM, TREVOR
M. JONES, DAWN E. HUDSON, RUSSELL T.
RAY, and DEBORAH DUNSIRE,

Defendants,

and

ALLERGAN, INC.,

Nominal Defendant.

C.A. No. 5795-VCL

OPINION

Date Submitted: March 29, 2012
Date Decided: June 11, 2012

Pamela S. Tikellis, Robert J. Kriner, Jr., Scott M. Tucker, CHIMICLES & TIKELLIS LLP, Wilmington, Delaware; Scott R. Shepherd, SHEPHERD, FINKELMAN, MILLER & SHAH, LLP, Media, Pennsylvania; Lesley E. Weaver, SHEPHERD, FINKELMAN, MILLER & SHAH, LLP, San Francisco, California; Jeffrey W. Golan, Lisa M. Lamb, BARRACK, RODOS & BACINE, Philadelphia, Pennsylvania; Attorneys for Plaintiffs.

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Cathy L. Reese, Jose P. Sierra, Joseph B. Warden, FISH & RICHARDSON P.C., Wilmington, Delaware; Attorneys for Nominal Defendant Allergan, Inc.

LASTER, Vice Chancellor.
On September 1, 2010, Allergan, Inc. entered into a settlement with the United States Department of Justice pursuant to which Allergan pled guilty to criminal misdemeanor misbranding and paid a total of $600 million in civil and criminal fines. Various specialized plaintiffs’ law firms quickly filed derivative actions in both this Court and in the United States District Court for the Central District of California (the “California Federal Court”).

Litigation proceeded in both courts. The California Federal Court initially dismissed a consolidated complaint pursuant to Rule 23.1 without prejudice, then later dismissed an amended and consolidated complaint pursuant to Rule 23.1 with prejudice (the “California Judgment”). Meanwhile, I postponed briefing on the defendants’ motions to dismiss to accommodate the efforts of one stockholder, U.F.C.W. Local 1776 & Participating Employers Pension Fund (“UFCW”), to obtain books and records using Section 220 of the General Corporation Law, 8 Del. C. § 220. UFCW subsequently intervened in this action, and the plaintiffs jointly filed an 84-page, 241-paragraph Verified Second Amended Derivative Complaint dated July 8, 2011 (the “Complaint”).

The defendants have moved to dismiss the Complaint. First, they say that the California Judgment mandates dismissal with prejudice under the doctrine of collateral estoppel. Second, they say that even if reviewed independently, the Complaint fails to plead demand futility under Rule 23.1. Third, they say that the Complaint fails to state a claim under Rule 12(b)(6). I reject these arguments and deny the defendants’ motions.
I. FACTUAL BACKGROUND

The facts for purposes of the motions to dismiss are drawn from the Complaint and the documents it incorporates by reference. The incorporated documents include publicly available information, such as a government sentencing memorandum, and non-public books and records that UFCW obtained by using Section 220, such as Allergan’s internal board-approved strategic plans and warning letters from the U.S. Food and Drug Administration (the “FDA”). The Complaint contains numerous particularized factual allegations from which inferences reasonably could be drawn in favor of either the plaintiffs or the defendants. At this stage of the case, the plaintiffs receive the benefit of all reasonable inferences.

A. Allergan And The Growth Of Botox

Nominal defendant Allergan is a Delaware corporation that develops and commercializes specialty pharmaceuticals, biologics, and medical devices. Allergan’s stock trades on the New York Stock Exchange under the symbol “AGN.” The twelve individual defendants comprised Allergan’s board of directors (the “Board”) at the time this action was initiated. Defendant Pyott has served as Allergan’s CEO since 1998 and as Chairman of the Board since 2001. Defendants Boyer, Gallagher, Herbert, and Schaeffer have served as outside directors since before 2000. Defendants Ryan, Ray, and Jones joined the board as outside directors in 2002, 2003, and 2004, respectively. Defendants Lavigne and Ingram joined the board in 2005. Defendants Dunsire and Hudson joined the board in 2006 and 2008, respectively.
Allergan manufactures Botox, a drug widely known for its muscle-relaxing properties. The trade name derives from its active ingredient, the neurotoxin botulinum toxin type A. The government settlement and this opinion address only Botox Therapeutic; they do not address its better-known sibling, Botox Cosmetic, which has its own FDA-approved label and drug code.

The FDA first approved Botox for therapeutic use in 1989 for treating two eye muscle disorders: strabismus (crossed eyes) and blepharospasm (abnormal spasm of the eyelids). In December 2000, the FDA approved Botox for treating pain associated with cervical dystonia (involuntary neck muscle contraction). In July 2004, the FDA approved the product for treating severe primary axillary hyperhidrosis (underarm sweating). Not until 2010 would the FDA approve two additional treatments: upper-limb spasticity (approved in March 2010) and migraine headaches (approved in October 2010).

A small market existed for the limited Botox uses approved by the FDA before 2010. Treating physicians, however, were not limited to FDA-approved applications. In the United States, a physician may prescribe an approved pharmaceutical product for any use, including uses not approved by the FDA. Prescribing a pharmaceutical product for an FDA-approved use is referred to as “on-label” use; prescribing the same product for an unapproved use is referred to as “off-label” use. “Off-label use is widespread in the medical community and often is essential to giving patients optimal medical care, both of which medical ethics, FDA, and most courts recognize.” Buckman Co. v. Plaintiffs’ Legal Comm., 531 U.S. 341, 351 n.5 (2001) (quoting James M. Beck & Elizabeth D.
Azari, FDA, Off-Label Use, and Informed Consent: Debunking Myths and Misconceptions, 53 Food & Drug L.J. 71, 72 (1998)).

Because a physician legally can prescribe a product for off-label use, a manufacturer legally can sell a product notwithstanding its potential off-label use. It is illegal, however, for a manufacturer to market a drug for off-label use. Under the Food, Drug, and Cosmetics Act, 21 U.S.C. §§ 301 et seq., the Public Health Service Act, 42 U.S.C. §§ 262 et seq., and their implementing regulations, drug manufacturers cannot market or promote drugs for uses that the FDA has not approved. See, e.g., 21 U.S.C. § 331(a), (d); 42 U.S.C. § 262(a)(1), (b); 21 C.F.R. § 601.12.

Allergan understood the critical distinction between off-label sales and marketing. Allergan’s 2004 Annual Report summarized the regulatory scheme as follows:

Physicians may prescribe pharmaceutical and biologic products for uses that are not described in a product’s labeling or differ from those tested by us and approved by the FDA. While such “off-label” uses are common and the FDA does not regulate a physician’s choice of treatment, the FDA does restrict a manufacturer’s communications on the subject of off-label use. Companies cannot actively promote FDA-approved pharmaceutical or biologic products for off-label uses . . . . If . . . our promotional activities fail to comply with the FDA’s regulations or guidelines, we may be subject to warnings from, or enforcement action by, the FDA or another enforcement agency.

This derivative action arises out of Allergan’s failed efforts (as demonstrated by the guilty plea and government settlement) to walk the fine line between off-label sales and off-label marketing.
B. **Allergan Provides Extensive Support For Off-Label Sales.**

Allergan strongly advocated expanded uses for Botox and supported off-label Botox sales with a phalanx of initiatives. The company sponsored Botox seminars and presentations about off-label uses, founded and financed organizations that advocated off-label uses, provided support services for physicians seeking reimbursement for off-label uses, and lobbied government healthcare programs to expand reimbursement for off-label uses. Allergen CEO Pyott was such a vocal advocate for the drug that he earned the nickname “Mr. Botox.”

Most importantly, Allergan cultivated relationships with physicians, a strategy it considered critical to increasing off-label Botox use. Allergan instituted a Physician Partnership Program in which it paid selected physicians to be travelling mentors to promote Botox use among their peers, and it funded physician “preceptorships” in which Allergan personnel shadowed participating physicians. Allergan monitored physician prescription writing, identified those doctors who prescribed high levels of Botox, and recruited them for its Physician Partnership Program. Allergan also funded continuing medical education programs, seminars, and promotional dinners. In 2006 alone, the company sponsored more than 1,200 physician speaker programs.

Allergan recognized that growth in off-label Botox use largely depended on physicians receiving reimbursement from healthcare programs. To facilitate reimbursement, Allergan employed Provider Reimbursement Account Managers to counsel physicians concerning off-label Botox prescriptions. The Provider Reimbursement Account Managers audited physician billing records and reviewed the
payments physicians received to assist in maximizing reimbursement for off-label use. Allergan maintained a physician-assistance hotline that doctors could call for additional off-label reimbursement advice and billing assistance. To provide a financial incentive for physicians to write more off-label prescriptions despite reimbursement limitations, Allergan implemented a Temporary Price Allowance Program. This program gave selected physicians below-invoice discounts to create a profitable spread between the physician’s acquisition cost and the Medicare reimbursement rate. Allergan’s written strategic plan for 1997-2001 cited the “U.S.-Reimbursement assistance” program as one of the reasons “Why Customers Buy From Us Now.” German Aff. Ex. D, Written Plan, at 59 [hereinafter the Written Plan].

Allergan also financed a number of organizations to support off-label Botox use. Mitchell Bren, Allergan’s chief scientific officer for Botox, founded WE MOVE, the Worldwide Education and Awareness for Movement Disorders Organization. WE MOVE distributed medical literature to physicians that provided dosing guidelines for off-label uses, including a “Suggested Pediatric BOTOX® Dosing” manual. Allergan also funded the Neurotoxin Institute, an on-line organization that disseminated information about off-label Botox uses. Although funded by Allergan, the Institute described itself on its website as “a multidisciplinary organization created to serve as a comprehensive independent source of information related to the basic science and the clinical applications of neurotoxins.” Compl. ¶ 78 (emphasis added; internal quotation omitted). Allergan financed another entity, the Alliance for Patient Access, whose mission was to reduce coverage barriers to reimbursement for off-label Botox uses.
C. The Board Approves And Oversees The Strategic Plan.

The Allergan Board played an active role in planning and monitoring the growth of Botox, which was one of the company’s most promising products. From at least 1997, the Board discussed and approved a series of annual strategic plans that sought to expand off-label Botox sales. A slide deck summarizing the 1997-2001 Strategic Plan listed “BOTOX – Spasticity, migraine, and pain” as one of Allergan’s “Top Corporate Priorities.” German Aff. Ex. D, Plan Slides, at 10 [hereinafter the Plan Slides]. At the time, those uses were not approved by the FDA. The slides further noted that Botox “represent[s] immediate growth” for Allergan and that the “[e]xpansion strategy enables Allergan to maximize . . . BOTOX® now.” Id. at 11. The plan noted that Botox would enable Allergan to compete in the “pain market” and “migraine headache market,” which were estimated to grow to a combined $6 billion by 2007. Written Plan at 3. The plan described Botox as having “tremendous growth potential as we fund opportunities . . . such as spasticity, pain, migraine, and tension headache.” Id. Each remained an off-label use until at least 2010.

The Board regularly monitored Botox sales. For example, at a September 2002 Board meeting, Pyott “reviewed BOTOX® growth in average daily sales.” Compl. ¶ 15. At a July 2003 Board meeting, Pyott “discussed BOTOX® sales growth over last 12 months, the then-current sales mix of BOTOX® Therapeutic (58%) v. BOTOX® Cosmetic (42%), intra-therapeutic growth rates for BOTOX®, and BOTOX® capacity utilization and scenarios.” Id.
D. Government Scrutiny Of Allergan’s Botox Programs

Allergan first drew government scrutiny for its Botox initiatives on August 22, 2001, when Allergan received a warning letter from the FDA. The letter noted that the FDA had “reviewed [Allergan] promotional activities and materials and has concluded that they are misleading and lacking in fair balance . . . .” German Aff. Ex. F. The letter requested that Allergan take “prompt action to correct . . . violations like those outlined in this letter.” Id. Allergan received a warning letter addressing misleading advertising for Botox Cosmetic in June 2003. German Aff. Ex. G.

Despite the FDA warnings, Allergan continued to drive Botox sales, which increased rapidly. Between 2000 and 2004, net sales of Botox grew between 25% and 42% annually, despite being approved by the FDA for only four limited uses. Compl. ¶ 53. Off-label sales skyrocketed. Between 1999 and 2006, spasticity sales grew by 332%; headache sales grew by 1,407%; and pain sales grew by 504%. Id. ¶ 12. By 2005, Botox accounted for 33% of Allergan’s total net sales. Id. ¶ 170.

E. The Schim Incident

On September 21, 2006, the FDA sent a letter to Allergen concerning off-label marketing during a presentation by an Allergan-sponsored speaker, Dr. Jack Schim. Dr. Schim is the co-director of the Headache Center of Southern California and was a frequent participant in Allergan’s sponsored-physician speaker program.

On October 24, 2006, Allergan’s General Counsel Douglas S. Ingram advised the Board by email about the FDA inquiry. Ingram noted that Dr. Schim’s speech “contained a large volume of information on the use of Botox for the treatment of headache,” which
was an off-label use at the time. German Aff. Ex. E. Ingram reminded the directors that the dinner programs were “directly funded, hosted, and controlled by Allergan” and that “the presentations are considered commercial promotion and Allergan is responsible for their content.” Id. Ingram reported that

[upon our internal investigation into this dinner meeting, it was discovered that Dr. Schim had been provided the approved . . . slide deck but had, instead, used another deck of slides that were not approved [by Allergan] . . . . These slides, many of which presumably came from continuing medical education events, contained some information about the mechanism of action of Botox and some information on the use of Botox for the treatment of cervical dystonia. However, the deck also contained a large volume of information on the use of Botox for the treatment of headache. Moreover, we have discovered that there were a total of 8 such dinner meetings over the last 12 months at which Dr. Schim presented these or similar slides.

Id. (emphasis added).

Ingram advised the Board that “[i]t appears that the primary basis for this failure to comply with policy related to a perceived lack of responsibility within the sales and marketing organization.” Id. According to Ingram, “[t]he sales representative and sales manager knew or should have known that [unapproved] slides were being used but apparently did not believe it was their responsibility to ensure that only [approved] slides were being used, as they were not part of the approval process for the slide decks.” Id. Ingram warned that “[t]his is a potentially serious matter and in the current environment, the chance of receiving Agency action, including but not limited to a Warning Letter, on this matter is in my opinion very high.” Id.
F. The Board Approves The 2007-2011 Strategic Plan And Off-Label Botox Sales Continue To Grow.

After the Schim incident, the Board continued to authorize aggressive efforts to increase Botox sales. For example, the Board approved Allergan’s 2007-2011 Strategic Plan, which explicitly linked the number of sales representatives, or Neuroscience Medical Consultants (“NMCs”), to increased off-label sales. Compl. ¶ 176 (noting that in “2006 [Allergan] Added 45 New NMCs & Spasticity grew 25%, and that in 2007, Allergan Added 19 New NMCs & Spasticity Est[imated] 18%” (alterations in original) (internal quotation omitted)). By February 2008, Allergan had nearly tripled the payroll for its Botox sales force relative to February 2003.

During the same period, the Board received detailed reports on Botox sales. For example, management presented the Board with a 2007 Customer Survey that showed U.S. Botox sales figures for on-label and off-label uses. By 2007, annual Botox sales for therapeutic uses totaled nearly $600 million, with 70-80% generated by off-label use.

G. The Government Settlement

On September 1, 2010, Allergan entered into a settlement with the United States Department of Justice. The settlement followed a three-year joint investigation of Allergan’s off-label marketing practices by the Federal Bureau of Investigation, the FDA’s Office of Criminal Investigation, and the Department of Health and Human Services, Office of Inspector General. Under the terms of the settlement, Allergan agreed to plead guilty to criminal misdemeanor misbranding for the period from 2000 through 2005 and pay criminal fines of $375 million. Allergan also agreed to pay an additional
$225 million in civil fines to resolve False Claims Act lawsuits which alleged similar off-label marketing claims. The $600 million penalty equaled 96% of the company’s reported net income in 2009 and exceeded both its 2007 and 2008 net income.

As part of the settlement, Allergan entered into a five-year Corporate Integrity Agreement with the Department of Health and Human Services, Office of Inspector General. The agreement mandates that Allergan implement a strict compliance program, notify physicians of the government settlement, and post information on payments to physicians on the company’s website.

H. The Derivative Actions

The public announcement of the settlement on September 1, 2010, prompted plaintiffs’ firms who specialize in stockholder representative litigation to rush to the courthouse. For reasons described below, this unfortunate behavior reflects understandable choices made by these rational economic actors given the incentives currently created by our legal system. See infra Part II.A.3.

On September 3, 2010, Louisiana Municipal Police Employees’ Retirement System (“LAMPERS”) filed this action. The original complaint relied solely on the Allergan press release and other publicly available information. Given the short time frame involved, counsel had minimal opportunity to investigate the claims. Nor could counsel have evaluated meaningfully whether or not a sufficient number of Allergan directors were disabled such that the Board was not the appropriate corporate actor to address the fallout from the government investigation.

On October 11, 2010, LAMPERS filed its first amended complaint in this action. The amended complaint contained additional detail drawn from publicly available materials. The principal sources were the False Claims Act complaints filed against Allergan in 2007, 2008, and 2009, a sentencing memorandum filed by the Department of Justice on October 4, 2010, in support of its settlement and plea agreement with Allergan, and the plea agreement itself, which was filed on October 5. The amended complaint cribbed from these documents. Allergan and the defendant directors moved to dismiss the amended complaint pursuant to Rules 23.1 and 12(b)(6).

On November 3, 2010, UFCW sent Allergan a Section 220 demand for books and records. On November 30, UFCW moved to intervene in this action. LAMPERS joined the defendants in vehemently opposing the motion to intervene. Rather than welcoming UFCW as a litigation partner and potential source of information to craft an even better complaint, LAMPERS attacked UFCW in an effort to maintain control over the case. LAMPERS’ opposition maligned UFCW’s efforts as “indefensible” and “serv[ing] only to unduly delay the adjudication of the rights of the original parties, while providing
absolutely no benefit to Allergan, Inc.” Dkt. 37, Opp’n Mem. 1-2. In doing so, LAMPERS seemed oblivious to the Delaware courts’ repeated exhortations that plaintiffs use Section 220 before filing derivative actions, as UFCW was doing, or that defendants regularly prevail when moving to dismiss hastily filed derivative complaints prepared without the benefit of books and records. See infra Part II.A.3.


Meanwhile, in the California Action, the California Federal Court dismissed the plaintiffs’ first complaint without prejudice on April 12, 2011. The California plaintiffs asked Allergan for the Section 220 production, and Allergan shared it. The California plaintiffs subsequently filed an amended complaint that incorporated the documents Allergan provided, and the California defendants again moved to dismiss.

For reasons that are not clear to me, briefing on the motions to dismiss moved forward more quickly in California than in Delaware. On January 17, 2012, without the benefit of oral argument, the California Federal Court issued the California Judgment, a five-page order dismissing the California Action with prejudice pursuant to Rule 23.1 for failure to plead demand futility. On February 22, the California Federal Court denied a
motion for reargument. The defendants then supplemented their motions to dismiss in this action to invoke collateral estoppel.

II. LEGAL ANALYSIS

The defendants identify three bases on which they say judgment should be entered in their favor: collateral estoppel, Rule 23.1, and Rule 12(b)(6). If collateral estoppel applies, then I need not consider the others, so I start there.

A growing body of precedent holds that a Rule 23.1 dismissal has preclusive effect on other derivative complaints.1 These cases reason that because a stockholder plaintiff in a derivative action sues in the name of the corporation, all other stockholder plaintiffs are in privity with the plaintiff in the dismissed derivative action. In my view, the answer to the privity question turns on the legal relationship between a stockholder and the corporation, which is governed by Delaware law under the internal affairs doctrine.

Controlling Delaware Supreme Court precedent makes clear that until a Rule 23.1 motion has been denied, a derivative plaintiff whose litigation efforts are opposed by the corporation does not have authority to sue in the name of the corporation. Consequently, at the time of the first Rule 23.1 dismissal, other stockholders are not in privity with the

stockholder plaintiff in the first derivative action, and a decision granting a Rule 23.1 dismissal cannot have preclusive effect. The dismissal remains persuasive authority, but it is not preclusive.

The defendants rely on *LeBoyer*, a California collateral estoppel decision that conflicts with controlling Delaware Supreme Court authority on the effect of a Rule 23.1 dismissal. If the collateral estoppel issue were properly presented to the California Federal Court, that court should decline to follow *LeBoyer* and hold instead that collateral estoppel does not bar a later derivative action by a different stockholder.

Because the California Judgment does not have preclusive effect, I analyze the defendants’ motions to dismiss pursuant to Rules 23.1 and 12(b)(6). Respectfully disagreeing with the California Federal Court, I deny the Rule 23.1 motion. With all reasonable inferences drawn in favor of the plaintiffs, as required at this procedural stage, the Complaint’s particularized allegations raise a reasonable doubt that a majority of the Board could properly consider a demand. Read as a whole, the particularized allegations support a reasonable inference that the Board consciously approved a business plan predicated on violating the federal statutory prohibition against off-label marketing.

“[O]ne cannot act loyally as a corporate director by causing the corporation to violate the positive laws it is obliged to obey.” *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003). “[I]t is generally accepted that a derivative suit may be asserted by an innocent stockholder on behalf of a corporation against corporate fiduciaries who knowingly caused the corporation to commit illegal acts and, as a result, caused the corporation to suffer harm.” *In re Am. Int’l Gp., Inc., Consol. Deriv. Litig.*, 976 A.2d 872, 889 (Del. Ch.
2009). The Complaint therefore pleads a non-exculpated breach of the duty of loyalty, exposes the defendants to a substantial threat of liability, and renders demand futile.

Determining that the Complaint alleges particularized facts that present a substantial threat of liability under the heightened Rule 23.1 pleading standard necessarily determines that the Complaint states a claim under the more plaintiff-friendly Rule 12(b)(6) standard. That motion is therefore denied as well.

A. Collateral Estoppel

The defendants observe that in *LeBoyer*, the California Federal Court applied collateral estoppel to hold that a California state court’s dismissal with prejudice of one stockholder plaintiff’s derivative action pursuant to Rule 23.1 barred a different stockholder plaintiff from suing derivatively. The defendants correctly point out that when applying collateral estoppel, this Court must give a judgment the same force and effect that it would be given by the rendering court. 2 Having obtained the California Judgment, they say I must follow *LeBoyer*. I disagree.

2 *See* U.S. Const. art. IV, § 1 (“Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State. And the Congress may by general Laws prescribe the Manner in which such Acts, Records and Proceedings shall be proved, and the Effect thereof.”); 28 U.S.C. § 1738 (“Acts [of the legislature of any State, Territory, or Possession of the United States and] records and judicial proceedings [of any such State, Territory or Possession] . . . shall have the same full faith and credit in every court within the United States and its Territories and Possessions as they have by law or usage in the courts of such State, Territory or Possession from which they are taken.”); *Thompson v. D’Angelo*, 320 A.2d 729, 734 (Del. 1974) (“We . . . note that as long as the order of the [United States] District Court [for the Eastern District of Pennsylvania] stands it is the duty of the Courts of this State to accord it the same force and effect as would be given to it by a Pennsylvania Court.”); *W. Coast Mgmt. & Capital, LLC v. Carrier Access Corp.*, 914 A.2d 636, 642 (Del. Ch. 2006) (“This court gives the
LeBoyer described collateral estoppel as having five elements:

First, the issue sought to be precluded from relitigation must be identical to that decided in a former proceeding. Second, this issue must have been actually litigated in the former proceeding. Third, it must have been necessarily decided in the former proceeding. Fourth, the decision in the former proceeding must be final and on the merits. Finally, the party against whom preclusion is sought must be the same as, or in privity with, the party to the former proceeding.

In substance, LeBoyer’s five-part test matches shorter formulations that the California Federal Court might apply. See, e.g., Hydranautics v. FilmTec Corp., 204 F.3d 880, 885 (9th Cir. 2000) (“Under both California and federal law, collateral estoppel applies only where it is established that ‘(1) the issue necessarily decided at the previous proceeding is identical to the one which is sought to be re-litigated; (2) the first proceeding ended with a final judgment on the merits; and (3) the party against whom collateral estoppel is asserted was a party or in privity with a party at the first proceeding.’” (quoting Younan v. Caruso, 59 Cal. Rptr. 2d 103, 106 (Ct. App. 1996)).

For purposes of this case, I need only consider privity. I need not contemplate whether a Rule 23.1 dismissal is “on the merits” for purposes of collateral estoppel.\(^3\)

same preclusive effect to the judgment of another state or federal court as the original court would give.”).

\(^3\) Compare, e.g., Ex Parte Capstone Dev. Corp., 779 So. 2d 1216, 1218-19 (Ala. 2000) (deeming a Rule 23.1 dismissal to be a decision based on a precondition and therefore not “upon the merits” for purposes of preclusive effect) and Kaplan v. Bennett, 465 F. Supp. 555, 561-62 (S.D.N.Y. 1979) (same) with Bed Bath & Beyond, 2007 WL 4165389, at *6 (“A dismissal for failure to make demand on a board is considered substantive and, therefore, on the merits.”) and LeBoyer, 2007 WL 4287646, at *2
Neither must I address the level of specificity at which the “same issue” analysis operates, nor ponder whether the analysis should be limited to information actually known to and alleged by the initial derivative plaintiff versus extending to information that could have been known to and alleged by the initial derivative plaintiff but were not. Because the defendants only invoke collateral estoppel (i.e., issue preclusion), I will not consider the more expansive doctrine of res judicata (i.e., claim preclusion).

(holding that under the internal affairs doctrine, Delaware law determines whether a Rule 23.1 dismissal is “on the merits”) and Henik, 433 F. Supp. 2d. at 379 (citing federal authorities to hold that a Rule 23.1 dismissal with prejudice is a “final adjudication” and “on the merits”). See also Sonus Networks, 499 F.3d at 59-62 (holding that a Rule 23.1 dismissal is binding as to demand futility regardless of the meaning of “on the merits”).

4 Compare, e.g., W. Coast Mgmt., 914 A.2d at 643 n.22 (suggesting that the issue decided in the original case should be limited to the allegations supporting demand futility that were made by that derivative plaintiff) with Bed Bath & Beyond, 2007 WL 4165389, at *6 (“[B]ecause the prior plaintiff did not plead every possible cause of action or include every possible time period or defendant does not alter the central issue—whether demand on the BBB board would have been futile—which has already been determined by the New York court.”) and LeBoyer, 2007 WL 4287646, at *2 (“[T]he issue here—whether a demand on the board to sue the directors over the 2003 restatement would have been futile—is the same.”).

5 Compare, e.g., W. Coast Mgmt., 914 A.2d at 643 n.22 (suggesting not giving issue preclusive effect to original complaint if subsequent complaint contains substantial additional facts developed using Section 220) with Sonus Networks, 499 F.3d at 62-63 (giving issue preclusive effect where facts were not alleged in original complaint but original plaintiff could have obtained the information) and Arduini, 2012 WL 893874, at *3 (noting that “Plaintiff’s arguments that he has allegations specific to the demand futility issue that are different from the allegations brought up in [the underlying proceeding do not] preclude our use of issue preclusion”).

6 Compare Henik, 433 F. Supp. 2d. at 381 (applying both res judicata and collateral estoppel to Rule 23.1 determination) and Bed Bath & Beyond, 2007 WL 4165389, at *8 (holding that relitigation of demand futility is precluded under the
1. Choice of Law

Whether successive stockholders are sufficiently in privity with the corporation and each other is a matter of substantive Delaware law governed by the internal affairs doctrine. *See Sonus Networks*, 499 F.3d at 64. “No principle of corporation law and practice is more firmly established than a State’s authority to regulate domestic corporations . . . .” *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 89 (1987). “Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.” *Cort v. Ash*, 422 U.S. 66, 84 (1975). “The internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation’s internal affairs—matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders . . . .” *Edgar v. MITE Corp.*, 457 U.S. 624, 645 (1982); accord *VantagePoint Venture P’rs 1996 v. Examen, Inc.*, 871 A.2d 1108, 1113 (Del. 2005) (explaining that “matters that pertain to the relationships among or between the corporation and its officers, directors, and shareholders” fall within the internal affairs doctrine); see Restatement (Second) of Conflict of Laws § 304 (1971) [hereinafter Conflict of Laws] (concluding that the law of state of incorporation generally should
“determine the right of a shareholder to participate in the administration of the affairs of the corporation”).

The United States Supreme Court has held that “the function of the demand doctrine in delimiting the respective powers of the individual shareholder and of the directors to control corporate litigation clearly is a matter of ‘substance,’ not ‘procedure,’” and is therefore governed by the internal affairs doctrine. *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 96-97 (1991); accord *Braddock v. Zimmerman*, 906 A.2d 776, 784 (Del. 2006) (“The demand requirement of Rule 23.1 is a substantive right . . . .” (internal quotation omitted)); *Ainscow v. Sanitary Co. of Am.*, 180 A. 614, 615 (Del. Ch. 1935) (Wolcott, Jos., C.) (“The question of whether a stockholder may act as a volunteer in taking up the cudgels in behalf of his corporation . . . is one of his right and authority to act.”). Whether a stockholder in a Delaware corporation can sue derivatively after another stockholder attempted to plead demand futility raises a question of demand futility law. In *Kamen*, the United States Supreme Court held that applying a universal-demand rule in federal court would disrupt the internal affairs of corporations and cautioned “against establishing competing federal—and state—law principles on the allocation of managerial prerogatives within [a] corporation.” *Kamen*, 500 U.S. at 106 (citing *Burks v. Lasker*, 441 U.S. 471 (1979)). In my view, whether a stockholder can sue derivatively after another stockholder attempted to plead demand futility is equally a matter involving the managerial prerogatives within a corporation. It is therefore a matter controlled by the internal affairs doctrine and governed by the law of the state of incorporation. *See id.* at 108-09 (“[A] court that is entertaining a derivative action . . .
must apply the demand futility exception as it is defined by the law of the State of incorporation.”); *VantagePoint*, 871 A.2d at 1115 (following *Kamen*).

As in *Kamen*, applying the internal affairs doctrine in this setting promotes the important objective of treating directors, officers, and stockholders uniformly across jurisdictions. *See* Conflict of Laws § 302, cmt. e (“Uniform treatment of directors, officers and shareholders is an important objective which can only be attained by having the rights and liabilities of those persons with respect to the corporation governed by a single law.”).

Large corporations that are listed on national exchanges, or even regional exchanges, will have shareholders in many States and shares that are traded frequently. The markets that facilitate this national and international participation in ownership of corporations are essential for providing capital not only for new enterprises but also for established companies that need to expand their businesses. This beneficial free market system depends at its core upon the fact that a corporation—except in the rarest situations—is organized under, and governed by, the law of a single jurisdiction, traditionally the corporate law of the State of its incorporation.

. . . .

It thus is an accepted part of the business landscape in this country for States to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares. A State has an interest in promoting stable relationships among parties involved in the corporations it charters, as well as in ensuring that investors in such corporations have an effective voice in corporate affairs.

*CTS Corp.*, 481 U.S. at 90-91. To my mind, whether a stockholder in a Delaware corporation can sue derivatively after another stockholder attempted to plead demand futility should not be governed by potentially different rules across twelve federal circuits, fifty states, and the District of Columbia, Puerto Rico, and other territories.
Applying different rules in different courts would disrupt the internal affairs of corporations. See *Kamen*, 500 U.S. at 106. Whether a stockholder in a Delaware corporation can sue derivatively after another stockholder attempted to plead demand futility should be governed uniformly by Delaware law.

2. **The Same Party Or A Party In Privity**

In determining that successive stockholders were in privity for purposes giving collateral estoppel effect to a Rule 23.1 dismissal, *LeBoyer* relied on the legal truism that a derivative plaintiff sues in the name of the corporation. In the court’s words, “the fifth element is satisfied in that in both suits the plaintiff is the corporation itself. The differing groups of shareholders who can potentially stand in the corporation’s stead are in privity for the purposes of issue preclusion.” 2007 WL 4287646, at *3. Other decisions giving preclusive effect to Rule 23.1 dismissals have reasoned similarly. 7 For

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7 See, e.g., *Arduini*, 2012 WL 893874, at *3 (holding that privity was satisfied in giving preclusive effect to Rule 23.1 dismissal because “plaintiffs in a shareholder derivative action represent the corporation”); *Bed Bath & Beyond*, 2007 WL 4165389, at *7 (finding privity met for preclusive application of Rule 23.1 dismissal because “[t]he claims alleged and any proceeds from a prior action do not belong to the shareholder plaintiffs; rather, they belong to the corporation itself”); *Hanson*, 2007 WL 5186795, at *5 (holding privity existed; “because shareholder derivative suits are brought on behalf of the corporation, it follows that the corporation is bound by the results of the suit in subsequent litigation, even if different shareholders prosecute the suits” (internal quotation omitted)); *Bennett*, 465 F. Supp. at 560 (holding that successive derivative actions involved the same party for purposes of preclusive effect of Rule 23.1 dismissal because the corporation “was the real party in interest in the other suits and is so here, regardless of the nominal plaintiffs”); *Carroll*, 2008 WL 731834, at *8 (finding privity met because “there is no difference between the plaintiffs in the Pfizer Derivative MDL and plaintiff here. Each plaintiff seeks to assert claims on behalf of Pfizer, not individual claims. Thus, plaintiff is bound by the determination in that case.”).
example in *Sonus Networks*, the leading federal decision on Rule 23.1 preclusion, the United States Court of Appeals for the First Circuit stated:

> It is a matter of black-letter law that the plaintiff in a derivative suit represents the corporation, which is the real party in interest. Under Massachusetts law, a derivative suit is prosecuted in the right of the corporation. Standing to represent a foreign corporation is governed by the laws of the state of incorporation, and Delaware law is in accord with the prevailing rule that the shareholder in a derivative suit represents the corporation.

499 F.3d at 63-64 (citations and internal quotation omitted).

> These cases miss that as a matter of Delaware law, a stockholder whose litigation efforts are opposed by the corporation does not have authority to sue on behalf of the corporation until there has been a finding of demand excusal or wrongful refusal. In *Rales v. Blasband*, the Delaware Supreme Court addressed this issue:

> Because directors are empowered to manage, or direct the management of, the business and affairs of the corporation, the right of a stockholder to prosecute a derivative suit is limited to situations where the stockholder has demanded that the directors pursue the corporate claim and they have wrongfully refused to do so or where demand is excused because the directors are incapable of making an impartial decision regarding such litigation.

634 A.2d 927, 932 (Del. 1993) (emphases added; citation omitted). In *Kaplan v. Peat, Marwick, Mitchell & Co.*, the Delaware Supreme Court was equally clear:

> [P]re-suit demand under Chancery Court Rule 23.1 is an objective burden which must be met in order for the shareholder to have capacity to sue on behalf of the corporation. *The right to bring a derivative action does not come into existence until the plaintiff shareholder has made a demand on the corporation to institute such an action or until the shareholder has demonstrated that demand would be futile.*
540 A.2d 726, 730 (Del. 1988) (emphasis added). Delaware Court of Chancery decisions have long expressed these same principles. See, e.g., Ainscow, 180 A. at 615 (“[A] stockholder has no right to file a bill in the corporation’s behalf unless he has first made demand on the corporation that it bring the suit and the demand has been answered by a refusal, or unless the circumstances are such that because of the relation of the responsible officers of the corporation to the alleged wrongs, a demand would be obviously futile . . . .”); accord Maldonado v. Flynn, 413 A.2d 1251, 1262 (Del. Ch. 1980) (“The stockholder’s individual right to bring the action does not ripen, however, until he has made a demand on the corporation which has been met with a refusal by the corporation to assert its cause of action or unless he can show a demand to be futile.”), rev’d on other grounds, Zapata Corp. v. Maldonado, 430 A.2d 779, 784 (Del. 1981) (“[W]here demand is properly excused, the stockholder does possess the ability to initiate the action on his corporation’s behalf.”).

The derivative plaintiff’s lack of authority to sue on behalf of the corporation until the denial of a Rule 23.1 motion likewise flows from the two-fold nature of the derivative suit. As the Delaware Supreme Court explained in Aronson v. Lewis, the seminal demand-futility decision, “[t]he nature of the [derivative] action is two-fold. First, it is the equivalent of a suit by the shareholders to compel the corporation to sue. Second, it is a suit by the corporation, asserted by the shareholders on its behalf, against those liable to
it.” 473 A.2d 805, 811 (Del. 1984). Later Delaware Supreme Court decisions repeatedly reaffirmed the two-fold nature of the derivative suit. Nor was this a new concept. Half a century before Aronson, Chancellor Josiah Wolcott wrote:

The complainants’ case, being asserted by them in their derivative right as stockholders, has a double aspect. Its nature is dual. It asserts as the principal cause of action a claim belonging to the corporation to have an accounting from the defendants and a decree against them for payment to the corporation of the sum found due on such accounting. In this aspect, the cause of action is the corporation’s. It does not belong to the

8 In Brehm v. Eisner, 746 A.2d 244, 253-54 (Del. 2000), the Delaware Supreme Court overruled seven precedents, including Aronson, to the extent those precedents reviewed a Rule 23.1 decision by the Court of Chancery under an abuse of discretion standard or otherwise suggested deferential appellate review. See id. at 253 n.13 (overruling in part on this issue Scattered Corp. v. Chicago Stock Exch., 701 A.2d 70, 72-73 (Del. 1997); Grimes v. Donald, 673 A.2d 1207, 1217 n.15 (Del. 1996); Heineman v. Datapoint Corp., 611 A.2d 950, 952 (Del. 1992); Levine v. Smith, 591 A.2d 194, 207 (Del. 1991); Grobow v. Perot, 539 A.2d 180, 186 (Del. 1988); Pogostin v. Rice, 480 A.2d 619, 624-25 (Del. 1984); and Aronson, 471 A.2d at 814). The Brehm Court held that going forward, appellate review of a Rule 23.1 determination would be de novo and plenary. Brehm, 746 A.2d at 254. The seven partially overruled precedents otherwise remain good law. In this decision, I do not rely on any of them for the standard of appellate review. Although the technical rules of legal citation would require noting that each was reversed on other grounds by Brehm, I have chosen to omit the cumbersome subsequent history, which creates the misimpression that Brehm rejected core elements of the Delaware derivative action canon.

9 See Schoon v. Smith, 953 A.2d 196, 201-02 (Del. 2008) (tracing history of derivative action and explaining its dual nature); Spiegel v. Buntrock, 571 A.2d 767, 773 (Del. 1990) (quoting Aronson for the “two-fold” nature of the derivative action); Sternberg v. O’Neil, 550 A.2d 1105, 1124 n.41 (Del. 1988) (“The normal derivative suit was ‘two suits in one: (1) The plaintiff brought a suit in equity against the corporation seeking an order against it; (2) to bring a suit for damages or other legal injury for damages or other relief against some third person who had caused legal injury to the corporation.’” (quoting Robert C. Clark, Corporate Law 639-40 (1986))); Peat, Marwick, 540 A.2d at 730 (quoting Aronson in describing the “two-fold” nature of the derivative action); Zapata, 430 A.2d at 784 (citing “the ‘two phases’ of a derivative suit, the stockholder’s suit to compel the corporation to sue and the corporation’s suit”).
complainants. Inasmuch however as the corporation will not sue because of the domination over it by the alleged wrongdoers who are its directors, the complainants as stockholders have a right in equity to compel the assertion of the corporation’s rights to redress. This is their individual right. A bill filed by stockholders in their derivative right therefore has two phases—one is the equivalent of a suit to compel the corporation to sue, and the other is the suit by the corporation, asserted by the stockholders in its behalf, against those liable to it. The former belongs to the complaining stockholders; the latter to the corporation.

_Cantor v. Sachs_, 162 A. 73, 76 (Del. Ch. 1932) (citations omitted); _accord Harff v. Kerkorian_, 324 A.2d 215, 218 (Del. Ch. 1974) (“The nature of the derivative suit is two-fold: first, it is the equivalent of a suit by the stockholders to compel the corporation to sue; and second, it is a suit by the corporation, asserted by the stockholders in its behalf, against those liable to it.”), _aff’d in part, rev’d in part on other grounds_, 347 A.2d 133 (Del. 1975). The granting of a Rule 23.1 motion does not address claims brought in the name of the corporation. It addresses only the first phase of the derivative action in which the stockholder sues individually.

Under these controlling Delaware precedents, until the derivative action passes the Rule 23.1 stage, the stockholder does not have authority to assert the corporation’s claims and is not suing in the name of the corporation. Until a Rule 23.1 motion is denied or the board decides not to oppose the derivative action, the stockholder plaintiff is only suing to “compel the corporation to sue.” _Aronson_, 473 A.2d at 811. Put differently, the stockholder is asking the Court for authority to sue in the name of the corporation. Indeed, where a court _grants_ a Rule 23.1 motion, the fact that the suing stockholder lacks authority to sue in the name of the corporation and assert corporate claims should be clear. That is precisely what granting a Rule 23.1 motion means. This fact in turn
exposes the inequity of defendants subsequently arguing for preclusive effect. Having first argued in their Rule 23.1 motion that the stockholder plaintiff lacks authority to assert claims derivatively on behalf of the corporation—and having prevailed on that point—the same defendants next argue that the stockholder nevertheless had authority to assert the claims on behalf of the corporation sufficient to bind all other stockholders. Judicial estoppel should bar such a reversal of position.10

In my view, therefore, the legal truism that the underlying claim in a derivative action belongs to the corporation and ultimately will be asserted in the corporation’s name if the stockholder plaintiff receives permission to sue does not support the proposition that stockholders are in privity for purposes of the preclusive effect of an order granting a Rule 23.1 motion. At that phase of the case, the competing stockholders are asserting only their individual claim to obtain equitable authority to sue. See Aronson, 473 A.2d at 811; Cantor, 162 A. at 76.

10 See, e.g., In re First Interstate Bancorp Consol. S’holder Litig., 729 A.2d 851, 859 n.8 (Del. Ch. 1998) (“The doctrine of judicial estoppel precludes a party ‘from asserting in a legal proceeding, a position inconsistent with a position previously taken by him in the same or in an earlier proceeding.’” (quoting Coates Int’l, Ltd. v. DeMott, 1994 WL 89018, at *5 (Del. Ch. Feb. 4, 1994))); see also Rissetto v. Plumbers & Steamfitters Local 343, 94 F.3d 597, 600 (9th Cir. 1996) (“Judicial estoppel, sometimes also known as the doctrine of preclusion of inconsistent positions, precludes a party from gaining an advantage by taking one position, and then seeking a second advantage by taking an incompatible position.”); InterGen N.V. v. Grina, 344 F.3d 134, 144 (1st Cir. 2003) (“As a general matter, the doctrine of judicial estoppel prevents a litigant from pressing a claim that is inconsistent with a position taken by that litigant either in a prior legal proceeding or in an earlier phase of the same legal proceeding.”); cf. Transclean Corp. v. Jiffy Lube Int’l, Inc., 474 F.3d 1298 (Fed. Cir. 2007) (holding that when plaintiff argued that privity existed for purposes of merits, judicial estoppel prevented plaintiff from reversing position to resist collateral estoppel).
Courts giving preclusive effect to Rule 23.1 dismissals also have relied on generally accurate statements to the effect that a judgment in an action brought by or on behalf of the corporation binds all stockholders. For example, in *Henik*, a decision often cited as authority for giving preclusive effect to a Rule 23.1 dismissal, the court quoted a 1942 decision for the proposition that “[a] judgment in the stockholders’ derivative action is res judicata both as to the corporation and as to all of its stockholders, including stockholders who were not parties to the original action in subsequent actions based upon the same subject matter.” 433 F. Supp. 2d at 380 (quoting *Ratner v. Paramount Pictures, Inc.*, 6 F.R.D. 618, 619 (S.D.N.Y. 1942)).

This statement of black letter law certainly holds true when the plaintiff has authority to assert the corporation’s claims. It holds, for example, when (i) the corporation has brought the case or taken it over through the special litigation committee

11 For similar propositions, see, e.g., *Cramer v. Gen. Tel. & Elecs. Corp.*, 582 F.2d 259, 269 (3d Cir. 1978) (“Nonparty shareholders are usually bound by a judgment in a derivative suit on the theory that the named plaintiff represented their interests in the case.”); *Dana v. Morgan*, 232 F. 85, 89 (2d Cir. 1916) (explaining that a stockholder derivative “action is really the action of all the stockholders, as it is necessarily commenced in their behalf and for their benefit. And as in such suits the wrong to be redressed is the wrong done to the corporation and as the corporation is a necessary part to the suit, it inevitably follows that there can be but one adjudication on the rights of the corporation. And it is undoubted law that the judgment in the state court is an estoppel and a finality not only as to all matters actually litigated in the suit but also as to all matters which were not but might have been presented to the court and passed upon therein.”); *Parkoff v. Gen. Tel. & Elecs. Corp.*, 425 N.E.2d 820, 824 (N.Y. 1981) (“Because the claim asserted in a stockholder’s derivative action is a claim belonging to and on behalf of the corporation, a judgment rendered in such an action brought on behalf of the corporation by one shareholder will generally be effective to preclude other actions predicated on the same wrong brought by other shareholders.”).
process, (ii) the derivative plaintiff has survived a Rule 23.1 motion, thereby gained authority to sue, and obtained a decision on summary judgment or at trial, or (iii) a court has approved a derivative action settlement and made the determinations required by Rule 23.1. The statement does not hold true when the stockholder plaintiff lacks authority to sue on behalf of the corporation, and it particularly does not hold true for a decision determining that the stockholder plaintiff lacks authority to sue.

This Court has held squarely that the adjudication of one stockholder’s individual claim does not have preclusive affect on a second stockholder’s ability to assert the claim. *Kohls v. Kenetech Corp.*, 791 A.2d 763 (Del. Ch. 2000), aff’d, 794 A.2d 1160 (Del. 2002). In *Kohls*, preferred stockholders filed suit to enforce their claimed entitlement to a preferential distribution on their securities. *Id.* at 766. Certain other non-party preferred stockholders previously had brought an individual action requesting similar relief that resulted in a post-trial judgment for the defendants. *Id.* at 767, 768 n.18. The defendants argued that under the doctrines of *res judicata* and collateral estoppel, the prior judgment barred the later stockholders from relitigating the claim to a preferential distribution. *Id.* at 767. This Court rejected the defendants’ preclusion arguments, *id.* at 770, and the Delaware Supreme Court affirmed, *Kohls v. Kenetech Corp.*, 794 A.2d 1160 (Del. 2002) (ORDER).

The Court of Chancery in *Kohls* started from the foundational principle that “[a] person who is not a party to an action is not bound by the judgment in that action.” 791 A.2d at 769 (quoting Restatement (Second) of Judgments § 62 cmt. c (1982) [hereinafter Judgments]). This “basic principle of law” is subject to three exceptions. Judgments §
62 cmt. a. One applies “where a non-party has a specific type of pre-existing legal relationship with a named party, such as bailor and bailee, predecessor and successor or indemnitor and indemnitee.” Kohls, 791 A.2d at 769. “Being fellow stockholders is plainly not the type of legal relationship that fits [this] exception . . . . An individual stockholder is not, solely because of potentially aligned interests, presumed to act in the place of (and with the power to bind) the other stockholders.” Id.

A second exception applies when “a person who is not a party to an action . . . is involved with it in a way that falls short of becoming a party but which justly should result in his being denied opportunity to relitigate the matters previously in issue.” Judgments § 62 cmt. a. “Several kinds of conduct by a non-party are recognized as having this effect. These include allowing the use of one’s name as a party when the effect is to mislead an opposing litigant; assuming control of litigation being maintained by another; and agreeing to be bound by an adjudication between others.” Id. (citations omitted). Concrete, case-specific actions by a stockholder plaintiff or its counsel might well trigger this exception, such as, for example, if the same counsel represented both stockholders or the plaintiffs otherwise collaborated. This Court’s Section 220 jurisprudence has developed similar principles for determining when one stockholder’s efforts to use Section 220 should be limited by a different stockholder’s filing of a federal securities action that triggered the automatic stay under the Private Securities Litigation Reform Act (the “PLSRA”). See, e.g., Beiser v. PMC-Sierra, Inc., 2009 WL 483321, at *3 (Del. Ch. Feb. 26, 2009); Cohen v. El Paso Corp., 2004 WL 2340046, at *2 (Del. Ch. Oct. 18, 2004). But the general scenario of parallel, overlapping, or seriatim efforts by
unaffiliated stockholders to assert or prompt the assertion of corporate claims does not implicate this exception.

This leaves the third and most pertinent exception: a properly commenced and maintained representative action. *Kohls*, 791 A.2d at 769. Stockholder class and derivative actions clearly qualify, but even here, the authority to represent others is not conferred automatically by filing of complaint. “A representative party must be granted . . . authority, either by the represented party itself (in accordance with agency principles) or, in the class action context, by the court.” *Id.* It is “self-evident that if a litigant never seeks to and is never compelled to act in a representative capacity, the class of people that *theoretically could have been* represented by that litigant is in no way precluded from asserting their own claims in a subsequent proceeding.” *Id.* at 769-70. See Judgments § 41 (identifying categories of persons who can bind non-parties as including “[t]he representative of a class of persons similarly situated, designated as such with the approval of the court, of which the person is a member” (emphasis added)); id. § 59 cmt. c (“The stockholder’s or member’s derivative action is usually though not invariably in the form of a suit by some of the stockholders or members as representatives of all of them. Whether the judgment in such a representative suit is binding upon all stockholders or members is determined by the rules stated in §§ 41 and 42.”).

Despite determining that neither *res judicata* nor collateral estoppel applied, the *Kohls* Court nevertheless dismissed the second lawsuit as a matter of *stare decisis*: “[B]ecause the [plaintiffs] fail to distinguish their claims, either factually or legally, from those adjudicated” in the prior action, “[n]ormal respect for the principle of *stare decisis*”
required dismissal under Rule 12(b)(6). 791 A.2d at 770. “[A]lthough plaintiffs are not literally bound by the [underlying judgment], they must still state a viable cause of action.” Id. In other words, the prior judgment was not preclusive, but it still could be persuasive and compel dismissal.

When a stockholder representative pursues claims on a class basis, authority is conferred by the Court’s class certification ruling. See Ct. Ch. R. 23; Schwarzchild v. Tse, 69 F.3d 293, 297 (9th Cir. 1995) (“[W]hen defendants obtain summary judgment before the class has been properly certified or before notice has been sent, . . . [the summary judgment] decision binds only the named plaintiffs.”); 3 Alba Conte & Herbert B. Newberg, Newberg on Class Actions § 7.15, at 52 (4th ed. 2002) (“[I]f a motion to dismiss or for summary judgment is granted in favor of the defendants” prior to class certification, “the resulting order would not be binding on the class which would not suffer prejudice.”). When a stockholder representative pursues claims in a derivative action, authority can be conferred in two ways. First, the board of directors or a duly empowered committee can approve the litigation expressly or by failing to oppose it. See Peat, Marwick, 540 A.2d at 730. Second, and more commonly, a court can determine that the stockholder plaintiff has authority to proceed by denying a Rule 23.1 motion because the complaint adequately pleads either that demand should be excused as futile or that demand was made and wrongfully refused.

When the same stockholder responds to a Rule 23.1 dismissal by attempting to file a second complaint alleging demand futility, the “same party” requirement is met and a Rule 23.1 dismissal may have preclusive effect. See W. Coast Mgmt., 914 A.2d at 641-
44 (holding that collateral estoppel bars “the same plaintiff” from filing a subsequent derivative suit); *see also* Meng *v. Schwartz*, 305 F. Supp. 2d 49, 60 (D.D.C. 2004) (applying collateral estoppel to bar same derivative plaintiffs’ efforts to relitigate previously dismissed claims); Treeby *v. Aymond*, 2000 WL 869502, at *8 (E.D. La. June 28, 2000) (issuing injunction against state court derivative action where same stockholder sought to relitigate demand excusal), aff’d, 251 F.3d 156 (5th Cir. 2001). The same stockholder therefore cannot attempt to plead demand futility, lose, and then try again. This is also true as a matter of demand futility law. In *Grimes*, the Delaware Supreme Court held that if a stockholder files a complaint alleging that demand should be excused as futile and the complaint is dismissed pursuant to Rule 23.1, that same stockholder cannot try again with a different set of demand futility allegations. 673 A.2d 1207, 1218-19. That the Delaware Supreme Court rendered its decision without mentioning collateral estoppel or *res judicata* suggests that the high court did not envision an expansive (if any) role for preclusion doctrine in the Rule 23.1 context.12

12 The *Grimes* Court also made clear that the same stockholder plaintiff can subsequently make a litigation demand, use Section 220 to explore whether the demand was wrongfully refused, and (if appropriate) file a demand-refused case. *See* 673 A.2d at 1218-19; *see also* Spiegel, 571 A.2d at 776-77. By filing the original demand futility complaint, the stockholder does not does not concede the independence or disinterestedness of the board for purposes of alleging wrongful refusal (as opposed to demand futility). *Scattered Corp.*, 701 A.2d at 74-75; *Grimes*, 673 A.2d at 1219. A stockholder who makes demand concedes that the board is disinterested and independent with respect to the demand and therefore cannot argue that demand should have been excused as futile; he only can argue that the demand was wrongfully refused. *Spiegel*, 571 A.2d at 775. Contrary to *Grimes*, at least one court has applied preclusion principles broadly to bar subsequent efforts to plead wrongful refusal. *See* Carroll, 2008 WL 731834, at *10 (applying Delaware law and holding that “plaintiff may not relitigate the
Consequently, when a different stockholder attempts to plead demand excusal, an earlier Rule 23.1 dismissal should not have preclusive effect. The earlier dismissal terminated the first phase of the prior derivative action, in which the complaining stockholder asserted an individual claim to seek equitable authority to sue on behalf of the corporation. Under Kohls, the prior ruling does not affect the individual claims of other stockholders to seek equitable authority to sue. It similarly has no effect on the second-phase issue of the corporation’s cause of action. The decision does, of course, carry persuasive weight and can operate as *stare decisis*.

The Court of Chancery traditionally has recognized these principles. “It is common practice in this court where there are inadequate allegations of demand futility to dismiss derivative suits as to the named plaintiff, but not as to the corporation or its other stockholders.” *W. Coast Mgmt.*, 914 A.2d at 642. Effective June 1, 2001, the Court of Chancery adopted Rule 15(aaa), which limits a plaintiff’s ability to file *seriatim* amended complaints. It provides:

[A] party that wishes to respond to a motion to dismiss under Rules 12(b)(6) or 23.1 by amending its pleading must file an amended complaint, or a motion to amend in conformity with this Rule, no later than the time such party’s answering brief in response to either of the foregoing motions is due to be filed. In the event a party fails to timely file an amended complaint or motion to amend under this subsection (aaa) and the Court thereafter concludes that the complaint should be dismissed under Rule 12(b)(6) or 23.1, such dismissal shall be with prejudice *(and in the case of complaints brought pursuant to Rules 23 or 23.1 with prejudice to the issue of the Board’s independence and disinterest [in the demand refusal context] because the Federal Court already conclusively resolved this issue [in the demand futility context]*)). Under Grimes, this holding appears incorrect.
named plaintiffs only) unless the Court, for good cause shown, shall find that dismissal with prejudice would not be just under all the circumstances. Rules 41(a), 23(e) and 23.1 shall be construed so as to give effect to this subsection (aaa).

Ct. Ch. R. 15(aaa) (emphasis added). The language of Rule 15(aaa) confirms that a dismissal pursuant to Rule 23.1 is “with prejudice to the named plaintiffs only.” Id.

This Court took a different approach in Career Education, a decision with which I respectfully disagree. Career Education followed the federal cases holding that a Rule 23.1 dismissal has broad preclusive effect. It summarized those decisions as follows:

[A] trend in recent federal case law extend[s] collateral estoppel to different plaintiffs in a second derivative suit. Those cases justified the extension of [estoppel] doctrine based on the unique position of the parties in derivative suits. Because the corporation is the true party in interest in a derivative suit, courts have precluded different derivative plaintiffs in subsequent suits. This commonality lends itself to the application of collateral estoppel or issue preclusion.

2007 WL 2875203, at *10 (footnotes omitted). The Career Education decision thus assumed, as did the federal cases, that privity exists for purposes of a Rule 23.1 dismissal because “the corporation is the true party in interest in a derivative suit.” Id. As discussed, controlling Delaware Supreme Court authority dictates a contrary conclusion at the Rule 23.1 stage. Notably, the plaintiffs in Career Education “concede[d] that collateral estoppel or issue preclusion applie[d] to their Rule 23.1 arguments” and

contended only that they should not be precluded from raising issues not addressed in the prior action. *Id.* at *7. The *Career Education* Court therefore accepted that a Rule 23.1 dismissal would have preclusive effect, did not grapple with the authority issue, and analyzed only whether (i) the plaintiffs in the prior proceeding provided adequate representation and (ii) the two cases involved different issues.

In my view, contrary to *Career Education*, an earlier Rule 23.1 dismissal does not have preclusive effect on a subsequent derivative action brought by a different plaintiff because, as the earlier Rule 23.1 decision itself established, the prior plaintiff lacked authority to sue on behalf of the corporation and therefore was not in privity with the corporation or other stockholders. This does not mean that the Rule 23.1 decision has no value or, as several courts have posited, that demand futility could be relitigated *ad infinitum.* As *Kohls* makes clear, the earlier decision remains persuasive authority and could operate as *stare decisis.* When any other derivative plaintiff faces a Rule 23.1 motion involving the same transaction, the plaintiff must distinguish the new complaint or explain how the prior court erred such that the outcome of the motion would be different. I suspect that in many cases, the second court will follow the earlier ruling.

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3. Inadequate Representation

As an independent basis for declining to give collateral estoppel effect to the California Judgment, I find that the California plaintiffs did not adequately represent Allergan. The decisions that give preclusive effect to a Rule 23.1 dismissal universally recognize that another stockholder still can sue if the first plaintiff provided inadequate representation.15

Chancellor Strine has suggested Delaware law presume that a fast-filing stockholder with a nominal stake, who sues derivatively after the public announcement of a corporate trauma in an effort to shift the still-developing losses to the corporation’s fiduciaries, but without first conducting a meaningful investigation, has not provided adequate representation. See King v. VeriFone Hldgs., Inc., 994 A.2d 354, 364 n.34 (Del. Ch. 2010) (“King I”), rev’d on other grounds, 12 A.3d 1140 (Del. 2011) (“King II”).

15 See, e.g., Sonus Networks, 499 F.3d at 64 (“[T]o bind the corporation, the shareholder plaintiff must have adequately represented the interests of the corporation.”); Henik, 433 F. Supp. 2d at 381 (“It should be noted that there may be grounds warranting a different preclusion analysis and result where the plaintiff shareholder in the first action is alleged to have inadequately represented the interests of all of the shareholders.”); Hanson, 2007 WL 5186795, at *6 (“[C]ollateral estoppel is improper where the interests of nonparty plaintiffs facing preclusion were not adequately represented in the prior litigation.”); Norfolk Cty., 2009 WL 353746, at *8 (“If a subsequent plaintiff makes credible allegations that the interests of the corporation were not suitably represented in the prior proceeding, collateral estoppel may not apply.”); Career Educ., 2007 WL 2875203, at *10 (“Where a plaintiff alleges that the interests of the corporation were not suitably represented in the prior proceeding collateral estoppel may not apply.”). See generally Judgments § 42 (“A person is not bound by a judgment for or against a party who purports to represent him if . . . [the] representative failed to prosecute or defend the action with due diligence and reasonable prudence, and the opposing party was on notice of facts making that failure apparent.”).
When a derivative plaintiff files a damages action hastily in the wake of a public announcement, there is no basis for expediting the case to further the interests of the corporation and its stockholders, and, when the derivative plaintiff forewent a books and records investigation and a period of deep reflection on the publicly available documents and the law, should not the presumption be that the plaintiff is not fit to serve as the lead fiduciary for the corporation and its stockholders? What rational argument is there that it advances the legitimate interests of investors to give a leg up to the first to get to court in a situation when being first to court is likely to compromise the ability of the filing plaintiff to sustain his derivative complaint? Admittedly, there are no easy answers to the question of how to select lead counsel in representative actions, but what is certain is that rewarding plaintiffs and their counsel who sue first, and investigate and think second is likely to maximize the costs to investors of representative suits and minimize the benefits. Put simply, the speed racer approach might benefit certain interests, but those interests do not include the investors of corporations or the other societal constituencies dependent on the effective and efficient governance of corporations.

King I, 994 A.2d at 364 n.34; see Baca v. Insight Enters., Inc., 2010 WL 2219715, at *5 (Del. Ch. June 3, 2010) (questioning “whether a stockholder with a nominal stake who files an indemnification-based derivative action” quickly after the announcement of a corporate trauma “is adequately representing the interests of the corporation, as opposed to facilitating the pursuit of economic self-interest by an entrepreneurial law firm”). I adopt and apply the fast-filer presumption in this case.

a. The Fast-Filing Problem

Appreciating the need for the fast-filer presumption requires a big-picture understanding of the role derivative actions play in the corporate landscape. For publicly traded Delaware corporations, the enforcement of fiduciary obligations is largely carried
out by specialized plaintiffs’ firms who bring claims on a contingent basis.\footnote{See Reinier Kraakman et al., \textit{When Are Shareholder Suits in Shareholder Interests?}, 82 Geo. L.J. 1733, 1733 (1994) ("Shareholder suits are the primary mechanism for enforcing the fiduciary duties of corporate managers."); Jonathan R. Macey & Geoffrey P. Miller, \textit{The Plaintiffs’ Attorney’s Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform}, 58 U. Chi. L. Rev. 1, 10 (1991) ("The shareholder’s derivative suit is one of many devices in corporate law for controlling these conflicts between managers and shareholders."); Donald E. Schwartz, \textit{In Praise of Derivative Suits: A Commentary on the Paper of Professors Fischel and Bradley}, 71 Cornell L. Rev. 322, 323 (1986) ("Liability rules, enforced by shareholder litigation, are theoretically sound and profoundly affect the conduct of corporate managers, at least some aspects of their duties.").} Because diversified investors are rationally passive, specialized plaintiffs’ firms play a critical role in the functioning of our legal system. As Chancellor Allen explained,

[a] fundamental condition of the corporate form when stockholders are widely dispersed, as typically occurs in public corporations, is that individual shareholders have little incentive to bear the costs associated with activities that monitor board of director (or management) performance. Of course, a fundamental advantage that the corporate form offers to owners of capital is the utility that an investor gains through centralized management. Centralized management allows passive (low cost) ownership and promotes investor diversification. Limited liability and the entity status of a corporation similarly allow investors to be relatively passive. While the conditions that allow investors to be rationally passive are a primary source of utility, they can also lead to inefficiency to the extent centralized management may have incentives that are not perfectly aligned with those of the residual owners of the firm, which is inevitably the case. This imperfect alignment of incentives will inevitably lead to excess costs associated with centralized management. For that reason some expenditures for shareholder monitoring would be efficient. Such monitoring is, of course, more or less costly to the shareholder who engages in it. In a public company with widely distributed shares any particular shareholder has very little incentive to incur those costs himself in pursuit of a collective good, since unless there is some method to force a sharing of costs, he will bear all of the costs and only a (small) pro rata share of any gains that the monitoring yields.
Bird v. Lida, Inc., 681 A.2d 399, 402-03 (Del. Ch. 1996) (footnote omitted). Due to rational passivity, “it is likely that in a public corporation there will be less shareholder monitoring expenditures than would be optimum from the point of the shareholders as a collectivity.” Id. at 403. Incentivized by contingent fees, specialized plaintiffs’ firms can “pursue monitoring activities that are wealth increasing for the collectivity (the corporation or the body of its shareholders).” Id.

Because specialized plaintiffs’ firms ultimately receive compensation from awards of attorneys’ fees, their interests can diverge from the class or entity they represent.17 Interests diverge routinely during the initial period following an event that could provide a basis for filing a case. See Biondi, 820 A.2d at 1158-59 (discussing representative counsel’s interests when filing a derivative action); see also Silverstein v. Warner Commc’ns, Inc., 1991 WL 12835, at *2-3 (Del. Ch. Feb. 5, 1991) (Allen, C.) (discussing similar interests of representative counsel in class action context).

17 See, e.g., In re Citigroup Inc. S’holder Deriv. Litig., 964 A.2d 106, 117 (Del. Ch. 2009) (“A shareholder plaintiff in a derivative suit alleges claims in the right of the corporation rather than directly; thus, representative actions raise the concern that the best interest of the class might diverge from the best interest of the representative plaintiff’s attorneys.”); Biondi v. Scrushy, 820 A.2d 1148, 1159 (Del. Ch. 2003) (“[R]epresentative actions pose certain dangers—in particular, the potential divergence in the best interests of the plaintiffs’ attorneys and the plaintiffs they are purporting to represent . . . .”), aff’d sub nom. In re HealthSouth Corp. S’holders Litig., 847 A.2d 1121 (Del. 2004); Stephen A. Saltzburg et al., Third Circuit Task Force Report on Selection of Class Counsel, 74 Temp. L. Rev. 689, 706-07 (2001) (discussing divergent interests); Macey & Miller, supra, at 17-18 (same); John C. Coffee, Jr., Understanding the Plaintiff’s Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions, 86 Colum. L. Rev. 669, 684-91 (1986) (same).
A plaintiffs’ firm only can obtain a fee if it first obtains a result. A firm cannot obtain a result if a competitor gains control of the case. Many jurisdictions are perceived to follow a “first-filed” rule that gives control within that jurisdiction to the first stockholder plaintiff and associated law firm to file a representative action. Many jurisdictions likewise are perceived to give precedence to a “first-filed” action versus later-filed actions in other jurisdictions. When an event occurs that could provide

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18 See, e.g., Elliot J. Weiss & John S. Beckerman, Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions, 104 Yale L.J. 2053, 2062 (1995) (“Courts most often appoint as lead counsel the lawyer who files the first complaint. Thus, plaintiffs’ lawyers ‘race to the courthouse.’” (footnote omitted)). In King II, the Delaware Supreme Court stated that “[b]eing the ‘first to file’ does not automatically confer lead-plaintiff status.” 12 A.3d at 1151. Within Delaware, that statement is true, and the Court cited two Chancery decisions in support. Id. Outside of Delaware, the answer is far from clear. The King II decision cited a Ninth Circuit case and one decision from each of the Northern District of California, the Northern District of Georgia, and the Northern District of Illinois in which the courts considered more than filing speed. See id. at 1151 n.66. I suspect that this sample is not representative, that many counsel selection decisions are not published, and that first-to-file still plays a significant role. See John Armour et al., Is Delaware Losing Its Cases? 37 (European Corporate Governance Inst., Law Working Paper No. 151/2010, 2012), available at http://ssrn.com/abstract=1578404 (reporting that “interviewees told us that the first-to-file ‘custom’ nevertheless remains important” outside of Delaware and that “[w]hen plaintiffs’ lawyers cannot resolve for themselves who should be lead counsel, judges outside Delaware often appoint as lead or co-lead counsel the firm that filed first”); see also Walker v. Discover Fin. Servs., 2011 WL 2160889, at *3 (N.D. Ill. May 26, 2011) (utilizing filing speed as proxy for amount of work by counsel in “identifying and investigating potential claims”); Wright v. Krispy Kreme Doughnuts, Inc., 232 F.R.D. 528, 530-31 (M.D.N.C. 2005) (appointing first-filer as lead plaintiff over plaintiff that opted to first pursue books and records action). Regardless, whether jurisdictions actually give significant weight to first-to-file has less significance for influencing filing behavior than lawyer perception.

19 See Edward P. Welch, et al., Mergers & Acquisitions Deal Litigation Under Delaware Corporation Law § 2.01[B][3][a], at 2-16 to -17 (noting that “either defendants or plaintiffs may cite to the ‘first-to-file’ rule” to support a motion to dismiss or stay
grounds for a representative action, the first-filed rule incentivizes plaintiffs’ lawyers to file as fast as possible in an effort to gain control of the litigation. Motivated by first-to-file pressure, plaintiffs’ firms rationally eschew conducting investigations and making books and records demands, fearing that any delay would enable competitors to gain control of the litigation and freeze-out the diligent lawyer. No role, no result, no fee.

The conflict arises because fast-filing imposes real costs on corporations and their stockholders. When fast-filed complaints follow the announcement of a transaction or other event that likely will require expedited litigation, they at least perform the beneficial function of identifying the firms who wish to compete for leadership status. In a quickly evolving deal setting, fast-filing enables a leadership structure to be put in place so that expedited litigation can begin in earnest. But in contexts that do not warrant expedition, any administrative benefit disappears. When plaintiffs sue derivatively to recover damages from directors and senior officers for harm suffered by the corporation, the hastily filed complaints have little chance of surviving a Rule 23.1 motion, yet the defendant fiduciaries must respond, and the corporation must underwrite the costs of defense, either directly through indemnification and advancement or indirectly through insurance.

later-filed actions in other jurisdictions (footnotes omitted)); Armour et al., supra, at 6 (noting that while defendants can seek a stay or dismissal by filing a forum non conveniens motion, “success . . . is not assured, with the likelihood of success decreasing if the case was filed first in that state court”); Geoffrey P. Miller, Overlapping Class Actions, 71 N.Y.U. L. Rev. 514, 522 (1996) (reporting that “courts are more likely to defer to sister-state proceedings if the parallel case was filed first”).
b. The Idealized Derivative Action

When a corporation suffers harm, the board of directors is the institutional actor legally empowered under Delaware law to determine what, if any, remedial action the corporation should take, including pursuing litigation against the individuals involved. See 8 Del. C. § 141(a). “A cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation.” Aronson, 473 A.2d at 811. “Directors of Delaware corporations derive their managerial decision making power, which encompasses decisions whether to initiate, or refrain from entering, litigation, from 8 Del. C. § 141(a).” Zapata, 430 A.2d at 782 (footnote omitted). Section 141(a) vests statutory authority in the board of directors to determine what action the corporation will take with its litigation assets, just as with other corporate assets. See id.

Absent sufficient reason to doubt the directors’ ability to make disinterested and independent decisions about litigation, the board is not only empowered but optimally positioned to make decisions on behalf of the corporation and, if appropriate, pursue litigation. The board can deploy the corporation’s resources to investigate the wrongdoing and seek a remedy. The directors have full access to the corporation’s internal information, including privileged communications. The board can seek cooperation from management and employees and utilize the company’s internal expertise. In contrast to the Court, which typically only can award some form of damages, the board can bargain with alleged wrongdoers and craft remedies that may better serve the entity. Perhaps most significantly, the board can take into consideration
and balance the interests of multiple constituencies when determining what outcome best serves the interests of stockholders. See, e.g., 1 R. Franklin Balotti & Jesse A. Finkelstein, *The Delaware Law of Corporations and Business Organizations* § 13.15, at 13-75 (3d ed. 1998) (listing factors that special litigation committee should consider, including “[t]he magnitude and merits of the claims; [t]he size and likelihood of a recovery of damages or other relief; [t]he possible detriment to the company from the assertion of any claims, as well as the indirect costs, such as the effect upon other potential litigation to which the company is a party, and relationships with customers or suppliers; and [t]he remedial steps already taken and that, in the future, could be taken by the corporation to prevent a reoccurrence of the challenged actions”). Consequently, both as a matter of legal authority and optimal resource allocation, the “board of directors, unless legally disabled, should be presented with the opportunity to manage litigation that seeks to redress harm inflicted upon the corporation.” *Saito v. McCall*, 2004 WL 3029876, *10 (Del. Ch. Dec. 20, 2004), overruled on other grounds, *Lambrecht v. O’Neal*, 3 A.3d 277 (Del. 2010).

In a derivative suit, a stockholder seeks to displace the board’s authority. *Aronson*, 473 A.2d at 811; see also *Desimone v. Barrows*, 924 A.2d 908, 914 (Del. Ch. 2007) (noting that issue for Rule 23.1 motion is “whether the . . . board should be divested of its authority to address [the underlying] misconduct”). To do so, the complaint must allege with particularity that the board was presented with a demand and refused it wrongfully or that the board could not properly consider a demand, thereby excusing the effort to make demand as futile. Framed in the language of controlling
Delaware Supreme Court precedent, demand is futile when “the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.”

A breach of fiduciary duty claim that seeks to hold directors accountable for the consequences of a corporate trauma is known colloquially as a Caremark claim, in a tip of the judicial hat to Chancellor Allen’s landmark decision. See In re Caremark Int’l Inc. Deriv. Litig., 698 A.2d 959 (Del. Ch. 1996). Because it is safe to say that non-

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20 Rales, 634 A.2d at 934. In Aronson, the Delaware Supreme Court first crafted a specific two-part version of the subsequently articulated Rales test that applies when a derivative plaintiff challenges a board decision made by the same directors who remain in office at the time suit is filed. Compare Aronson, 473 A.2d at 814 (articulating two-part test where board composition did not change) with Rales, 634 A.2d at 933-34 (explaining that “[c]onsistent with the context and rationale of the Aronson decision, a court should not apply the Aronson test for demand futility where the board that would be considering the demand did not make a business decision which is being challenged in the derivative suit.”). The Rales test addresses the same concerns that animate the Aronson test and frames the more comprehensive standard. See David B. Shaev Profit Sharing Account v. Armstrong, 2006 WL 391931, at *4 (Del. Ch. Feb. 13, 2006) (“the Rales test, in reality, folds the two-pronged Aronson test into one broader examination”); Guttman, 823 A.2d at 501 (“At first blush, the Rales test looks somewhat different from Aronson, in that [it] involves a singular inquiry . . . . Upon closer examination, however, that singular inquiry makes germane all of the concerns relevant to both the first and second prongs of Aronson.”); Donald J. Wolfe, Jr. & Michael A. Pittenger, Corporate and Commercial Practice in the Delaware Court of Chancery § 9.02[b][3][iii], at 9-97 (2011) (“[I]t is arguable that the current state of the law is conceptually inverted and that it would be both simpler and more direct to regard the original Aronson analysis as a subpart of the more generally applicable and flexible principle set forth in Rales.”). To recognize the tests as complementary versions rather than exclusive alternatives becomes particularly important for a mixed board where only a subset of the directors made the original decision. As to those directors, Aronson helpfully focuses the demand-futility analysis; as to the new directors, Rales frames the overarching test.
sociopathic directors never consciously choose for the entity they oversee to suffer a disaster, a Caremark claim contends that the directors set in motion or “allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in doing so they violated a duty to be active monitors of corporate performance.” Id. at 967. The list of corporate traumas for which stockholders theoretically could seek to hold directors accountable is long and ever expanding: regulatory sanctions, criminal or civil fines, environmental disasters, accounting restatements, misconduct by officers or employees, massive business losses, and innumerable other potential calamities.

A stockholder cannot displace the board’s authority simply by describing the calamity and alleging that it occurred on the directors’ watch. “‘[M]ost of the decisions that a corporation, acting through its human agents, makes are, of course, not the subject of director attention.’” Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 364, 372 (Del. 2006) (quoting Caremark, 698 A.2d at 968). “[O]rdinary business decisions that are made by officers and employees deeper in the interior of the organization can . . . vitally affect the welfare of the corporation and its ability to achieve its various strategic and financial goals.” Caremark, 698 A.2d at 968. “[D]irectors’ good faith exercise of oversight responsibility may not invariably prevent employees from violating criminal laws, or from causing the corporation to incur significant financial liability, or both . . . .” Stone, 911 A.2d at 373. Without a connection to the board, a corporate calamity will not lead to director liability. Without a substantial threat of director liability, a court has no reason to doubt the board’s ability to evaluate a demand.
To plead a sufficient connection between the corporate trauma and the board, the plaintiff’s first and most direct option is to allege with particularity actual board involvement in a decision that violated positive law. In *Caremark*, Chancellor Allen framed the test as whether the directors “knew or . . . should have known” about illegality. *Caremark*, 698 A.2d at 971. In *Stone*, the Delaware Supreme Court tightened the test to require actual knowledge: “[I]mposition of liability requires a showing that the directors knew they were not discharging their fiduciary obligations.” 911 A.2d at 370. Nevertheless, because sophisticated and well-advised individuals do not customarily confess knowing violations of law, a plaintiff following this route effectively must plead facts and circumstances sufficient for a court to infer that the directors knowingly violated positive law. *See In re Am. Int’l Gp., Inc., Consol. Deriv. Litig.*, 965 A.2d 763, 777, 795 (Del. Ch. 2009).

If the plaintiff cannot point to a decision, then the next alternative is to plead that the board consciously failed to act after learning about evidence of illegality—the proverbial “red flag.” A plaintiff might plead, for example, that the directors ignored “red flags” indicating misconduct in defiance of their duties. A claim that an audit committee or board had notice of serious misconduct and simply failed to investigate, for example, would survive a motion to dismiss, even if the committee or board was well constituted and was otherwise functioning. *Shaev*, 2006 WL 391931, at *5 (footnote omitted). A board that fails to act in the face of such information makes a conscious decision, and the decision not to act is just as much of a decision as a decision to act. *See Krieger v. Wesco Fin. Corp.*, 30 A.3d 54, 58 (Del. Ch. 2011); *Hubbard v. Hollywood Park Realty Enters., Inc.*, 1991 WL 3151, at *10 (Del.
Ch. Jan. 14, 1991). The decision to act and the conscious decision not to act are thus equally subject to review under traditional fiduciary duty principles and equally able to create the requisite connection to the board. See Spiegel, 571 A.2d at 773-74 (“[A] conscious decision by a board of directors to refrain from acting may be a valid exercise of business judgment . . . .”); Aronson, 473 A.2d at 813 (equating “a conscious decision to refrain from acting” with a decision to act).

If there is no evidence of direct board action or conscious inaction, then the plaintiff might seek to plead “that a board of directors is dominated or controlled by key members of management, who the rest of the board unknowingly allowed to engage in self-dealing transactions.” Shaev, 2006 WL 391931, at *5 n.11. Typically, however, the plaintiff must fall back to the final means of connecting the directors to illegality: the board’s obligation to adopt internal information and reporting systems that are “reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation’s compliance with law and its business performance.”

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21 Caremark, 698 A.2d at 970; see, e.g., Stone, 911 A.2d at 364 (evaluating claim under failure-to-monitor branch of Caremark when “the plaintiffs acknowledge that the directors neither knew nor should have known that violations of law were occurring, i.e., that there were no red flags before the directors” (alteration and internal quotation omitted)); Shaev, 2006 WL 391931, at *1 (evaluating claim under failure-to-monitor branch of Caremark after noting that the plaintiffs had no indications that the director defendants had any contemporaneous knowledge of the alleged misconduct by Citigroup employees).
conduct, and if the directors failed “to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists,” then there is a sufficient connection between the occurrence of the illegal conduct and board level action or conscious inaction to support liability. *Caremark*, 698 A.2d at 970.

The burden on a plaintiff when seeking to establish liability under this final route “is quite high.” *Id.* at 971.

Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation, as in *Graham v. Allis-Chalmers Manufacturing Company*, 188 A.2d 125 (Del. 1963)) or in [the Caremark case itself], . . . only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.

*Id.* “Concretely, this latter allegation might take the form of facts that show the company entirely lacked an audit committee or other important supervisory structures, or that a formally constituted audit committee failed to meet.” *Shaev*, 2006 WL 391931, at *5 (footnote omitted); see *Gutman*, 823 A.2d at 507 (“[T]he kind of fact pleading that is critical to a Caremark claim [is] . . . contentions that the company lacked an audit committee, that the company had an audit committee that met only sporadically and devoted patently inadequate time to its work, or that the audit committee had clear notice of serious accounting irregularities and simply chose to ignore them or, even worse, to encourage their continuation.”). As with the business judgment rule, this demanding standard benefits stockholders as a whole, because “it makes board service by qualified
persons more likely, while continuing to act as stimulus to good faith performance of duty by such directors.” Caremark, 698 A.2d at 971.

The standard for Caremark liability thus parallels the standard for imposing damages when a corporation has an exculpatory provision adopted pursuant to 8 Del. C. § 102(b)(7). See Desimone, 924 A.2d at 935. “Such a provision can exculpate directors from monetary liability for a breach of the duty of care, but not for conduct that is not in good faith or a breach of the duty of loyalty.” Stone, 911 A.2d at 367.

A failure to act in good faith may be shown, for instance, [1] where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, [2] where the fiduciary acts with the intent to violate applicable positive law, or [3] where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.

In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 67 (Del. 2006) (quoting In re Walt Disney Co. Deriv. Litig., 907 A.2d 693, 755-56 (Del. Ch. 2005), aff’d, 906 A.2d 27 (Del. 2006). A Caremark claim based on the failure to establish a monitoring system seeks to invoke the third of these examples. See Stone, 911 A.2d at 369 (“The third of [the Disney] examples describes, and is fully consistent with, the lack of good faith conduct that the Caremark court held was a ‘necessary condition’ for director oversight liability . . . .” (quoting Caremark, 698 A.2d at 971)). See generally Stephen M. Bainbridge et al., The Convergence of Good Faith and Oversight, 55 UCLA L. Rev. 559 (2008) (discussing the re-interpretation of Caremark as a good faith case and the potential liability risks to directors that result).

Because a plaintiff must plead a connection to the board, only the extremely rare
complaint will be able to establish the necessary linkage without referring to internal corporate documents. To obtain the necessary documents, the Delaware courts have long exhorted potential derivative plaintiffs to use Section 220 to investigate their claims and obtain corporate books and records before filing derivative litigation. The Delaware courts have dismissed a steady stream of Caremark claims where the plaintiffs have not

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22 See, e.g., Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1056-57 (Del. 2004) (“Both this Court and the Court of Chancery have continually advised plaintiffs who seek to plead facts establishing demand futility that the plaintiffs might successfully have used a Section 220 books and records inspection to uncover such facts.”); White v. Panic, 783 A.2d 543, 556-57 (Del. 2001) (“[T]his case demonstrates the salutary effects of a rule encouraging plaintiffs to conduct a thorough investigation, using the ‘tools at hand’ including the use of actions under 8 Del. C. § 220 for books and records, before filing a complaint. . . . [F]urther pre-suit investigation in this case may have yielded the particularized facts required to show that demand is excused or it may have revealed that the board acted in the best interests of the corporation.” (footnote omitted)); Brehm, 746 A.2d at 266-67 (disregarding plaintiffs’ complaint “that the system of requiring a stockholder to plead particularized facts in a derivative suit is basically unfair because the Court will not permit discovery under Chancery Rules 26-37 to marshal the facts necessary to establish that pre-suit demand is excused,” reasoning that “[p]laintiffs may well have the ‘tools at hand’ to develop the necessary facts for pleading purposes . . . [by] seek[ing] relevant books and records of the corporation under Section 220”); Scattered Corp., 701 A.2d at 78-79 (“[P]laintiffs inexplicably did not bring [a Section 220 action before filing their derivative complaint]. Accordingly, plaintiffs cannot argue that they have used the available ‘tools at hand to obtain the necessary information before filing a derivative action.’” (quoting Grimes, 673 A.2d at 1216)); Security First Corp. v. U.S. Die Casting & Dev. Co., 687 A.2d 563, 567 n.3 (Del. 1997) (“This Court has encouraged the use of Section 220 as an information-gathering tool in the derivative context, provided a proper purpose is shown.” (internal quotation omitted)); Rales, 634 A.2d at 934 n.10 (expressing surprise at the rarity with which Section 220 had been used to gather information to satisfy Court of Chancery Rule 23.1, and encouraging Court of Chancery to reward lawyers who use Section 220 before filing by appointing them lead counsel instead of the first-filers).
first used Section 220 to obtain books and records.23 In bringing these actions, “plaintiffs seem to hope the Court will accept the conclusion that since the Company suffered large losses, and since a properly functioning risk management system would have avoided such losses, the directors must have breached their fiduciary duties in allowing such losses.” Citigroup, 964 A.2d at 129. The Delaware courts consistently have rejected “such general ipse dixit syllogisms.” Id. Not surprisingly, without first obtaining books and records, stockholders have not been able to link the trauma to the directors, and their

23 See, e.g., Wood v. Baum, 953 A.2d 136, 144 (Del. 2008) (affirming dismissal of Caremark claim under Rule 23.1; noting that “plaintiff could have, but chose not to, make a ‘books and records’ request”); In re Dow Chem. Co. Deriv. Litig., 2010 WL 66769, at *13 (Del. Ch. Jan. 11, 2010) (dismissing Caremark claim under Rule 23.1 where plaintiff did not use Section 220); Desimone, 924 A.2d at 951 (noting that plaintiff filed complaint with using Section 220 and therefore had “no idea what the [board’s] investigation actually entailed and is unable to plead any facts about what the . . . board did, when they did it, what they discussed, what conclusions they reached, and why the board did or did not do anything”); Rattner v. Bidzos, 2003 WL 22284323, at *14 (Del. Ch. Sept. 30, 2003) (“[A] symptomatic and ultimately fatal defect to all of Rattner’s claims is a failure to plead facts with particularity. . . . [T]he books and records provisions of 8 Del. C. § 220 . . . might have been helpful here . . . .”); In re Citigroup Inc. S’holders Litig., 2003 WL 21384599, at *3 (Del. Ch. June 5, 2003) (“Despite its prolixity, the Amended Complaint completely fails to set forth adequate reasons why demand is excused. Perhaps the absence of particularized facts excusing demand is the product of a race to the courthouse. It is certainly a result of the plaintiffs’ failure to use the ‘tools at hand’ . . . .”), aff’d sub nom. Rabinovitz v. Shapiro, 839 A.2d 666 (Del. 2003); Guttmann, 823 A.2d at 493 (“Having failed to heed the numerous admonitions by our judiciary for derivative plaintiffs to obtain books and records before filing a complaint, the plaintiffs have unsurprisingly submitted an amended complaint that lacks particularized facts compromising the impartiality of the . . . board that would have acted on a demand.”); id. at 504 (noting that a § 220 action “could have provided the basis for the pleading of particularized facts”); White v. Panic, 793 A.2d 356, 371-72 (Del. Ch. 2000) (“White I”) (dismissing Caremark claim after noting that the plaintiff failed to use Section 220), aff’d, 783 A.2d 543 (Del. 2001) (“White II”).
Caremark complaints have been dismissed.24 By contrast, stockholders who have used Section 220 and obtained documents showing board consideration or involvement have been able to survive Rule 23.1 motions.25 Put simply, fast-filing generates dismissals.

If dispersed stockholders could act collectively following a corporate trauma, they would want the corporation to pursue claims vigorously against its fiduciaries only if there was a risk-adjusted prospect of a net-positive recovery. They would not file suit hastily, thereby imposing needlessly on themselves both the cost of their offensive litigation and the burdens of defense. The hypothetical stockholder collective would recognize there was no need to rush. The statute of limitations on a breach of fiduciary 24 See, e.g., Wood, 953 A.2d at 143 (rejecting assertion that a director “should have been on notice” about improper accounting or internal control issues due to his senior position at the company and membership on audit committee); Hauspie v. Stonington P’rs, Inc., 945 A.2d 584, 587-88 (Del. 2008) (rejecting argument that director must have known of financial misstatement because he served as a Managing Director and Vice Chairman); Desimone, 924 A.2d at 940 (“Delaware courts routinely reject the conclusory allegation that because illegal behavior occurred, internal controls must have been deficient, and the board must have known so.”).

25 Compare Ash v. McCall, 2000 WL 1370341, at *16 (Del. Ch. Sept. 15, 2000) (dismissing Caremark claims without prejudice where plaintiff failed to use Section 220; noting that “if plaintiffs can allege with some particularity facts indicating that HBOC directors had actual knowledge of accounting irregularities, or knowledge of facts indicating potential accounting irregularities, and took no action until confronted with the DeLoitte audit report in early 1999 (after the merger), such facts, to my mind, could possibly excuse demand as to the Second Oversight Claim”) with Saito v. McCall, 2004 WL 3029876, *7 (holding after stockholder used Section 220 that complaint challenging same transaction stated Caremark claim); compare Brehm, 746 A.2d at 266-67 (affirming Rule 23.1 dismissal of complaint for failure to plead particularized facts where plaintiff failed to use Section 220) with In re The Walt Disney Co. Deriv. Litig., 825 A.2d 275, 287-90 (Del. Ch. 2003) (holding after stockholder used Section 220 that complaint challenging same transaction survived Rule 23.1 motion).
duty claim is three years. *In re Tyson Foods, Inc.*, 919 A.2d 563, 584 (Del. Ch. 2007). If the underlying corporate trauma resulted from a government investigation, securities class action, or some other slowly unfurling event, there would likely be further developments that would yield additional information that could materially affect whether to sue.\(^{26}\) This Court routinely stays indemnification-based derivative claims to allow the underlying action giving rise to potential liability to unfold.\(^{27}\) Trustees who have been empowered to assert corporate claims regularly take their time, conduct thorough investigations, and may sue late in the statute of limitations period after they are

\(^{26}\) See *Baca*, 2010 WL 2219715, at *5 (explaining why a rational stockholder plaintiff, “free of the compulsion to win a first-to-file sweepstakes,” would not file a derivative action seeking to recover for corporate losses stemming from a restatement and related federal securities action “until after a ruling on a motion to dismiss the Federal Securities Action”); *King I*, 994 A.2d at 357 (noting “the lack of an investor-beneficial reason for urgent filing” in derivative suit where alleged damages were corporation’s liability in underlying securities suit that had not yet been resolved).

\(^{27}\) See, e.g., *Brenner v. Albrecht*, 2012 WL 252286, a *7 (Del. Ch. Jan. 27, 2012) (staying derivative indemnification proceeding pending outcome of securities class action); *Brudno v. Wise*, 2003 WL 1874750, at *5 (Del. Ch. Apr. 1, 2003) (granting stay “[g]iven that the overwhelming thrust of the Delaware Action complaint is a demand for indemnification largely for harm to be incurred by [the corporation] in the Federal Securities Action, the sensible ordering of events is for the Federal Securities Action to proceed first”); see also *In re Massey Energy Co.*, 2011 WL 2176479, *27 (Del. Ch. May 31, 2011) (“[T]he plaintiffs, as fiduciaries for other Massey stockholders, [should] be reluctant to prosecute the Derivative Claims they claim are so valuable until the direct claims against Massey are resolved. . . . Thus, the Derivative Claims should follow, rather than precede, the resolution of the key direct suits and regulatory proceedings.”); *Pfeiffer v. Toll*, 989 A.2d 683, 708 (Del. Ch. 2010) (directing parties to confer where “[i]t would be counter-intuitive if an action such as this one, which exists to recover for harm imposed on the corporation, was permitted to proceed in a way that increased the burden on the corporation. At a minimum, sensible coordination with the Federal Securities Action is warranted. A stay . . . also could make sense.”), abrogated on other grounds, *Kahn v. Kohlberg Kravis Roberts & Co., L.P.*, 23 A.3d 831, 840 (Del. 2011).
Rather than filing hastily, the hypothetical stockholder collective would proceed deliberately. It would hire well-qualified counsel. Through counsel, it would conduct an investigation and seek books and records using Section 220. After obtaining books and records, counsel would evaluate whether it made sense to sue. The books and records might show that the board had an appropriate monitoring system in place, but that the system did not alert the board. Or the books and records might show that despite their good faith efforts, the directors were misinformed or misled. Under these or other circumstances, the hypothetical stockholder collective logically might decide not to sue, preferring to leave their elected fiduciaries to the task of remedying the harm suffered by

the corporation and dispensing with expensive litigation that likely would founder on Rule 23.1. If the stockholders had concerns, they might make a litigation demand, provide the board with the results of their investigation, and put the directors on notice. If the board declined to take action, the stockholders again could use Section 220 to investigate and consider a suit if the refusal was wrongful.

By contrast, if the books and records showed director misconduct, then the stockholders could decide to pursue a claim. Their counsel at that point would be well positioned to plead demand futility and survive a motion to dismiss. Importantly for all concerned, the costly process of briefing and arguing motions to dismiss would take place once, based on the stockholders’ post-inspection complaint.

Under a first-to-file system, plaintiffs’ lawyers cannot act as stockholders collectively would want because by proceeding deliberately, a law firm risks losing control of the case to competitors who file immediately. For fast-filing lawyers, the resulting action has the dynamics of a lottery ticket. In most cases, the fast-filing plaintiff will not have pled a derivative claim that can overcome Rule 23.1. But in the rare case, fate may bless the fast-filer with something implicating the board, or a court might be offended by the magnitude of the corporate trauma and allow the derivative action to proceed. If the action survives a motion to dismiss, then its settlement value increases exponentially. See Kenneth B. Davis, Jr., The Forgotten Derivative Suit, 61 Vand. L. Rev. 387, 429-30 (2008) (“At least four of the eight [Caremark] cases where plaintiffs survived a motion to dismiss ultimately settled, all with significant attorneys’ fees or
monetary awards. . . . [T]he substantial corporate losses incurred in these cases increase the settlement value of a successful demand-excused claim.”).

A fast-filer can readily build a portfolio of cases in the hope that one will hit. Filing a derivative claim is relatively cheap. Search costs are minimal because corporations publicly announce material adverse events. Public disclosures, news stories, and analyst reports provide the background information for the claim. See id. at 417 (finding empirical evidence “consistent with the critique that derivative suits simply piggyback on what the government (or perhaps even the media) already has uncovered and investigated”); John C. Coffee, Jr., Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working, 42 Md. L. Rev. 215, 221 n.15 (1983) (observing phenomenon of “piggybacking” by private plaintiffs’ attorneys on efforts by government investigators to unearth wide range of classes of misconduct). Indeed, derivative plaintiffs often piggyback on the efforts of other specialized plaintiffs’ firms by filing indemnification-based claims that crib from other complaints. See, e.g., Guttman, 823 A.2d at 504 (noting admission by plaintiffs’ counsel that the complaints in federal securities class actions provided “the primary source of information” for the derivative complaint). As with a federal securities law claim, the lawyer’s most difficult task typically will be finding a suitable plaintiff.29

29 Cf. Weiss & Beckerman, supra, at 2060 (“[T]he usual pattern is for a lawyer who specializes in representing plaintiffs to take the initiative. The lawyer typically becomes aware of a significant move in the price of a company’s stock following disclosure of worse-than-expected earnings or other significant, unexpected information. She then conducts a brief investigation, generates a class action complaint, finds someone
The first-to-file regime disserves stockholder interests across multiple dimensions. It prevents plaintiffs’ lawyers from acting optimally. It forces defendants to respond to multiple complaints in multiple jurisdictions. It also confers significant litigation advantages on defendants. All else equal, defendants would vastly prefer to litigate against a plaintiff that has not used Section 220 or otherwise conducted a meaningful investigation. Witness the string of pleadings-stage dismissals in derivative actions filed after large corporate traumas. A state that ritualistically favored defendants might embrace such a regime, but Delaware has a long history of striving to balance the interests of stockholders and managers to craft an efficient corporation law.30 “Representative litigation plays an important role in protecting the interests of
to serve as a ‘representative’ plaintiff, and files the complaint, often within a few days of the disclosure at issue.”); Coffee, Jr., Understanding the Plaintiff’s Attorney, supra, at 679 (“[B]ecause the attorney as private enforcer looks to the court, not the client, to award him a fee if successful, the attorney can find the legal violation first and the client second.”).

30 Lawrence A. Hamermesh, The Policy Foundations of Delaware Corporate Law, 106 Colum. L. Rev. 1749, 1763-64 (2006) (“[T]oday’s drafters of the DGCL do not devote an iota of conscious effort to make that statute more friendly to management and less protective of stockholders. . . . [W]e favor a much more conservative approach that seeks to maintain whatever balance currently exists, and we are distinctly uncomfortable with any change that alters that balance in either direction.”); Leo E. Strine, Jr., The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face, 30 Del. J. Corp. L. 673, 680 (2005) (“[C]orporation law in Delaware is influenced by only the two constituencies whose views are most important in determining where entities incorporate: managers and stockholders. . . . [I]t is . . . fair to say that both groups have a lot of clout, and that Delaware corporate lawmakers seriously consider each group’s perspective on all key issues. . . . [T]he key takeaway point is that Delaware’s financial self-interest in legal excellence leads to a productive dynamic for the creation and maintenance of an efficient and fair corporation law.”).
stockholders, but it will not optimally serve investors unless suits are actually filed on the basis of a real concern that wrongdoing has occurred and after a proper investigation.”

King I, 994 A.2d at 356.

c. This Court’s Efforts To Address Fast Filing

The fast-filer presumption suggested by Chancellor Strine comports with other steps this Court has taken to shape the legal incentives of specialized plaintiffs’ firms. In addition to criticizing fast-filed, non-substantive complaints, this Court has made clear that when stockholder plaintiffs sue in a representative capacity, first-to-file does not control which plaintiff has the substantive right to proceed. 31 For claims implicating the internal affairs of Delaware corporations, this mitigates the first-to-file problem.

31 TCW Tech. Ltd. P’ship v. Intermedia Commc’ns, Inc., 2000 WL 1654504, at *3 (Del. Ch. Oct. 17, 2000) (“[N]one of the pending lawsuits in this litigation is entitled to any special status as the lead or coordinating lawsuit simply by virtue of having been filed earlier than any other pending action.”); id. (“Although it might be thought, based on myths, fables, or mere urban legends, that the first to file a lawsuit in this Court wins some advantage in the race to represent the shareholder class, that assumption, in my opinion, has neither empirical nor logical support. . . . It is not the race to the courthouse door . . . that impresses the members of this Court when it comes to deciding who should control and coordinate litigation on behalf of the shareholder class.”); see, e.g., In re Del Monte Foods Co. S’holders Litig., 2010 WL 5550677, at *6 (Del. Ch. Dec. 31, 2010) (choosing lead counsel based on a “nuanced and case-specific test in which the Court examines both the proposed lead counsel and the proposed named plaintiff,” but not which complaint was filed first, because “[t]he Court’s overriding goal is [to] establish a leadership structure that will provide effective representation”); Wiehl v. Eon Labs, 2005 WL 696764, at *1-3 (Del. Ch. Mar. 22, 2005) (appointing lead plaintiff and lead counsel by reference to various factors other than filing speed); Hirt v. U.S. Timberlands Serv. Co., 2002 WL 1558342, at *2 (Del. Ch. July 3, 2002) (same); TCW Tech., 2000 WL 1654504, at *4 (same).
This Court likewise has recognized the need to avoid a ritualistic first-to-file rule when representative plaintiffs compete across multiple jurisdictions. In *Biondi*, Chancellor Strine, then Vice Chancellor, considered whether to defer to a prior-filed Alabama case “initiated by a hastily-filed and cursorily pled complaint that barely alleged one of the claims raised by the Delaware plaintiffs as to only one of the transactions raised by them.” 820 A.2d at 1150. In declining to stay the Delaware actions in favor of prior-filed Alabama proceedings, Chancellor Strine recognized that

representative actions pose certain dangers—in particular, the potential divergence in the best interests of the plaintiffs’ attorneys and the plaintiffs they are purporting to represent—that are not addressed, and indeed may be exacerbated, by a legal rule that places determinative weight on which complaint was filed first.

. . . The mere fact that a lawyer filed first for a representative client is scant evidence of his adequacy and may, in fact, support the contrary inference. 820 A.2d at 1159 (footnote omitted). In lieu of first-to-file, this Court balances the factors pertinent to a *forum non conveniens* analysis to determine where it makes sense for the representative action to proceed. *See, e.g., Rosen v. Wind River Sys., Inc.*, 2009 WL 1856460, at *6 (Del. Ch. June 26, 2009); *In re Topps Co. S’holders Litig.*, 924 A.2d 951, 956-64 (Del. Ch. 2007); *Ryan v. Gifford*, 918 A.2d 341, 350-51 (Del. Ch. 2007).

This Court also adopted Rule 15(aaa), quoted above, to limit a plaintiff’s ability to re-plead. Ct. Ch. R. 15(aaa). Under this rule, a plaintiff who files a derivative action cannot freely amend after engaging in briefing on the motion to dismiss. *See Braddock*, 906 A.2d at 783 (explaining purpose and operation of Rule 15(aaa)). By imposing
consequences for litigating to a pleadings-stage decision, Rule 15(aaa) encourages plaintiffs to do their homework and prepare a well-crafted complaint.

The Delaware Supreme Court has rejected two other attempts by this Court to address the first-to-file problem, but in each case expressed support for the effort. In *King I*, Chancellor Strine held that by filing a derivative action, a stockholder plaintiff represented consistent with Rule 11 that the plaintiff and his counsel had sufficient information to plead demand futility and did not require additional information. *See* 994 A.2d at 356; *see also* Ct. Ch. R. 11. The Chancellor ruled that the stockholder plaintiff therefore could not plead a proper purpose in a later-filed Section 220 action to obtain books and records relating to the issue of demand futility. *Id.* at 361. In reaching this holding, the Chancellor discussed the incentives created by the first-to-file rule and sought to thwart efforts by fast-filing plaintiffs’ lawyers to eat their cake (by filing quickly) while still having it (by obtaining books and records through Section 220). *Id.* at 357-59. The Delaware Supreme Court rejected this interpretation of the proper purpose requirement in cases where the derivative action had been dismissed without prejudice.32

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32 *See King II*, 12 A.3d at 1150 (“[I]t is a proper purpose under Section 220 to inspect books and records that would aid the plaintiff in pleading demand futility in a to-be-amended complaint in a plenary derivative action, when the earlier-filed plenary complaint was dismissed on demand futility-related grounds without prejudice and with leave to amend.”); *see also* Amalgamated Bank v. NetApp, Inc., 2012 WL 379908, at *7 (Del. Ch. Feb. 6, 2012) (recognizing limitation of *King II* to without-prejudice dismissals in which stockholder-plaintiff could re-file). Because *King II* permits a derivative plaintiff to use Section 220 after a without-prejudice dismissal, Rule 15(aaa) now has the unfortunate side effect of encouraging plaintiffs to file derivative actions in courts that lack a similar rule and favor without-prejudice dismissals.
At the same time, the Delaware Supreme Court acknowledged the policy concerns that animated Chancellor Strine’s decision. *King II*, 12 A.3d at 1150-51. Rather than addressing the first-to-file problem through the proper purpose requirement of Section 220, however, the Supreme Court suggested that “appropriate remedies are available in the plenary court” and that “[o]ne possible remedy for a prematurely-filed derivative action might be for the plenary court to deny the plaintiff ‘lead plaintiff’ status in such circumstances.” *Id.* at 1151.

Similarly in *White I*, Vice Chancellor Lamb suggested that a plaintiff’s failure to obtain books and records could be taken into account when evaluating whether a complaint’s allegations were sufficiently particularized to satisfy Rule 23.1. *See* 793 A.2d at 364 (stating that because the plaintiff failed to use Section 220, “I will not give a broad reading to the facts alleged in the complaint, nor will I infer from them the existence of other facts that would have been proved or disproved by a further presuit investigation”). On appeal, the Delaware Supreme Court rejected this approach as inconsistent with Rule 23.1, but observed that “[t]he Court of Chancery was certainly justified in chastising the plaintiff for his lackluster pre-suit efforts.” *White II*, 783 A.2d at 549. Chancellor Chandler tried again in *Beam v. Stewart*, where he suggested that Delaware Supreme Court decisions interpreting Rule 23.1 were “wholly consistent with [*White I*’s approach of] not giving ‘a broad reading to the facts alleged in the complaint.’” *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961, 982 n.66 (Del. Ch. 2003) (“*Beam I*”), *aff’d on other grounds*, 845 A.2d 1040 (Del. 2004) (“*Beam II*”). He further suggested that “one might argue that following [*White I*’s] interpretive
suggestion would be a reasonable method to further the Supreme Court’s desire to encourage the use of § 220.” Id. On appeal, the Delaware Supreme Court affirmed the dismissal of the complaint but reiterated that “[a] plaintiff’s use of, or failure to use, a books and records inspection does not change the standard to be applied to review of the complaint.” Beam II, 845 A.2d at 1057 n.52. The Supreme Court nevertheless “agree[d] with the Chancellor’s point about cost and drain on resources in weak cases where the plaintiff does not seek books and records.” Id.

d. Applying The Fast-Filer Presumption

In Rales, the Delaware Supreme Court made clear that “[n]othing requires the Court of Chancery, or any other court having appropriate jurisdiction, to countenance [fast-filing] by penalizing diligent counsel who has employed [investigative] methods, including section 220, in a deliberate and thorough manner in preparing a complaint that meets the demand excused test of Aronson.” 634 A.2d at 934 n.10; see also King II, 12 A.3d at 1151 (suggesting denial of lead plaintiff status as remedy for fast-filed derivative action). In my view, a court in a plenary derivative action such as this one has discretion to address a rush to the courthouse by determining that the plaintiff in the original derivative action did not provide adequate representation for the corporation and declining on that basis to give preclusive effect to a Rule 23.1 dismissal of the fast-filer’s complaint. In this case, to give preclusive effect to the California Judgment would favor the lawyers who filed hastily, penalize the diligent counsel who used Section 220, and confer a case-dispositive advantage on the defendants at the potential expense of the corporation.
The origins of this case exemplify the race-to-the-courthouse problem. Less than 48 hours after Allergan announced its settlement, LAMPERS filed the first derivative complaint, without using Section 220, without conducting any serious investigation, and without any meaningful allegations that could defeat a demand-futility motion. Within weeks, three comparably scant complaints had been filed in the California Federal Court. These prematurely filed complaints were filed hastily for one reason only: to enable the specialized law firms to gain control of a case that could generate legal fees.

Fast-filing might have benefited the specialized law firms, but it did not benefit Allergan. The complaints forced Allergan to fund the teams of the lawyers hired by the individual defendants to respond in each jurisdiction, address coordination issues, and brief parallel motions to dismiss. The fast-filed complaints also forced two separate court systems to expend judicial resources on the litigation. Ironically, when one stockholder—UFCW—attempted to proceed properly by using Section 220, the defendants and the fast-filing Delaware plaintiff joined forces to oppose its effort to develop the facts needed to plead a complaint with a meaningful chance of success.

By leaping to litigate without first conducting a meaningful investigation, the California plaintiffs’ firms failed to fulfill the fiduciary duties they voluntarily assumed as derivative action plaintiffs. Rather than seeking to benefit Allergan, they sought to benefit themselves by rushing to gain control of a case that could be harvested for legal fees. In doing so, the fast-filing plaintiffs failed to provide adequate representation.

Subsequent events did not transform the fast-filing plaintiffs into adequate representatives. True, the defendants voluntarily provided the California plaintiffs with
the Section 220 materials, after UFCW invested the time and resources to obtain them, and the California plaintiffs used the materials to file an amended complaint. But in my view, the fast-filing plaintiffs already had shown where their true loyalties lay. Asking for and receiving the benefit of another lawyer’s work did not rehabilitate them. It rather evidenced their continuing desire to control the case. In this regard, I disagree that the policy goal of encouraging plaintiffs to use Section 220 will not be undercut by a rule that affords priority to fast filers if the corporation gives them the same books and records that a diligent stockholder fought to obtain. *But see Career Educ.*, 2007 WL 2875203, *10 n.58 (asserting that policy of encouraging stockholders to use of Section 220 would not be undercut by allowing fast-filing plaintiffs to copy complaint prepared by stockholder who used Section 220 and then giving preclusive effect to dismissal in fast-filed action). Under the rule enunciated in *King I*, the issue would not arise because stockholders like the California plaintiffs would not be able to file fast, suffer dismissal, and then ask for books and records to try again.

Assuming *LeBoyer* accurately states the law of collateral estoppel as I am bound to apply it (a point with which I disagree), the doctrine does not require dismissal in the current case because the plaintiffs in the California Action provided inadequate representation for Allergan. Rather than representing the best interests of the corporation, the California plaintiffs sought to maximize the potential returns of the specialized law firms who filed suit on their behalf.
B. **Rule 23.1**

Having determined that collateral estoppel does not require judgment for the defendants, I must consider independently whether Rule 23.1 requires dismissal. Although not binding, the California Judgment is potentially persuasive.

Rule 23.1 requires that a derivative plaintiff “allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff’s failure to obtain the action or for not making the effort.” Ct. Ch. R. 23.1. For a board to consider a demand properly, a majority of the directors must be able to exercise their independent and disinterested business judgment about whether to pursue litigation. *Aronson*, 473 A.2d at 815. The Delaware plaintiffs contend that demand should be excused as futile because each of the directors would face a substantial risk of liability if the litigation were pursued.

The requirement of factual particularity does not entitle a court to discredit or weigh the persuasiveness of well-pled allegations. “The well-pleaded factual allegations of the derivative complaint are accepted as true on such a motion.” *Rales*, 634 A.2d 931. “Plaintiffs are entitled to all reasonable factual inferences that logically flow from the particularized facts alleged . . . .” *Brehm*, 746 A.2d at 255. Put differently, once a plaintiff pleads particularized allegations, then the plaintiff is entitled to all “reasonable inferences [that] logically flow from particularized facts alleged by the plaintiff.” *Beam II*, 845 A.2d at 1048. Rule 23.1 requires that a plaintiff allege specific facts, but “he need not plead evidence.” *Id.* at 816; accord *Brehm*, 746 A.2d at 254 (“[T]he pleader is not required to plead evidence . . . .”). A plaintiff also need not “plead particularized facts
sufficient to sustain a ‘judicial finding’ either of director interest or lack of director independence” or other disabling factor. *Grobow*, 539 A.2d at 183. The Delaware Supreme Court in *Grobow* interpreted the Court of Chancery as having adopted a “judicial finding” standard and explicitly rejected it as “an excessive criterion” for pleading under the “reasonable doubt test.” *Id.*

Similarly, to show that a director faces a “substantial risk of liability,” the plaintiff does not have to demonstrate a reasonable probability of success on the claim. In *Rales*, the Delaware Supreme Court rejected such a requirement as “unduly onerous.” 634 A.2d at 935. “The purpose of [Rule 23.1’s] heightened standard is to ensure only derivative actions supported by a reasonable factual basis proceed.” *Dow Chem.*, 2010 WL 66769, at *6. Plaintiffs need only “make a threshold showing, through the allegation of particularized facts, that their claims have some merit.” *Rales*, 634 A.2d at 934.

Corporate misconduct involving fraud or illegality presents a different situation. Even under a pure *Caremark* monitoring theory,

[t]here are significant differences between failing to oversee employee fraudulent or criminal conduct and failing to recognize the extent of a Company’s business risk. Directors should, indeed must under Delaware law, ensure that reasonable information and reporting systems exist that would put them on notice of fraudulent or criminal conduct within the company. Such oversight programs allow directors to intervene and prevent frauds or other wrongdoing that could expose the company to risk of loss as a result of such conduct.

*Citigroup*, 964 A.2d at 131. “[I]mposing *Caremark*-type duties on directors to monitor business risk is fundamentally different from imposing on directors a duty to monitor fraud and illegal activity.” *Goldman Sachs*, 2011 WL 4826104, at *22 (internal quotation omitted).

“Delaware law does not charter law breakers.” *Massey Energy*, 2011 WL 2176479, at *20. “Delaware law allows corporations to pursue diverse means to make a profit, subject to a critical statutory floor, which is the requirement that Delaware corporations only pursue ‘lawful business’ by ‘lawful acts.’” *Id.* (citing 8 Del. C. §§ 101 & 102). “Under Delaware law, a fiduciary may not choose to manage an entity in an illegal fashion, even if the fiduciary believes that the illegal activity will result in profits for the entity.” *Metro Commc’n Corp. BVI v. Advanced Mobilecomm Techs. Inc.*, 854 A.2d 121, 163-64 (Del. Ch. 2004).

In short, by consciously causing the corporation to violate the law, a director would be disloyal to the corporation and could be forced to answer for the harm he has caused. Although directors have wide authority to take lawful action on behalf of the corporation, they have no authority knowingly to cause the corporation to become a rogue, exposing the corporation to penalties from criminal and civil regulators. Delaware
corporate law has long been clear on this rather obvious notion; namely, that it is utterly inconsistent with one’s duty of fidelity to the corporation to consciously cause the corporation to act unlawfully. The knowing use of illegal means to pursue profit for the corporation is director misconduct.

Desimone, 924 A.2d at 934-35 (footnote omitted). “As a result, a fiduciary of a Delaware corporation cannot be loyal to a Delaware corporation by knowingly causing it to seek profits by violating the law.” Massey Energy, 2011 WL 2176479, at *20.

The plaintiffs in this case have alleged a direct connection between the Board and a business plan premised on illegal activity. The Complaint pleads that from 1997 onward, the Board discussed and approved a series of annual strategic plans that contemplated expanding Botox sales dramatically within geographic areas that encompassed the United States. The plans contemplated new markets for Botox that involved applications that were off-label uses in the United States. So significant was the scope of the expansion that it necessarily contemplated marketing and promoting off-label uses within the United States. The Board then closely monitored Allergan’s dramatic success in increasing its sales of Botox at rates far exceeding what the market for existing on-label uses could support or that could be generated by physicians serendipitously learning about and trying new off-label applications. The Board kept Allergan’s business plan in place even after the Schim incident and FDA inquiries illustrated the extent of Allergan’s regulatory exposure. From these allegations, one can reasonably infer that the Board knowingly approved and monitored a business plan that contemplated illegality.
Critically, the Complaint does not merely allege that this misconduct took place. Unlike the parade of hastily filed Caremark complaints that Delaware courts have dismissed, and like those rare Caremark complaints that prior decisions have found adequate, the Complaint supports these allegations with references to internal Allergan books and records that UFCW obtained using Section 220. For example, the Complaint references a slide presentation to the Board that summarized the Strategic Plan for 1997-2001. The presentation projected ramping up Botox sales in North America from $86.1 million to $141.1 million. Plan Slides at 5. A slide entitled “Top Corporate Priorities” identified “Maximize New Products” as the second of three bullet points. Id. at 10. The fourth bullet point under the “Maximize New Products” heading read “BOTOX – Spasticity, migraine, and pain.” Id. At the time, none were approved uses in the United States, which one can readily infer at the pleadings stage constituted a non-trivial part of the North American Botox-purchasing market.

Other slides in the deck provide further support for the inference that the Board-approved plan contemplated affirmative marketing and support for off-label uses. A slide described the “Charter” for the Botox “Business Portfolio Strateg[y]” in North America as “[i]nvest to grow new indications & develop follow-on toxins.” Id. at 5. It listed “[s]pasticity,” “[b]ack pain,” and “[h]ead ache.” Id. None were FDA-approved uses in the United States. Another slide entitled “Transitioning to a Future with Sustainable Growth” stated:

- BOTOX®, Tazorac®, Alphagan®, and Array® represent immediate growth
- Major opportunities exist to expand into other specialty therapeutic areas with tremendous growth
  - Back pain & headache
  - Oncology
  - Diabetes

- Expansion strategy enables Allergan to maximize Eye, Skin, & BOTOX® now, while establishing technology platforms to build our businesses in new areas.

*Id.* at 11. One can reasonably infer from these slides that the plan contemplated pursuing as “Top Corporate Priorities” new Botox uses not yet approved by the FDA as a source of “immediate growth” for Allergan and a means for “Allergan to maximize . . . BOTOX® now.”

The text of Allergan’s actual, written strategic plan expanded on the points identified in the slides. It identified “Maximize New Products” as the number 1 item on Allergan’s list of six “Top Corporate Priorities.” Written Plan at 14. The fourth bullet point under this number 1 item read: “Botox - Maximize sales for spasticity and new indications such as migraine.” *Id.* Neither was an FDA-approved use. The section of the plan entitled “Corporate Portfolio Strategy” identified the “Role/Charter” for “Botox/Neuromuscular” as follows: “Invest to develop follow-on toxins with improved performance characteristics that protect and expand our toxin franchise. Sales expected to grow from $94 million in 1997 to $215 million in 2001.” *Id.* at 22. The “Strategic Rationale” for this step was that

*Botox* will continue to be one of Allergan’s fastest growing business areas as usage expands to new indications and penetration expands in all regions. Investments in new indications of pain and migraine headache represent
two of the top three future growth opportunities in our portfolio with combined peak year sales of $1.26 billion!

*Id.* One can reasonably infer that “all regions” included the United States, where “pain” and “migraine headaches” were off-label applications. *See also id.* at 3 (identifying Botox as one of “five core Allergan businesses” and describing the treatment as having “tremendous growth potential as we fund opportunities with new indications and uses such as spasticity, pain, migraine and tension headache”).

Allergan’s plan projected that the company would enter the “Migraine Headache” market in 2001 and achieve estimated peak-year, risk-adjusted sales of $596 million. *Id.* at 5. “Migraine headache” was an off-label use. The plan also projected that Allergan would enter the back pain market in 2002 and achieve estimated peak-year, risk-adjusted sales of $666 million. *Id.* “Back pain” was an off-label use.

The plan further anticipated that Allergan’s sales growth would be driven in part by “continued growth from Botox” and that Allergan’s improvement in gross profit margin would be “driven by changes in the sales mix as sales growth comes from higher priced and higher margin products such as Alphagan, Botox, and Zorac.” *Id.* at 8. The plan further noted that

Allergan is at the beginning of major new product launches with Alphagan, Zorac, the Array IOL and new indications for Botox. Each of these new product opportunities represents significant advances in technology which have the potential to change the way physicians approach the management of their patients’ conditions. Also they all participate in relatively large markets. As a result, there are best case scenarios for these products which are not prudent to include in our projections, but which do represent potential upside opportunities.
Id. at 9. The plan warned that Allergan was largely dependent on these products, and that “[t]he majority of Allergan’s growth over the next five years is expected to come from Alphagan, Array IOL, Zorac and Botox.” Id. at 10.

As the Complaint alleges, Allergan pursued the Board’s strategic plan by deploying an array of programs to support off-label Botox use. These efforts included sponsoring physicians to speak about and promote off-label use, assisting physicians in seeking reimbursement for off-label use, and providing pricing support to promote off-label use. The strategic plan specifically cited “U.S.-Reimbursement assistance” as one of the reasons “Why Customers Buy From Us Now.” Id. at 59.

The Complaint pleads that the Board regularly monitored Botox sales and cites specific occasions where the Board was made aware of growth in average daily sales and the revenue mix across different usage categories. The Complaint specifically pleads that between 2000 and 2004, Botox achieved annual sales growth of 25% to 42%, despite being approved by the FDA for only four uses where demand was limited. Off-label sales skyrocketed with spasticity sales growing by 332%, headache sales by 1,407%, and pain sales by 504%. Although it is not the only possible inference, one can reasonably infer at the pleadings stage that the Board knew physicians were not harmonically converging on off-label uses in the same areas that Allergan happened to be targeting aggressively for sales growth.

The Complaint specifically pleads that in October 2006, the Board learned that the FDA was inquiring about off-label marketing by Dr. Schim, an Allergan-sponsored speaker. The Board was advised that the dinner programs at which Dr. Schim spoke
were “directly funded, hosted, and controlled by Allergan,” and that “the presentations are considered commercial promotion and Allergan is responsible for their content.”

German Aff. Ex. E. The Board was further advised that Allergan business and marketing personnel knew about Dr. Schim’s non-compliant materials and failed to take responsibility for addressing his promotion of off-label uses. The directors were told by in-house counsel that “[t]his is a potentially serious matter and in the current environment, the chance of receiving Agency action, including but not limited to a Warning Letter, on this matter is . . . very high.” *Id.*

The Complaint pleads that after the Schim incident, the Board approved the 2007-2011 Strategic Plan which explicitly linked the number of sales representatives to increased off-label sales. During the same period, the Board continued to receive detailed reports on Botox sales and the revenue mix, including reports showing that 70% to 80% of Botox sales were generated from off-label use. These particularized allegations support a reasonable inference that the Board knew Allergan personnel were engaging in or turning a blind-eye towards illegal off-label marketing and promotion and that the Board nevertheless decided to continue Allergan’s existing business practices in pursuit of greater sales.

Ten of the twelve defendant directors have served on the Board since 2005 and earlier. One can reasonably infer that these directors approved multiple iterations of Allergan’s strategic plan, monitored Botox’s explosive sales growth, learned of the Schim incident in October 2006, then approved the 2007 Strategic Plan, fully conscious of the role of off-label marketing in Allergan’s success. The inference is more tenuous
for Dunsire and Hudson, who joined the Board in 2006 and 2008, respectively. Because the Complaint implicates more than half of the Board, I need not make any determination one way or the other as to those two directors.

It is not unreasonable to infer that the Allergan Board, led by a hard-charging CEO who earned the nickname “Mr. Botox,” could have believed that Allergan knew better than the FDA which Botox applications were safe, particularly off-label uses already approved (or at least permitted) in other countries. It is not unreasonable to infer that the Board and CEO saw the distinction between off-label selling and off-label marketing as a source of legal risk to be managed, rather than a boundary to be avoided. Based on this premise, the CEO and his management team devised, and the Board approved, a business plan that relied on off-label-use-promoting activities, confident that the risk of regulatory

33 Others have embraced this view. See, e.g., David L. Engel, An Approach to Corporate Social Responsibility, 32 Stan. L. Rev. 1, 34-55 (1979) (arguing that corporations can and should maximize profits by factoring in the cost of regulatory and legal sanctions discounted by likelihood of detection and successful enforcement); Frank H. Easterbrook & Daniel R. Fischel, Antitrust Suits by Targets of Tender Offers, 80 Mich. L. Rev. 1155, 1168 n.36 (1982) (asserting that “[m]anagers have no general obligation to avoid violating regulatory laws, when violations are profitable to the firm.”); id. at 1177 n.57 (asserting that “managers do not have an ethical duty to obey economic regulatory laws just because the laws exist. They must determine the importance of these laws. The penalties Congress names for disobedience are a measure of how much it wants firms to sacrifice in order to adhere to the rules; the idea of optimal sanctions is based on the supposition that managers not only may but also should violate the rules when it is profitable to do so.”). See generally Cynthia A. Williams, Corporate Compliance With the Law In the Era of Efficiency, 76 N.C. L. Rev. 1265, 1285-1300 (1998) (collecting and summarizing authorities endorsing the view of “law-as-price”). Delaware law explicitly rejects the notion that a board of directors can act loyally by consciously deciding to violate positive law in pursuit of greater profits. See Leo E. Strine, Jr. et al., Loyalty’s Core Demand: The Defining Role of Good Faith in Corporation Law, 98 Geo. L.J. 629, 649 (2010).
detection was low, that most regulatory problems could be solved, and that dealing with regulatory risk was a cost of doing business. As profits increased and the regulatory risk seemed well managed, the extent of off-label use-promoting activities grew. The appearance of formal compliance cloaked the reality of non-compliance, and directors who understood the difference between legal off-label sales and illegal off-label marketing continued to approve and oversee business plans that depended on illegal activity. See Massey Energy, 2011 WL 2176479, at *19 (crediting inference that outside directors went “through the motions” rather than making “good faith efforts to ensure that [the company] cleaned up its act”).

Obviously this is not the only inference that can be drawn. Alternatively, one could infer that the directors received advice from sophisticated counsel about the difference between legal off-label sales and illegal off-label marketing, understood where the boundary lay, and approved a business plan and management initiatives in the good faith belief that Allergan was remaining within the bounds of the law, although perhaps close to the edge. The directors then closely monitored Allergan’s performance with this

34 See Williams, supra, at 1279-80 (“[P]art of the calculation to violate the law includes a calculation of the probability that the violation will go undetected; or if detected, that it will go unpunished for any one of a plethora of reasons; or if prosecuted, that liability will not be established; or if liability is established, that the penalty will be lower than the profits obtained; or that the penalty will not be upheld on appeal in any event. Moreover, the probabilities at each of these stages can be, and in many cases will be, driven downward by actions by the corporation and the corporation’s lawyers. So, although the theory may treat the question as one of violating a law deliberately and paying the penalty, the reality is that of risking paying a penalty at best.” (alterations, footnote, and internal quotation omitted)).
understanding. Unfortunately for everyone, the directors’ good faith belief proved incorrect, and Allergan pled guilty to criminal misdemeanor misbranding for the period from 2000 through 2005, paid criminal fines of $375 million, and paid another $225 million in civil fines. If this scenario proves true, then the directors will not have acted in bad faith and will not be liable to Allergan for any of the harm it suffered. See id. at *22.

I cannot presently determine what actually happened at Allergan. I hold only that a reasonable inference can be drawn from the particularized allegations of the Complaint and the documents it incorporates by reference that the Board knowingly approved and subsequently oversaw a business plan that required illegal off-label marketing and support initiatives for Botox. At this stage of the case, I must credit this inference, even if I believe it more likely that the directors acted in good faith. The complaint need not “plead particularized facts sufficient to sustain ‘a judicial finding’ either of director interest or lack of director independence” or other disabling factor. Grobow, 539 A.2d at 183. Nor must it demonstrate a reasonable probability of success. Rales, 634 A.2d at 934-35. The complaint needs only to make a “threshold showing, through the allegation of particularized facts, that their claims have some merit.” Id. at 934. I believe the Complaint meets this standard.

In reaching this conclusion, I part company with the California Federal Court and find unpersuasive the analysis in the California Judgment. The California Federal Court correctly described Delaware law in stating that that the California complaint only could survive a Rule 23.1 motion to dismiss if the particularized allegations presented the
directors with a substantial threat of liability. The California Federal Court nevertheless
determined that the California complaint failed to meet this test.

The California Federal Court held that the California complaint fell short because
“[t]here is still no evidence of a decision by board members to promote the use of off-
label marketing, nor are there any facts suggesting that the Directors would be incapable
of making an impartial decision concerning litigation. The 1997-2001 Strategic Plan
makes no mention of off-label marketing.” California Judgment at 4. The California
Federal Court stated that the “Top Corporate Priorities” slide listed bullet points, “the
first of which does not even mention Botox.” Id. As the California Federal Court
recognized in denying the plaintiffs’ motion for reargument, the fourth bullet point
identified Botox as one of four products the sales of which Allergan sought to maximize.
22, 2012). As discussed above, the underlying written plan identified “Maximize New
Products” as the number 1 item on Allergan’s list of six “Top Corporate Priorities.”
German Aff. Ex. D at 14. The fourth bullet point under this number 1 item reads: “Botox
- Maximize sales for spasticity and new indications such as migraine.” Id. Neither was
an FDA-approved use.

In my view, a plaintiff does not have to point to actual confessions of illegality by
defendant directors to survive a Rule 23.1 motion in a Caremark case. Particularly at the
pleadings stage, a court can draw the inference of wrongful conduct when supported by
particularized allegations of fact. 35 Given that off-label marketing is illegal, it would be astounding if the 1997-2001 Strategic Plan or any other board presentation actually used that term. If in-house counsel hoped to keep their jobs, those words only could make it into a board presentation in the context of a statement against the practice. But sadly, sophisticated corporate actors at times engage in illegal behavior and attempt to hide their misconduct with the appearance of legal compliance. Having reviewed the summary slides and the underlying strategic plans, I believe there are sufficient references in the documents to support a reasonable inference that Allergan expected to drive increased sales by promoting off-label use. When, as here, the pled facts can support a reasonable inference that directors in fact approved a business plan that contemplated off-label marketing, the plaintiffs receive the benefit of the inference at the pleadings stage.

The California Federal Court similarly concluded that a Board-sanctioned “Headache Development” program for Botox “had absolutely nothing to do with marketing; rather, it was a clinical presentation regarding Botox’s potential efficacy in

35 See, e.g., Massey Energy, 2011 WL 2176479, at *19 (“Although the defendants point to a lot of motion by the independent directors, some of which resulted from a 2008 court-ordered settlement, the plaintiffs in turn point to evidence creating a plausible inference that the independent directors of Massey did just that—go through the motions—rather than make good faith efforts to ensure that Massey cleaned up its act.”); Saito, 2004 WL 3029876, at *7 (denying Rule 23.1 motion to dismiss Caremark claims where “[p]laintiffs allege well-pled facts sufficient to infer that separately, both the HBOC and McKesson boards were aware (or should have been) of accounting irregularities at HBOC.”); cf. Am. Int’l Gp., 965 A.2d at 795 (drawing the “very plausible inference” that “those who engage in sophisticated forms of financial fraud do their best not to leave an obvious paper trail” but rather “try to conceal their roles and not leave marked paths leading to their doorsteps”).

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treated migraines.” California Judgment at 4. The California Federal Court likewise dismissed the sufficiency of the allegation that the Board oversaw a “Cervical Dystonia/Headache Expansion Initiative” by noting that cervical dystonia was an approved FDA use at the time. *Id.*

In my view, both descriptions adopt one possible and defendant-friendly interpretation of the underlying documents and related allegations. At the pleadings stage, I believe the plaintiffs are entitled to the reasonable inference that the Board oversaw company-wide efforts to promote off-label use of Botox for treating migraine headaches, which was not an FDA-approved use at the time.

The California Federal Court also held that the Board’s knowledge of the Schim incident did not demonstrate wrongdoing by the Board. According to the California Judgment, “[n]ot only was the presentation approved prior to the presentation without the offending slides, but the Directors took appropriate remedial action after learning of the presentation.” *Id.* (citing defendants’ motion). Whether the directors took “appropriate remedial action” is unclear and strikes me as a factual issue that reasonably could be disputed at this stage of the case. Regardless, as I understand the plaintiffs’ theory, the argument is not that the Schim incident itself established wrongdoing. The point rather is that the Schim incident should have further illuminated the serious legal risks posed by Allergan’s various programs for supporting off-label use, including its sponsored-speaker program, and the existence of a culture of non-compliance at the company. Despite being confronted with this red-flag, the directors subsequently approved iterations of the business plan that further ramped up Allergan’s support for off-label use. It may be that
the directors in fact acted in good faith after the Schim incident and when taking these steps, but at the pleadings stage I do not believe that I can adopt a defendant-friendly interpretation of the plaintiffs’ allegations.

As should be abundantly clear, this is a pleadings-stage decision. To prevail ultimately, the plaintiffs actually will have to prove their claims. At later stages of the case, the plaintiffs will not be entitled to pleadings-stage presumptions, and the defendants will have strong arguments against liability. See Massey Energy, 2011 WL 2176479, at *20-21. For present purposes, however, the plaintiffs need only plead particularized allegations that support a reasonable inference that their claims have “some merit.” Rales, 634 A.2d at 934. Because the plaintiffs have met this standard, the Rule 23.1 motion is denied.

C. Rule 12(b)(6)

“The standard for pleading demand futility under Rule 23.1 is more stringent than the standard under Rule 12(b)(6) . . . .” Citigroup, 964 A.2d at 139. A complaint that pleads a substantial threat of liability for purposes of Rule 23.1 “will also survive a 12(b)(6) motion to dismiss.” McPadden v. Sidhu, 964 A.2d 1262, 1270 (Del. Ch. 2008). Accordingly, the Rule 12(b)(6) motion is denied.

III. CONCLUSION

As Chancellor Allen famously observed, a Caremark theory “is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.” 698 A.2d at 967. But “difficult” does not mean “impossible,” and “win a judgment” does not mean “survive a motion to dismiss.”
Under my understanding of controlling Delaware Supreme Court precedent, collateral estoppel does not mandate dismissal. Separately and independently, by filing hastily and failing to conduct a meaningful investigation, the California plaintiffs acted self-interestedly and contrary to Allergan’s best interests. They did not provide adequate representation, rendering collateral estoppel inapplicable.

On the merits of the Rule 23.1 motion, the California Judgment is not persuasive because it adopts one possible defendant-friendly inference from the pled facts. Even under Rule 23.1, the plaintiffs receive the benefit of reasonable inferences that can be drawn from adequately pled facts. Here, the particularized allegations support a reasonable inference that the Board knowingly approved a business plan that contemplated illegal off-label marketing in the United States. The particularized allegations of the Complaint, which are supported by internal documents obtained through Section 220, present a substantial threat of liability for all but two members of the Board.

Demand is therefore excused as futile. For the same reasons, the Complaint states a claim under Rule 12(b)(6). The motions to dismiss are denied. IT IS SO ORDERED.
IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF OHIO
EASTERN DIVISION

WARREN MONDAY, et al., derivatively on behalf of KeyCorp,
Plaintiffs,
v.
HENRY L. MEYER, III et al.,
Defendants.

CASE NO.: 1:10 CV 1838
JUDGE DONALD C. NUGENT

MEMORANDUM OPINION

This matter is before the Court on Defendants Motion to Dismiss the Verified Amended Consolidated Shareholder Derivative Complaint. (ECF #32) Plaintiffs have filed an Opposition and supplemental authority and Defendants have filed a Reply and a Response to Plaintiffs’ supplemental authority. The Court heard oral argument on the Motion and permitted the parties to file an additional brief. For the reasons that follow, Defendants’ Motion to Dismiss is granted.

STATEMENT OF FACTS¹

Warren Monday, et al. (“Plaintiffs”) are shareholders of KeyCorp, a banking and financial institution headquartered in Cleveland, OH. Plaintiffs filed this derivative action on August 19, 2010, against a number of current and former directors and executives of KeyCorp. For the purposes of this opinion, the focus is on ten of these directors: William G. Bares, Henry L. Meyer III, Carol A. Cartwright, Edward P. Campbell, Bill R. Sanford, Alexander M. Cutler,

¹ Except as otherwise cited, the facts stated herein are derived from the Amended Complaint, Answers, and the parties’ briefings and submissions. The Court construes these facts in the light most favorable to the Plaintiff, as is required when deciding a motion to dismiss. Directv, Inc. v. Treesh, 487 F.3d 471, 476 (6th Cir. 2007).
Thomas C. Stevens, Eduardo R. Menascé, Lauralee E. Martin, and H. James Dallas ("Defendants"). The opinion focuses on these Directors because they were on the Board of KeyCorp at the time the Complaint was filed in 2010. Plaintiffs did not name the remaining six Directors of the August 2010 Board as defendants in this action.

Count I of the Complaint alleges that Defendants violated §10(b) of the Exchange Act and SEC Rule 10b-5. (Am. Compl. ¶¶ 313-323). Count II alleges that Defendants violated §20(a) of the Exchange Act. (Am. Compl. ¶¶ 324-335). Count III of the Complaint claims that Defendants breached their fiduciary duty to KeyCorp. (Am. Compl. ¶¶ 336-349). Count IV claims that Defendants are liable for committing corporate waste. (Am. Compl. ¶¶ 350-360). Finally, Count V charges Defendants with being unjustly enriched at the expense of KeyCorp.

In the mid to late 1990's, Defendants engaged in certain leveraged lease transactions known as “lease-in-lease-outs” (“LILOs”), which were designed to derive tax benefits by depreciating assets, amortizing costs, and deducting the interest. (Am. Compl. ¶¶ 113-116). In 1999, the Internal Revenue Service (“IRS”) outlawed tax benefits stemming from LILOs, labeling the transactions as abusive and impermissible tax shelters. At this time, Defendants ceased entering into LILO transactions and began restructuring existing LILOs as “sale-in-lease-outs” (“SILOs”). (Am. Compl. ¶¶ 119-121). SILOs were structurally similar to LILOs and ultimately helped to generate similar tax benefits for the party originating the leases.

Plaintiffs allege the following conduct gives rise to the Counts in the Complaint: Defendants restructured LILOs as SILOs in order to circumvent the IRS’ disallowance of LILOs (Am. Compl. ¶¶ 119-121). Defendants knew or should have known that the circumvention and the tax benefits stemming from the circumvention were unlawful and likely to be disallowed by
the IRS (Am. Compl. ¶ 124), and Defendants concealed the nature of LILOs, the similar nature and structure of SILOs, and KeyCorp’s true financial position, including the magnitude of losses relating to the tax benefits claimed for the SILO transactions. (Am. Compl. ¶ ¶ 131-170).

Plaintiffs further allege that immediate gains recognized by SILO transactions caused KeyCorp’s stock price to artificially inflate at a time when Defendants were repurchasing millions of shares of KeyCorp stock. (Am. Compl. ¶ ¶ 185-203). Plaintiffs claim that the artificially inflated stock price also served as the inaccurate and misguided basis for Defendants’ award of millions of dollars in executive and directorial compensation. (Am. Compl. ¶ ¶ 211-218)

On January 5, 2011, Defendants moved to dismiss the action, claiming that Plaintiffs lacked standing after failing to seek redress from KeyCorp through a pre-suit demand on the Board of Directors. Defendants further argue that two categories of Plaintiffs’ claims are time-barred on their face.

STANDARD OF REVIEW

Defendants move to dismiss the Complaint based upon Plaintiffs’ failure to make a pre-suit demand and failure to adequately allege that demand was futile. The Sixth Circuit considers such motions under Rule 12(b)(6). See Fed. R. Civ. P. 12(b)(6); McCall v. Scott, 239 F.3d 808, 815 (6th Cir. 2001).

When deciding a motion to dismiss, the court must construe the complaint in the light most favorable to the plaintiff, accept its factual allegations as true, and draw reasonable inferences in favor of the plaintiff. See Directv, Inc. v. Treesh, 487 F.3d 471, 476 (6th Cir. 2007). However, “the tenet that a court must accept a complaint’s allegations as true is inapplicable to
threadbare recitations of a cause of action’s elements, supported by mere conclusory statements.”

Ashcroft v. Iqbal, 129 S. Ct. 1937, 1940 (2009). See also Gregory v. Shelby County, 220 F.3d 433, 446 (6th Cir. 2000) (declaring that the court will not accept conclusions of law or unwarranted inferences cast in the form of factual allegations).

In order to survive a motion to dismiss, a complaint must provide the grounds of the entitlement to relief; this requires more than labels and conclusions, and a formulaic recitation of the elements of a cause of action. See Bell Atl. Corp. v. Twombly, 550 U.S. 544, 555 (2007). That is, “[f]actual allegations must be enough to raise a right to relief above the speculative level, on the assumption that all the allegations in the complaint are true (even if doubtful in fact).” Id. (internal citation omitted); see Association of Cleveland Fire Fighters v. City of Cleveland, No. 06-3823, 2007 WL 2768285, at *2 (6th Cir. Sept. 25, 2007) (recognizing that the Supreme Court “disavowed the oft-quoted Rule 12(b)(6) standard of Conley v. Gibson, 335 U.S. 41, 45-46, S. Ct. 99, 2 L. Ed.2d 80 (1957)”). Accordingly, the claims set forth in a complaint must be plausible, rather than conceivable. See Twombly, 550 U.S. at 570.

On a motion brought under Rule 12(b)(6), the court’s inquiry is limited to the content of the complaint, although matters of public record, orders, items appearing in the record of the case, and exhibits attached to the complaint may also be taken into account. See Bassett v. Nat’l Collegiate Athletic Ass’n, 528 F.2d 426, 430 (6th Cir. 2008); Amini v. Oberlin College, 259 F.3d 493, 502 (6th Cir. 2001). Public records include any materials subject to judicial notice, including securities filings made with the SEC and publicly available stock prices. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499, 2509 (2007); Bovee v. Coopers & Lybrand C.P.A., 272 F.3d 356, 360-61 (6th Cir. 2001).
Generally, a claim need only give fair notice as to the grounds upon which it rests. In re DeLorean Motor Co., 991 F.2d 1236, 1240 (6th Cir. 1993). In a shareholder derivative suit, a plaintiff must allege, with particularity, that a pre-suit demand was made upon the board of directors. See Fed. R. Civ. P. 23.1; Ohio Civ. R. 23.1. If plaintiffs do not make a pre-suit demand, Rule 23.1 requires, as a procedural matter, that plaintiffs plead with particularity the reasons why they believe demand is excused. Id. This requirement differs substantially from the principles of notice pleading. See McCall, 239 F.3d at 815.

DISCUSSION

Defendants move to dismiss Plaintiffs’ action for two reasons. First, Defendants assert that the Complaint should be dismissed for failure to comply with the condition precedent to all shareholder derivative suits: making a pre-suit demand on the board of directors. Second, Defendants assert that any claims arising from both the “stock repurchase” and the “entering into the transaction” claims are time-barred. The Court will address these grounds for dismissal in order.

A. Demand Futility

Federal Rule of Civil Procedure 23.1 provides that, in a shareholder derivative suit, the complaint must “allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for the plaintiff’s failure to obtain the action or for not making the effort.” See Fed. R. Civ. P. 23.1. The sufficiency of the reasons for failing to make a pre-suit demand is determined under the law of the state of incorporation. Kamen v. Kemper Fin
Servs., Inc. 500 U.S. 90, 108-09 (1991); McCall, 239 F.3d at 815. KeyCorp is an Ohio corporation, thus the Court applies Ohio law to determine whether demand should be excused.

In Ohio, “directors of a corporation are charged with the responsibility of making decisions on behalf of the corporation and are the proper parties to bring a suit on behalf of the corporation or, in their business judgment, to forego a lawsuit.” In re Ferro Corp. Derivative Litig., 511 F.3d 611, 617-18 (6th Cir. 2008) (quoting Drage v. Procter & Gamble, 119 Ohio App. 3d 19, 24, 694 N.E.2d 479, 482 (1st Dist. 1997). Ohio adheres to the business judgment rule. This doctrine holds that there is a presumption “that any action taken by a director on behalf of the corporation is taken in good faith and for the benefit of the corporation.” Ohio Rev. Code § 1701.59(C)(1). As such, shareholders do not have standing to bring a suit on behalf of the company “unless the board refuses to do so and that refusal is wrongful, fraudulent, or arbitrary, or is the result of bad faith or bias on the part of the directors.” Drage, 119 Ohio App. 3d at 24, 694 N.E.2d 479 (citing Cooper v. Cent. Alloy Steel Corp., 43 Ohio App. 455, 459-60, 183 N.E. 439 (5th Dist. 1931)).

Ohio law provides an exception to the demand requirement “when the shareholder can demonstrate that demand would have been futile.” Ohio Civ. R. 23.1. Futility, in this context, means that “the directors’ minds are closed to argument and that they cannot properly exercise their business judgment in determining whether the suit should be filed.” Drage, 119 Ohio App. 3d at 25, 694 N.E.2d 479. If demand futility is proved, a shareholder can proceed with an independent suit. Ohio Civ. R. 23.1. Establishing futility is “not an easy task.” In re Ferro Corp. Derivative Litig., No. 1:04CV1626, 2006 WL 2038659 at *5 (N.D. Ohio 2006). A “bare allegation that the directors would not want to sue themselves or each other does not show that
demand would be futile.” *Drage*, 119 Ohio App. 3d at 25, 694 N.E.2d 479. Examples of when demand may be futile include “when all directors are named as wrongdoers and defendants in a suit, when there is self-dealing by the directors such that the directors gain directly from the challenged transactions, or when there is domination of nondefendant directors by the defendant directors.” *Carlson v. Rabkin*, 152 Ohio App.3d 672, 681, 789 N.E.2d 1122. Shareholders bear the burden of proving demand futility. *Drage*, 119 Ohio App.3d at 25, 694 N.E.2d 479.

Demand futility is difficult to establish and is not just a procedural technicality. “Rather, it serves the very important purpose of ensuring that before a shareholder derivative suit is brought, the company’s board of directors has considered all possible intracorporate remedies.” *Grand Council of Ohio v. Owens*, 86 Ohio App.3d 215, 221, 620 N.E.2d 234 (10th Dist.Ct.App. 1993) (quoting *Smachlo v. Birkelo*, 576 F.Supp. 1439, 1443 (D.Del. 1983)). The rationale is that management should be the first line of defense in initiating litigation, “since the responsibility for determining whether or not the corporation should pursue a claim in court ordinarily is an issue of internal management that rests within the discretion of the directors.” *In re Keithley Instruments, Inc., Deriv. Litig.*, 599 F. Supp. 2d 908, 919 (N.D. Ohio 2009).

Demand futility is determined with respect to the board as it existed at the time the complaint was filed. *McCall*, 239 F.3d at 816; *Drage*, 119 Ohio App.3d at 26, 694 N.E.2d 479. Plaintiffs must show that a majority of the board members have an interest in the matter at hand and, therefore, could not objectively consider a demand. *McCall*, 239 F.3d at 826; *Drage*, 119 Ohio App.3d at 29, 694 N.E.2d 479. Plaintiffs must therefore set forth particularized facts establishing that at least eight of the sixteen KeyCorp Board members, as of August 19, 2010, were not disinterested, and thus could not have fairly considered a demand.
Rule 23.1's requirements are neither oppressive nor unreasonable. Failure to obtain action from the board, after making a pre-suit demand, does not result in a loss to Plaintiffs or preclude them from bringing the action again later. Plaintiffs are still free to go back and make a demand and then, if it fails, plead demand futility. To do this they must, with particularity, explain what they did to obtain the action desired from the directors and the reasons for the failure to obtain the action. *Fed R. Civ. P. 23.1.* The demand requirement recognizes the importance of giving directors the opportunity to either cure problems from within or choose to bring a lawsuit on behalf of the corporation. *Keithley*, 599 F. Supp. 2d at 919.

Demand is excused only when Plaintiffs adequately plead actionable claims against a majority of the board at the time the suit was filed, thus showing that a majority of the board faces a substantial likelihood of liability. Plaintiffs brought this action on August 19, 2010. Defendants are past and present members of the Board of Directors for KeyCorp, the nominal defendant in this derivative action. (Am. Compl. ¶¶ 56-79).

KeyCorp’s Board of Directors comprised sixteen members when the Complaint was filed in August 2010. (Am. Compl. ¶ 242). Of the sixteen members, only two were in-house directors employed by KeyCorp. (Am. Compl. ¶¶ 57, 58). The remaining fourteen directors were hired as independent, outside advisors. (ECF #25, Ritts Decl. Ex. A). Plaintiffs name eight of the fourteen outside directors as defendants as well as two in-house directors. (Am. Compl. ¶¶ 64-71). Plaintiffs do not claim that the remaining six outside directors would be incapable of objectively hearing a demand. (Am. Compl. ¶ 242). Plaintiffs name thirteen other current and former officers and directors. (Am. Compl. ¶¶ 59-63, 72-79). These parties are not relevant to the analysis because the demand inquiry focuses only on the members of KeyCorp’s Board of Directors as it

Here, Plaintiffs argue that a pre-suit demand would be futile because the conduct and decisions of Defendants were not valid exercises of business judgment and are not protected by the presumption in favor of business judgment. (Am. Compl. ¶¶ 243-255). Plaintiffs attempt to plead, with particularity, that the individual Defendants did not act in good faith and in the best interests of the company, and that they either knew or consciously disregarded the possibility that their actions would harm the company. (Am. Compl. ¶ 244). They further contend that Defendants failed to act on a reasonably informed basis and with due care. *Id.*

Ohio Rev.Code § 1701.59(C)(1) provides that a director is presumed to act in accordance with his statutorily defined duties “unless it is proved by clear and convincing evidence that the director has not acted in good faith . . .” In the case at bar, Plaintiffs fail to show in their allegations that the Defendants are not entitled to the presumption of the business judgment rule. Plaintiffs make unfounded claims and offer nothing more than bare legal conclusions. The Complaint merely identifies the individual Defendants as members of KeyCorp’s Board of Directors, and repeats the conclusion that Defendants, as a group, knew or recklessly disregarded that the stock price was inflated, resulting in “unjustified compensation” to Defendants. (Am. Compl. ¶ 245). The Complaint tries to satisfy the particularity requirement by alleging that Defendants were “well aware of the relevant tax authority as it related to the Company’s leveraged-lease transactions . . . were [also] aware that KeyCorp’s SILO’s were structurally and
Furthermore, during the economically turbulent period from 2007-2010, it was not uncommon for financial institutions to have balance sheets, cash flow statements, and other financial statements that were, in reality, inaccurate; this is now understood with the benefit of hindsight.

functionally similar to LILOs transactions . . . [and] knew that, like KeyCorp’s LILOs, the Company’s SILOs had no real business purpose other than to secure the claimed tax benefits . . .” (Am. Compl. ¶ 246). In these allegations of knowledge or conscious disregard, Plaintiffs do not point to any meeting, report, conversation, or process used by the Board to make the challenged decisions. The Complaint relies on the structure of KeyCorp’s corporate governance to show that Defendants must have known that their actions were not valid exercises of business judgment; this fails to meet the high standard of pleading demand futility.

Plaintiffs further contend that demand should be excused as futile because a majority of KeyCorp’s Board faces a substantial likelihood of liability for their wrongdoing. (Am. Compl. ¶ 256). The Complaint alleges that Defendants “breached their fiduciary duty of loyalty when they knowingly, recklessly, or in conscious disregard for their duty of oversight failed to prevent the publication and dissemination of false and misleading statements to KeyCorp shareholders and approved and signed false and misleading Forms 10-K.” (Am. Compl. ¶ 257). Plaintiffs fail to offer particularized factual allegations tending to show that any of the Directors, at the time the Complaint was filed, knew or consciously disregarded that KeyCorp’s financial statements were misleading, nor do they show that the allegedly misleading statements were inaccurate. The Complaint does not say when, or where, or how Defendants approved the “misleading Forms 10-K.” Plaintiffs sole allegation is that Defendants allowed this financial information to be disseminated to shareholders, thus manifesting Defendants’ tacit approval of allegedly misleading information. However, directorial approval of a challenged board decision is

Furthermore, during the economically turbulent period from 2007-2010, it was not uncommon for financial institutions to have balance sheets, cash flow statements, and other financial statements that were, in reality, inaccurate; this is now understood with the benefit of hindsight.
insufficient on its face to raise a reasonable doubt about a director’s objectivity. Shareholders would be able to regularly sidestep the demand requirement if all that was required was a showing that board members agreed to or approved some challenged decision.

Furthermore, the Complaint fails to allege that any individual director approved or took part in the decision making process for any LILO or SILO transaction, other than the AWG SILO restructuring in 1999. It merely offers the insufficient conclusion that Defendants “caused” KeyCorp’s entry into these transactions, and that they knew or recklessly disregarded the fact that the transactions would ultimately be disallowed. (See, e.g., Am. Compl. ¶¶ 40, 110, 113, 247). The Complaint is void of any facts showing what individual Board members considered, with whom they consulted, and what they were counseled to do by management or other outside advisors when it came to entering into SILOs.

Even if the Complaint did provide particularized allegations regarding Defendants’ roles in the SILO transactions, there can be no substantial likelihood of personal liability for a majority of the Board because most of the directors, at the time the suit was filed in August 2010, were not on the Board in 1999 when KeyCorp entered into the AWG transaction. Furthermore, the Complaint merely mentions that KeyCorp stopped engaging in SILO transactions after 2004, but it does not allege that a particular SILO transaction was consummated in 2002 or later. This is relevant because a majority of the August 2010 Board was not in place until 2002, and Plaintiffs are required to show personal liability for a majority of the Board at the time the suit was filed. As a rule, directors cannot face a substantial likelihood of personal liability for claims based on events that occurred prior to appointment on the board. See In re Am. Int’l Group, Inc. Deriv. Litig., 700 F. Supp. 2d 419, 434 (S.D.N.Y. 2010).
Plaintiffs further allege demand futility on the grounds that Defendants face a substantial likelihood of liability “in connection with the unjustified compensation of KeyCorp executives.” (¶¶ 268-271). Alleging improper or excessive grants of executive compensation, as grounds for demand futility, has traditionally been difficult. Courts defer heavily to the business judgment of directors in this arena. Deference stems from the notion that “[t]he value of assets bought and sold in the marketplace, including the personal services of executives and directors, is a matter best determined by the good faith judgments of disinterested and independent directors, men and women with business acumen appointed by shareholders precisely for their skill at making such evaluations.” In re infoUSA, Inc. S’holders Litig., 953 A.2d 963, 984 (Del.Ch.2007).

Here, Plaintiffs fail to plead specific facts showing that the Directors intended to harm or acted with conscious disregard when determining executive compensation. The Complaint tries to satisfy the requirement by showing that five Defendants were members of the Compensation and Organization Committee and, therefore, knew or should have known that the awarded compensations were inflated. (Am. Compl. ¶ 268). Plaintiffs claim that Defendants Bares, Campbell, Cartwright, Cutler, and Menascé “face a substantial likelihood of liability for their approval of unjust performance-based compensation when they knew the metrics underlying such compensation was artificially inflated.” (Am. Compl. ¶ 269). The Complaint does not allege which metrics the Defendants relied on, nor does it show why it would have been unreasonable for the Directors to rely on such metrics. The Complaint, in essence, avers that Defendants knew

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3Plaintiffs supplemental case filing depicts a case where demand futility was adequately alleged on the basis of excessive executive compensation. (ECF #41). In NECA-IBEW Pension Fund v. Cox, et al., 2011 U.S. Dist. LEXIS 106161 (S.D. Ohio Sept. 20, 2011), the plaintiffs were able to show that the defendant directors submitted executive compensation to shareholders for a vote. The proposed figures were shot down by the shareholders and the board in that case approved the salaries anyway. Id. at *8-9. Plaintiffs here do not offer any such specific facts.
of the inflated data because of their membership on the Compensation and Organization Committee. Courts repeatedly reject allegations of membership on committees, and recitation of the roles of the committees, as establishing a likelihood of liability. See Wood v. Baum, 953 A.2d 136, 142 (Del.2008). If membership on a particular committee automatically imputed knowledge of wrongdoing in challenged board decisions, shareholders could plead around the demand requirement in every derivative action.

Finally, the Complaint claims futility through a variety of other allegations, aiming to show that the Board could not have objectively heard a demand. Much of this portion of the Complaint focuses on Defendants’ membership on the Audit Committee and the Risk Management Committee. (Am. Compl. ¶¶ 272-280). It is insufficient to allege that, because Defendants were members of certain committees, and because of the defined roles of those committees, Defendants automatically knew or should have known about the falsity of financial statements, inflated compensations stemming from inaccurate data, and that SILOs were likely to be treated by the IRS as LILOs. In order to allege futility based on a director’s committee membership, the Complaint would have to show some specific report or piece of information that the committee was given which would have tipped them off to misconduct. Here, the Complaint relies on listing Defendants’ committee memberships, a recitation of the roles of those committees, and the conclusion that, in these roles, Defendants would have known or consciously chose not to know of wrongdoing. Allegations that “the individual Defendants knew

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4 Among other things, Plaintiffs allege that a likelihood of personal liability could be found if the Sixth Circuit reversed this Court’s dismissal of the ERISA action in Taylor v. KeyCorp. (Am. Compl. ¶¶ 281-283). The possibility that the Sixth Circuit could reverse the dismissal of Taylor does not establish Directors’ personal liability here. In Taylor, we determined that the plaintiff suffered no injury and therefore lacked standing. Nothing was proven against any of the defendants in that case. The future of Taylor is immaterial to the demand futility analysis in this case.
While the Amended Complaint will be dismissed in its entirety pursuant to Fed. R. Civ. P. 23.1 for failure to make a pre-suit demand, the Court will consider the fully briefed statute of limitations arguments presented by the parties in an effort to streamline the issues for the parties and the court should Plaintiffs make a future demand on KeyCorp’s board based upon the claims asserted in this Amended Complaint.

Accordingly, the Court finds that Plaintiffs have failed to demonstrate that pre-suit demand was futile. The demand requirement is not excused and this action must be dismissed.

**B. STATUTE OF LIMITATIONS**

Defendants assert that Plaintiffs’ claims based upon the “Stock Repurchase” and the “Entering into the Transaction” are time-barred and should be dismissed.

Moving first to the “Stock Repurchase” claims, Plaintiffs allege that the Defendants violated federal securities laws (Section 10(b)(5) and Section 20(a)) and Ohio common law (breach of fiduciary duty and corporate waste) by allowing KeyCorp to make stock repurchases from January 2005 to August 2007, when they knew that the price of KeyCorp stock was artificially inflated as a result of the allegedly illegal leverage lease transactions, the legality of which had allegedly been hidden from the public. (Am. Compl., ¶¶ 1, 28, 191, 195, 199).

Defendants assert that the limitations period for those claims is two years and because Plaintiffs filed their complaint on August 19, 2010, more than two years after August 2007, the repurchase claims are time-barred. Plaintiffs assert that the common law breach of fiduciary duty and corporate waste claims are governed by Ohio’s four year statute of limitations for fraud.

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5 While the Amended Complaint will be dismissed in its entirety pursuant to Fed. R. Civ. P. 23.1 for failure to make a pre-suit demand, the Court will consider the fully briefed statute of limitations arguments presented by the parties in an effort to streamline the issues for the parties and the court should Plaintiffs make a future demand on KeyCorp’s board based upon the claims asserted in this Amended Complaint.
Under 28 U.S.C. § 1658(b)(1)-(2), Plaintiffs’ federal securities claims were required to have been brought “not later than the earlier of 2 years after the discovery of the facts constituting the violation, or 5 years after such violation.” The claim “accrues (1) when the plaintiff did in fact discover, or (2) when a reasonably diligent plaintiff would have discovered, ‘the facts constituting the violation’–whichever comes first.” *Merck & Co. v. Reynolds*, 130 S.Ct. 1784, 1789-90 (2010). Plaintiffs argue that their federal securities claims based upon the Stock Repurchase are timely under *Merck* because Plaintiffs were unable to discover facts constituting the violation, including facts indicating that Defendants acted with scienter, until at least October 21, 2008, when Defendants announced that they had dismissed their appeal of the *AWG* action. Up until that point, Plaintiffs allege that Defendants were still refuting Judge Gwin’s findings in *AWG* as evidenced by the filing with the SEC of a Form 8-K on June 12, 2008, which stated “management notes that, while it has recognized the effects of the adverse Court decision for financial statement purposes, *it continues to believe that the tax treatment it applied to its leveraged lease transactions complied with all applicable tax laws, regulations and judicial authorities in effect at the time*....” (Am. Compl. ¶297, emphasis in original) Plaintiffs also note that Defendants’ filed Form 10-Qs on August 8, 2008 and November 7, 2008, which stated that the Company will “not recognize[] any charge for penalties or interest on penalties that the IRS has asserted or may assert in the future” and noted that “[m]anagement disagreed with the [AWG Leasing] decision . . .” (Am. Compl. ¶¶298-99).

However, Plaintiffs’ Complaint gives lie to their assertion that they were unable to discover facts demonstrating a violation or that Defendants’ acted with scienter. Specifically, Plaintiffs allege that “**KeyCorp’s Unlawful Tax Shelter Scheme Is Publicly Exposed**” during
the trial of the *AWG* litigation. (Am. Compl., ¶ 33 heading, emphasis in original) “Court [Judge Gwin] also upheld the government’s claim that penalties were properly assessed because there was no reasonable cause for Key Corp’s tax position and the position was not taken in good faith.” (Am. Compl., ¶ 33) In paragraph 36, Plaintiffs state that Judge Gwin’s decision in *AWG* confirmed that “the billion dollars of tax benefits claimed for all of KeyCorp’s SILO transactions were unlawful and the Company imminently faced probable and massive loss contingencies.” Judge Gwin’s decision in *AWG* was issued on May 28, 2008. KeyCorp publicly disclosed Judge Gwin’s *AWG* decision in a Form 8-K filing issued the next day, May 29, 2008 (5/29/08 Form 8-K, Ritts Decl. Ex. K). Plaintiffs also allege on June 12, 2008, KeyCorp announced a charge to earnings of $1.1 billion to $1.2 billion to resolve claims involving LILO and SILO related unpaid taxes, which included $475 million of interest. KeyCorp’s stock dropped 10% within a day of the announcement. (Am. Compl. ¶ 38) Plaintiffs further allege that “[i]n June 2008, when news of the [Defendants’] illicit and improper tax schemes began to emerge, . . . the Company’s stock price plummeted 25% . . .” (Am. Compl. ¶ 184) Finally, Plaintiffs refer to the *Taylor* ERISA action, which was filed on August 11, 2008, and makes the same allegations about the leveraged lease transactions as those made by Plaintiffs’ in this case. (See Am. Compl. ¶¶ 43-46) Specifically, the Taylor complaint alleged that KeyCorp’s stock price was artificially inflated, and that revelation of the “truth” at the *AWG* trial caused the stock to fall. (See Complaint In *Taylor v. KeyCorp, et al.*, Case No. 1:08 CV 1927, filed in the N.D. of Ohio on Aug. 11, 2008, ECF #1, ¶¶ 61-62.) Plaintiffs’ note that the Taylor complaint alleged that “**Defendants knew of Key’s high-risk conduct which exposed it to extraordinary risk.**” (Am. Compl., ¶ 44, emphasis in original)
Based upon the allegations in Plaintiffs’ Complaint, it is clear that “a reasonably diligent plaintiff would have discovered ‘the facts constituting the violation,’” as well as scienter as early as May 28, 2008, when the AWG decision was issued, or by June 12, 2008 when KeyCorp announced its charge to earnings, or at the latest when Taylor filed her ERISA action on August 11, 2008. Plaintiffs did not file this action until August 19, 2010. Accordingly, because all of these events occurred more than two years before Plaintiffs’ filed their federal 10(b)(5) and 20(a) claims based, in part, on the “Stock Repurchase” claims, those claims (the parts of the claims that are based upon the “Stock Repurchase” allegations) are time barred.

Plaintiffs also assert that the “stock repurchases” form part of the basis of Plaintiffs’ common law breach of fiduciary duty and corporate waste claims. Defendants assert that the parts of Plaintiffs’ common law claims of breach of fiduciary duty and corporate waste that are based upon the stock repurchases, and thus on the sale of securities, are governed by Ohio’s Blue Sky law in Ohio Rev. Code § 1707.43(B) which provides a two year limitations period for claims “based upon or arising out of” a sale of securities. Plaintiffs argue that their fiduciary duty and corporate waste claims sound in fraud and are governed by Ohio’s four year statute of limitation and its discovery provisions. See Ohio Rev. Code § 2305.09(D).

Ohio courts “look to the actual nature or subject matter of the case, rather than to the form in which the action is pleaded” when deciding which limitations period applies. Lawyers Coop. Publ’g Co. v. Muething, 65 Ohio St.3d 273, 277 (1992). As this Court stated in Lopardo v. Lehman Bros., Inc., 548 F.Supp.2d 450, 467 (N.D. Ohio 2008), “Ohio law weighs heavily toward a finding that common law claims which are predicated on or inextricably interwoven with the sale of securities or the contracts related to securities sales are governed by the statute of
limitations in § 1707.43(B).” To the extent that Plaintiffs’ breach of fiduciary duty and corporate waste claims are based upon the Defendants’ decision to purchase KeyCorp securities at an artificially inflated price, such claim is predicated on or inextricably interwoven with the sale of securities. As such, the two year statute of § 1707.43(B) applies.

Like federal law, Ohio law requires a plaintiff to file its action within two years “after the plaintiff knew, or had reason to know, of the facts by reason of which the actions of the person or director were unlawful, or . . . five years from the date of such sale or contract for sale, whichever is the shorter period.” § 1707.43(B). For the same reasons set forth above regarding Plaintiffs’ federal securities claims, Plaintiffs’ common law breach of fiduciary duty and corporate waste claims, to the extent that they are based upon the “stock repurchases,” are time barred.

Defendants also assert that Plaintiffs’ breach of fiduciary duty and corporate waste claims are time barred to the extent that they are based on the decision to enter into the leveraged lease transactions between 1999 and 2004. According to Defendants, these claims are governed by Ohio’s general four year limitations period found in Ohio Rev. Code § 2305.09(D); and further, § 2305.09 does not include a discovery rule for breach of fiduciary duty claims. Thus, a plaintiff’s “cause of action for breach of fiduciary duty arises when the act or commission constituting the breach of duty occurs.” Tablack v. Wellman, No. 04-MA-218, 2006 WL 2590599, at *13 (Ohio App. Sept. 8, 2006). Since Plaintiffs allege KeyCorp entered into the challenged transactions which constitute the breach of fiduciary duty “between 1996 and 2004,” (Am. Compl. ¶ 153), the fiduciary duty and corporate waste claims are barred to the extent that they are based on this conduct which occurred more than four years before the filing to the
Complaint.

Plaintiffs contend that their breach of fiduciary duty claims sound in fraud since they center on Defendants’ alleged intentional or reckless misleading misstatements and omissions. Significantly, in a footnote in their opposition brief, and more clearly at oral argument, Plaintiffs clarified that their claims were not based on Defendants’ causing KeyCorp to enter the LILO and SILO transactions between 1999 and 2004. Rather, their claims are based on alleged misrepresentations about the transactions made after the transactions occurred. Assuming that Plaintiffs’ breach of fiduciary duty claims sound in fraud and center around Defendants’ misrepresentations and misleading statements, then the discovery rule would apply. See Orvets v. Nat’l City Bank, Ne., 772 N.E.2d 114, 120-121 (Ohio App. Ct. 1999). The Court is unable at this point in the proceedings to determine when all of the alleged misrepresentations or omissions occurred and when they reasonably should have been discovered. Thus, Defendants’ Motion to Dismiss the breach of fiduciary duty/corporate waste claims as barred by the statute of limitations is denied at this time.

However, to the extent that Plaintiffs’ Amended Complaint can be interpreted to base the claims of breach of fiduciary duty/corporate waste on the alleged mismanagement of Defendants for authorizing and/or permitting KeyCorp to violate the federal and state tax laws by entering the LILO and SILO transactions, such claims do not sound in fraud and would be time-barred as the last transaction occurred more than four years before Plaintiffs filed this action. (See Am. Compl.¶341)

CONCLUSION

For the reasons set forth above, Defendants’ Motion to Dismiss for failure to make a pre-
suit demand on the KeyCorp Board of Directors is granted. Further, Plaintiffs’ federal securities claims (Counts One and Two) based upon the “stock repurchases” are dismissed as time-barred. Plaintiffs’ common law breach of fiduciary duty and corporate waste claims, to the extent that they are based upon the “stock repurchases,” are also time barred. The Amended Complaint is dismissed and this action is terminated.

IT IS SO ORDERED.

_/s/_
DONALD C. NUGENT
UNITED STATES DISTRICT JUDGE

DATED: November 29, 2011
IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

MARC S. HERMELIN, )
) Plaintiff,
) )
) Civil Action No. 6936-VCG )
)v. )
K-V PHARMACEUTICAL COMPANY, )
) Defendant.
)

OPINION

Date Submitted: January 5, 2012
Date Decided: February 7, 2012


GLASSCOCK, Vice Chancellor
No corporation can be a success unless led by competent and energetic officers and directors. Such individuals would be unwilling to serve if exposed to the broad range of potential liability and legal costs inherent in such service despite the most scrupulous regard for the interests of stockholders. This is the rationale behind the indemnification and advancement provisions of Delaware corporate law. Currently before me are several issues arising from those provisions and from a contract between the parties providing for the indemnification of the Plaintiff.

Delaware statutory law is largely enabling with respect to the indemnification rights of corporate officers and directors. The Delaware General Corporation Law (“DGCL”) sets two boundaries for indemnification: The statute requires a corporation to indemnify a person who was made a party to a proceeding by reason of his service to the corporation and has achieved success on the merits or otherwise in that proceeding. At the other end of the spectrum, the statute prohibits a corporation from indemnifying a corporate official who was not successful in the underlying proceeding and has acted, essentially, in bad faith. In setting these broad boundaries, Delaware law furthers important public policy goals of encouraging corporate officials to resist unmeritorious claims and allowing corporations to attract qualified officers and directors by
agreeing to indemnify them against losses and expenses they incur personally as a result of their service.\textsuperscript{1} Prohibiting the indemnification of unsuccessful “bad actors” also relieves stockholders of the costs of faithless behavior and provides corporate officials with an appropriate incentive to avoid such acts to begin with.

For any circumstance between the extremes of “success” and “bad faith,” the DGCL leaves the corporation with the discretion to determine whether to indemnify its officer or director. Consequently, corporations routinely refine their indemnification obligations by charter, bylaw, or contract. Thus, because indemnification between the boundaries of “success” and “bad faith” is permissive, when a corporation has established by contract the indemnification rights of a corporate official, the agreement controls unless it conflicts with a mandatory statutory provision.

In this case, the Plaintiff, a former corporate officer, is suing the Defendant, his former employer, for advancement and indemnification in connection with several proceedings that arose out of regulatory and criminal investigations at the Defendant corporation. The Plaintiff and Defendant are parties to an Indemnification Agreement that generally makes mandatory what are permissive provisions for indemnification under the

\textsuperscript{1} See Stifel Fin. Corp. v. Cochran, 809 A.2d 555, 561 (Del. 2002).
The dispute centers around whether the Plaintiff succeeded on the merits of any of the aforementioned proceedings, thus entitling him to indemnification as a matter of law, or whether additional discovery is required to determine whether the Plaintiff acted in good faith, in which case he will be entitled to indemnification under the Indemnification Agreement. The parties have briefed the matter, and I consider it submitted as on cross-motions for partial summary judgment. For the indemnification claims that require additional discovery regarding the Plaintiff’s good faith, I set forth the scope of evidence relevant to that issue. Finally, I address the remaining advancement issue in the case.

I. FACTUAL BACKGROUND

This case involves a number of indemnification and advancement claims by Plaintiff Marc S. Hermelin against his former employer, Defendant K-V Pharmaceutical Company ("KV"). Hermelin, who served as CEO of KV from 1975 to 2008 and held various positions on KV’s Board of Directors from 1975 to 2010, seeks indemnification or advancement for several criminal, civil, and regulatory matters that arose following KV’s distribution of oversized morphine sulfate tablets into the market. The facts

2 The parties have briefed the issue of what evidence is relevant to the Court’s analysis of whether the Plaintiff’s actions were in good faith.
3 The facts are not in dispute unless otherwise noted. The disputes that exist are immaterial to my findings in this Opinion.
giving rise to the proceedings at issue are more relevant to permissive indemnification than mandatory indemnification, the former of which requires that the indemnitee meet a “good faith” standard of conduct. Although, as I explain below, I cannot reach a decision on permissive indemnification on the current record, a brief summary of the undisputed background facts is useful.

In May 2008, two pharmacies notified KV that they had received oversized morphine sulfate tablets from KV. These tablets were manufactured by KV and distributed by ETHEX Corporation (“ETHEX”), a subsidiary of KV. KV began an internal investigation into the cause of the distribution of the oversized tablets. In the course of its investigation, KV discovered that it had manufactured additional oversized tablets, including propafenone, an anti-arrhythmic drug, and dextroamphetamine sulfate, a stimulant. KV notified the Food and Drug Administration (“FDA”) of its discovery of the oversized morphine sulfate tablets, but it did not report its discovery of the other oversized pills.

Following these events and after receiving complaints from employees, KV’s Audit Committee conducted an internal investigation and ultimately decided to terminate for cause Hermelin’s employment as CEO of KV. The disclosure of Hermelin’s termination in KV’s Form 8-K filing
precipitated an investigation by the U.S. Attorney’s Office for the Eastern District of Missouri (“USAO”) and regulatory actions by the FDA and the Office of Inspector General of the Department of Health and Human Services (“OIG”). Hermelin seeks advancement and indemnification for several proceedings arising out of these investigations and regulatory actions.

A. Indemnification Matters

In his Verified Amended Complaint (“Complaint”), Hermelin sought a declaration that he was entitled to indemnification for six completed proceedings arising from his conduct during his employment with KV. Two of those proceedings are no longer at issue, as the matters have concluded and the Defendant has agreed not to seek claw-back on the amounts already advanced. I summarize below the remaining four proceedings: the Audit Committee Matter, the Criminal Matter, the FDA Consent Decree Matter, and the HHS Exclusion Matter. In summarizing these proceedings, I focus on the charges Hermelin faced and the outcomes he achieved, as those are the principal facts upon which I evaluate whether Hermelin succeeded on the merits or otherwise.

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4 The two proceedings are the SEC Enforcement Matter and the Derivative Action, which are discussed at Verified Am. Compl. ¶¶ 68, 82, 85, 123, 131 [hereinafter “Compl. ___”].
Arguing that none of these matters justifies mandatory indemnification, KV invokes the “victory” of Pyrrhus of Epirus at the Battle of Asculum in 279 B.C. and asserts that any success by Hermelin in the underlying actions was a win as bad as a defeat. Pyrrhic victories, however, where success in the matter comes at great sacrifice, are entitled to mandatory indemnification under Delaware law. In any event, most of the “successes” alleged by Hermelin are not Pyrrhic wins at great cost, but instead losses akin to that of Lee at Appomattox, of which it may be said that the surrender on generous terms avoided an inevitable loss requiring supreme sacrifice, and was in that sense successful.

1. The Audit Committee Matter

In August 2008, KV’s Audit Committee began an investigation into allegations by KV employees that Hermelin had refused to take appropriate

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7 The Pyrrhic victor would be entitled to his *reasonable* fees and costs only. See 8 Del. C. § 145(c) (“[S]uch person shall be indemnified against expenses . . . actually and reasonably incurred . . . .”).

8 Hermelin seeks only permissive, rather than mandatory, indemnification for the Audit Committee Matter. Thus, I summarize the facts of the Audit Committee Matter simply as background for the other proceedings. Hermelin’s entitlement to indemnification for the Audit Committee Matter depends on whether Hermelin acted in good faith with respect to the conduct that was at issue in that Matter and is therefore not addressed in this Opinion, which simply defines the scope of relevant evidence with respect to Hermelin’s permissive indemnification claims.
action in response to the discovery that KV’s manufacturing process had produced several oversized tablets. The Audit Committee retained independent counsel and purportedly conducted over fifty interviews and obtained and reviewed hundreds of thousands of documents. Hermelin retained his own counsel during the investigation. Following this investigation, the board decided in December 2008 to terminate Hermelin’s employment for cause.\(^9\) KV disclosed its decision in a December 5, 2008, Form 8-K filing.\(^10\) This disclosure caught the attention of the USAO and other federal agencies.

2. The Criminal Matter

Soon after Hermelin’s departure as CEO of KV, the USAO began an investigation into KV’s release of oversized pills into the market. Based on Hermelin’s position as a responsible corporate officer of both KV and

\(^9\) The parties dispute whether Hermelin officially retired before his employment was terminated. Hermelin claims that he retired on December 1, 2008, and that the Board decided to terminate his employment on December 5; KV asserts that it terminated Hermelin’s employment on December 1 and that this termination was merely confirmed on December 5. See Am. Answer Def. K-V Pharm. Co. ¶ 31. Nevertheless, because Hermelin does not seek mandatory indemnification for the Audit Committee Matter, I need not resolve this factual dispute at this time.

\(^10\) See Opening Mem. Law Pl. Marc S. Hermelin Regarding Applicable Legal Stds. and Appropriate Scope Disc. 14 (“[T]he [KV] Board . . . acting upon the recommendation of the Audit Committee as a result of its investigation with respect to a range of specific allegations involving, among other things, FDA regulatory and other compliance matters and management misconduct, terminated the employment agreement of Marc S. Hermelin, the Chief Executive Officer of the Company, ‘for cause’ . . . . In addition, the Board . . . removed Mr. Hermelin as the Chairman of the Board . . . and as [CEO], effective December 5, 2008. Mr. Hermelin is expected to remain a member of the Board . . . .”) [hereinafter “Pl.’s Opening Indem. Mem. ___”].
ETHEX, the USAO charged Hermelin with two federal strict liability misdemeanors, to which Hermelin pled guilty. The United States District Court for the Eastern District of Missouri (“District Court”) ordered Hermelin to pay $1.9 million in criminal fines and forfeitures and sentenced him to a term “not less than 30 days” in the St. Louis County Jail. Hermelin spent fifteen days in jail, during which time many of his private conversations were recorded. The threatened public disclosure of those recordings is the subject of the Jail Records Matter described later in this Opinion.

Hermelin contends that the USAO could have brought more serious charges against him and that by pleading guilty to the two charged strict liability misdemeanors he avoided conviction on those harsher charges. On this basis, Hermelin argues that he was “successful on the merits or otherwise” in the Criminal Matter, and he seeks indemnification for his $1.9 million criminal penalty as well as his attorney fees and expenses. KV counters that Hermelin’s incarceration and his payment of a large fine are

11 The responsible corporate officer (“RCO”) doctrine originates from the U.S. Supreme Court case of United States v. Dotterweich, 320 U.S. 277 (1943), in which the Supreme Court found corporate officers in positions of authority to be criminally liable on misdemeanor charges under the Food, Drug, and Cosmetic Act (“FDCA”). Affirmed in United States v. Park, 421 U.S. 658 (1975), the RCO doctrine permits conviction, without a finding of fault, “of responsible corporate officials who, in light of [the high standard of care imposed by the FDCA], have the power to prevent or correct violations of [the FDCA’s] provisions.” Id. at 672-74, 676.
per se indicators that Hermelin was not successful on the merits or otherwise.

3. The FDA Consent Decree Matter

The FDA Consent Decree Matter involved an investigation by the FDA, during December 15, 2008, to February 2, 2009, into whether KV’s manufacturing facilities and processes were in compliance with current Good Manufacturing Practices (“cGMP”). The FDA sought an injunction generally requiring KV, Hermelin, and other named defendants to refrain from manufacturing, holding, or distributing any drug until certain cGMP and quality control measures were undertaken by the defendants. At the time the FDA filed its complaint, Hermelin was no longer the CEO of KV, although he remained on KV’s Board. On March 18, 2010, the FDA, KV, Hermelin, and the other defendants entered a consent decree whereby the defendants agreed to destroy certain drugs and refrain from manufacturing or distributing any drugs until KV and the other defendants complied with cGMP and other quality controls (“Consent Decree”). Notably, however, in the only paragraph of the Consent Decree referring to Hermelin, the Consent Decree clearly states that the provisions of the Decree do not apply to Hermelin so long as (1) KV’s Board’s resolutions to terminate Hermelin’s

13 See generally id. Ex. 9.
employment remain in effect and (2) Hermelin “has no role in the
decisionmaking, management, or operation of the Defendant KV that could
affect the company’s compliance with the [Food, Drug, and Cosmetic] Act,
its implementing regulations, or [the] Decree.”¹⁴ The Consent Decree
specifies that if the Board changes its resolutions or if Hermelin
subsequently becomes involved with KV in the manner specified, the terms
of the Consent Decree immediately apply in full force to Hermelin.¹⁵

Hermelin argues that because the FDA’s investigation did not find
him guilty of misconduct and because the Consent Decree does not apply to
him, he achieved success in the FDA Consent Decree Matter. KV asserts
that Hermelin was not successful because the Consent Decree effectively
bars Hermelin from returning to KV, and such a result cannot be construed
as “success.”

4. The HHS Exclusion Matter

The HHS Exclusion Matter involved a determination by the OIG to
exclude Hermelin from all federal healthcare programs. In May 2010,
Hermelin received notice from the OIG of its intent to exclude him from all
federal healthcare programs based on his association with ETHEX, a
subsidiary of KV that had already been convicted of violating federal law.

¹⁴ Id. Ex. 9, at 23.
¹⁵ Id.
This exclusion would effectively prevent Hermelin from claiming payment under any federal healthcare program for any items or services he rendered. The exclusion was to be based on federal law permitting the exclusion of an individual “(i) who has a direct or indirect ownership or control interest in a sanctioned entity and knows or should know . . . of the action constituting the basis for the conviction or exclusion . . . or (ii) who is an officer or managing employee . . . of such entity.” Hermelin’s counsel met with OIG lawyers and submitted information in Hermelin’s defense. Nevertheless, in October 2010, the OIG issued its formal determination to exclude Hermelin from all federal healthcare programs for twenty years.

Unlike Hermelin, KV faced the threat of mandatory exclusion by state Medicaid agencies based on its potential ownership of an excluded entity (ETHEX) and its being controlled by an excluded individual (Hermelin). To avoid exclusion, KV made arrangements with the OIG whereby the OIG agreed to delay its exclusion of ETHEX on the condition that KV dissolve

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16 See 42 U.S.C. § 1320a-7(b)(15) (providing for permissive exclusion of individuals controlling sanctioned entities).
17 See Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 6502, 124 Stat. 119, 776 (2010) (repealed 2010) (current version at 42 U.S.C. § 1396a(a)) (requiring state Medicaid agencies to exclude from their programs entities that own excluded entities or are controlled by excluded persons or entities) [hereinafter “PPACA § 6502”]. Presumably, the same law that permitted the OIG to exclude Hermelin would have permitted the OIG to exclude KV; however, whether the OIG sought permissive exclusion against KV is unclear.
ETHEX immediately.\textsuperscript{18} By dissolving ETHEX before it became excluded, KV could avoid its own mandatory exclusion for owning an excluded entity.

KV also faced mandatory exclusion due to Hermelin’s controlling interest in the company. Hermelin contends that he was faced with a “Hobson’s Choice”\textsuperscript{19}: either divest himself of his ownership interest in KV and agree not to contest his own exclusion, or suffer the exclusion of KV.\textsuperscript{20}

\textsuperscript{18} Def.’s Answering Br. Addressing Mand. Indem. and Scope Disc. Ex. 1.
\textsuperscript{19} Compl. ¶ 53. It has been pointed out to me that, technically speaking, Hermelin’s purported dilemma was not a “Hobson’s Choice,” which refers to a choice between that which is offered or nothing at all; i.e., “take it or leave it.” The term originates from Thomas Hobson (1544-1631), a Cambridge, England, livery stable operator who, after realizing that his strongest and fastest horses were more popular and consequently overused, instituted a rotation of horses whereby he presented his customers with a choice: take the horse nearest the stable door or none at all.

Hermelin’s predicament, as it were, was instead a “Morton’s Fork”: a choice between two equally undesirable alternatives. The Morton’s Fork gets its name from John Morton, the Archbishop of Canterbury and later Lord Chancellor under Henry VII. Morton justified taxing the rich as well as the poor on the grounds that subjects living in opulence could clearly afford to give generously, and subjects living frugally clearly had amassed savings and could thus give generously.

Neither a Hobson’s Choice nor a Morton’s Fork should be confused with a “Catch-22,” see JOSEPH HELLER, CATCH-22, at 45-46 (Simon & Schuster paperback ed. 2004) (describing a rule whereby a combat pilot declared insane by evaluation would be grounded, but the pilot must have requested the evaluation, and requests for evaluations were conclusive evidence of sanity because “[a]nybody who wants to get out of combat duty isn’t really crazy”), or “Buridan’s Ass,” which satirizes moral determinism by hypothesizing an ass placed precisely between a stack of hay and a pail of water, where the ass, which is presumed to go to whichever is closer, cannot make a rational choice and thus dies of both starvation and dehydration.

\textsuperscript{20} Again, it is unclear whether KV faced only mandatory exclusion under PPACA § 6502 or whether the OIG also intended to pursue permissive exclusion under 42 U.S.C. § 1320a-7(b)(8); however, I need not resolve that factual dispute to reach my decision here.
Hermelin agreed to sell his KV shares and waive his right to appeal his exclusion, and the OIG agreed not to seek permissive exclusion of KV.\textsuperscript{21}

Hermelin now argues that he should not be “punished” (by having to bear his own legal expenses) for falling on his proverbial sword, and that KV must indemnify him for his expenses in connection with the HHS Exclusion Matter.\textsuperscript{22} Hermelin also claims to have achieved success because the OIG found no misconduct on his part and his exclusion was based solely on his association with ETHEX. KV responds that Hermelin was not successful because he suffered the worst punishment that the OIG could have bestowed upon him: an effective lifetime ban from federal healthcare programs. KV also argues that although the divestiture of Hermelin’s stock may have saved KV from mandatory exclusion, that should not change the calculus because the OIG negotiated Hermelin’s exclusion separately from Hermelin’s agreement to divest his stock and waive his right to appeal.

\textsuperscript{21} See generally Pl.’s Opening Indem. Mem. Ex. 13 (covering the terms of a settlement agreement between Hermelin, KV, the OIG, and Sarah Welscheff, Hermelin’s wife).

\textsuperscript{22} The parties dispute whether the OIG would have sought the divestiture of Hermelin’s ownership in KV but for the possibility of mandatory exclusion under PPACA § 6502; specifically, Hermelin argues that he should not lose his right to mandatory indemnification for having “saved” KV from exclusion. For the reasons discussed later in this Opinion, I find this factual dispute immaterial to whether Hermelin succeeded on the merits in the HHS Exclusion Matter.
B. Advancement for the Jail Records Matter

In addition to his claims for indemnification for the matters described above, Hermelin seeks advancement for his legal fees and expenses in prosecuting an action for injunctive relief against the St. Louis County Jail, where Hermelin was incarcerated following his conviction in the Criminal Matter. After pleading guilty on March 10, 2011, in the Criminal Matter to two federal strict liability misdemeanor charges, the District Court, in addition to imposing a $1.9 million fine and forfeiture, sentenced Hermelin to a jail term of “30 days or less” in the St. Louis County Jail. Hermelin spent fifteen days in jail, beginning March 14, 2011. During his jail stint, Hermelin received and conversed with several visitors, including his wife, other family members, friends, clergy, and his personal assistant. Hermelin did not discuss KV or its business during his stay. Rather, his conversations were of a private and personal nature and included discussions related to medical, religious, legal, and other private matters. These conversations were recorded per the jail’s policy.

On April 25, 2011, a reporter at the St. Louis Post-Dispatch requested, under the purported authority of the Missouri Sunshine Law, a number of records from the jail pertaining to Hermelin’s incarceration. According to Hermelin, the reporter requested these records because the Post-Dispatch
was covering the demise of KV and Hermelin’s role therein. The requested records included visitation logs, documents related to disciplinary findings or proceedings involving Hermelin’s incarceration, and, at issue here, recordings of telephone calls made and received by Hermelin and conversations he had with visitors while incarcerated. On May 5, the Jail released to the newspaper everything except the recordings and stated its intent to release the recordings unless ordered otherwise. Hermelin filed suit to enjoin the release of the recordings, arguing that they were of a private and personal nature. The Circuit Court of St. Louis County entered a permanent injunction on December 6, 2011, enjoining the release of the recordings by the jail on the grounds that the conversations were “purely private matters.”

Hermelin’s Indemnification Agreement excludes indemnification for actions or portions thereof initiated by the indemnitee. Hermelin contends that he is nonetheless entitled to advancement because he effectively did not initiate the Jail Records Matter, but rather employed the only defense available to him when he was faced with the potential disclosure of sensitive private information. Additionally, Hermelin argues that his action for injunctive relief was the equivalent of a compulsory counterclaim and that

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the Indemnification Agreement does not except such claims from advancement. KV asserts that Hermelin’s action for an injunction clearly falls within the exceptions that the Indemnification Agreement carves out of Hermelin’s advancement rights. KV also argues that even if the Indemnification Agreement requires advancement for compulsory counterclaims, Hermelin’s lawsuit was not a compulsory counterclaim because it was not “compulsory” as defined in the Federal Rules of Civil Procedure or Court of Chancery Rules.24

C. Procedural Posture

The parties briefed the issue of whether Hermelin is entitled to advancement for the Jail Records Matter, and the parties presented oral argument on that issue on January 5, 2012. I now find, for the reasons stated below, that the Indemnification Agreement expressly excludes advancement for the Jail Records Matter on the grounds that Hermelin initiated the action for injunctive relief.

I also decide here Hermelin’s entitlement to mandatory indemnification and the scope of relevant, discoverable evidence going forward in regards to permissive indemnification. As I explain below, the court can determine an indemnitee’s right to mandatory indemnification,

24 See Fed. R. Civ. P. 13(a); Ch. Ct. R. 13(a).
which turns on whether the indemnitee succeeded in a proceeding on the merits or otherwise, on a record substantially more limited than that required to determine the indemnitee’s right to permissive indemnification, which inquires into the indemnitee’s good faith. Given this disparity in the evidence necessary for a determination on mandatory versus permissive indemnification, I requested briefing from the parties addressing whether the Plaintiff was “successful” in any of the proceedings for which he seeks indemnification—thus triggering mandatory indemnification under 8 Del. C. § 145(c)—and, for the proceedings for which mandatory indemnification is not available, what the proper scope of relevant evidence is in regards to permissive indemnification under 8 Del. C. § 145(a).25 Having reviewed the parties’ briefs and the record evidence, I find that, as a matter of law, Hermelin is not entitled to mandatory indemnification for the Criminal Matter and the HHS Exclusion Matter, but that he is entitled to mandatory indemnification for the FDA Consent Decree Matter. With respect to the scope of evidence relevant to permissive indemnification in the Criminal, HHS Exclusion, and Audit Committee Matters, I find that discovery is

25 See Hermelin v. K-V Pharm. Co., 2011 WL 5921647, at *1 (Del. Ch. Nov. 23, 2011) (directing the parties to “submit memoranda addressing which, if any, of the Plaintiff’s indemnification claims arise from proceedings in which the Plaintiff was ‘successful on the merits,’ thus triggering mandatory indemnification” and what “the proper scope of discovery [is] under section 145(a)”.

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limited to the conduct underlying those proceedings. I elaborate on these findings below.

**II. STANDARD OF REVIEW**

Neither party in its papers has alleged that there are material issues of fact that prevent me from reaching a decision on the issues of advancement, mandatory indemnification, or the scope of relevant evidence for the purposes of permissive indemnification. Additionally, the parties agreed at Oral Argument on January 5, 2012, that their briefing on these issues should be treated as cross-motions for summary judgment.\(^{26}\) I therefore deem these issues submitted for a decision based on the extant record.\(^{27}\) A party is entitled to summary judgment where the record demonstrates that no genuine issue of material facts exists and that the movant is entitled to judgment as a matter of law.\(^{28}\) Where only a portion of the action may be resolved on the record submitted, entry of partial summary judgment is appropriate.\(^{29}\)

Hermelin and KV are parties to an Indemnification Agreement, the language of which provides the primary source of KV’s indemnification obligations. The Indemnification Agreement provides that in any proceeding

\(^{26}\) Oral Arg. Tr. 7:24-8:6 (Jan. 5, 2012).
\(^{27}\) See Ch. Ct. R. 56(h).
\(^{28}\) Id. 56(c).
\(^{29}\) See id. 56(d).
commenced to enforce Hermelin’s right to indemnification, KV “shall, to the fullest extent not prohibited by law, have the burden of proof to overcome that presumption.” Additionally, where a proceeding to which Hermelin is a party “is resolved in any manner other than by adverse judgment against [Hermelin] . . . it shall be presumed that [Hermelin] has been successful on the merits or otherwise . . . . Anyone seeking to overcome this presumption shall have the burden of proof and the burden of persuasion by clear and convincing evidence.”

III. ANALYSIS

A. Advancement for the Jail Records Matter

Delaware law authorizes corporations to advance expenses incurred by their officers or directors in defending any “action, suit or proceeding” for which indemnification is permitted. Article IX, Section 1(e), of KV’s Bylaws tracks this authorization and enables KV to agree to advance expenses to officers and directors. Per the authorization of these permissive sources of indemnification and advancement rights, the Indemnification Agreement mandates advancement of Hermelin’s expenses for certain

30 Compl. Ex. B, at 8 (Indemnification Agreement § 8(b)) [hereinafter “Indemnification Agreement ___”].
31 Indemnification Agreement § 7(e)(iii).
32 See 8 Del C. § 145(e).
33 See Compl. Ex. A, at A-11 [hereinafter “KV Bylaws ___”] (“Expenses incurred in defending a civil or criminal action . . . may be paid by [KV] in advance of the final disposition of such action . . . .” (emphasis added)).
matters. Because the Indemnification Agreement is the only source that places mandatory advancement obligations on KV, the Agreement provides the controlling language in my analysis here, except to the extent that it references or contravenes KV’s Bylaws or the DGCL.\(^{34}\)

Section 4(a) of the Indemnification Agreement provides:

\[(a) \text{ Except as otherwise provided in Section 3(b)(iv) of this Agreement, the Company shall advance Expenses to Indemnitee}^{35}\text{ to the fullest extent permitted by the [DGCL] . . . if Indemnitee is or was a party or is or was threatened to be made a party to any Proceeding}^{36}\text{ by reason of his or her Official Capacity or by reason of anything done or not done by Indemnitee in his or her Official Capacity.}^{37}\]

\(^{34}\text{See Levy v. HLI Operating Co., Inc.}, 924 A.2d 210, 226 n.59 (Del. Ch. 2007) (“Under [section] 145(f), a corporation may provide indemnification rights that go ‘beyond’ the rights provided by . . . the other substantive subsections of [section] 145. At the same time, such indemnification rights provided by a corporation must be ‘consistent with’ the substantive provisions of [section] 145 . . . .” (quoting Waltuch v. Conticommodity Servs., Inc., 88 F.3d 87, 91 (2d Cir. 1996))).

\(^{35}\text{The Indemnification Agreement defines “Indemnitee” as Hermelin. See Indemnification Agreement at 1 (describing an agreement “between [KV] . . . and Marc S. Hermelin (‘Indemnitee’)”).}

\(^{36}\text{The Indemnification Agreement defines “Proceeding” broadly to include}

\begin{itemize}
\item any actual, threatened, pending or completed inquiry, investigation, action, suit, arbitration, or any other such actual or threatened action or occurrence, whether civil, criminal, administrative or investigative, including any appeal or petition resulting from such action or occurrence,
\item . . . except a proceeding initiated by an Indemnitee . . . to enforce his or her rights under this Agreement.
\end{itemize}

\(^{37}\text{Id. § 4(a) (emphasis added). Section 1(f) of the Agreement defines “Official Capacity”:}

\begin{itemize}
\item “Official Capacity” means Indemnitee’s corporate status as an officer and/or director and any other fiduciary capacity in which}
Section 3(b)(iv) provides a key exception to indemnification and advancement: “Indemnitee shall receive no indemnification of Expenses . . . in connection with any Proceeding, or part thereof (including claims and permissive counterclaims) initiated by Indemnitee . . . unless the Proceeding (or part thereof) was authorized by [KV’s] Board of Directors . . . .” Hermelin argues that this provision does not preclude advancement for the Jail Records Matter because he did not “initiate” that proceeding; rather, the Post-Dispatch initiated the proceeding when it sent a request for information to the Jail’s Custodian of Records. Along similar lines, Hermelin argues that his claim for injunctive relief was akin to a compulsory counterclaim and points out that Section 3(b)(iv) implicitly does not exclude advancement for compulsory counterclaims.

Hermelin’s argument that the Post-Dispatch or the Jail’s Custodian of Records initiated the Jail Records Matter by threatening to release Hermelin’s recorded private conversations simply misconstrues the language of Section 3(b)(iv). Section 3(b)(iv) not only excludes proceedings initiated

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Indemnitee serves the Company, its subsidiaries and affiliates, its employee benefit plans, and any other entity which Indemnitee serves in such capacity at the request of the Company’s CEO, its Board of Directors or any committee of its Board of Directors. “Official Capacity” also refers to all actions which Indemnitee takes or does not take while serving in such capacity.

Id. § 1(f).

38 Id. § 3(b)(iv) (emphasis added). Section 3(b)(iv) carves out of its exception “judicial proceeding[s] . . . to enforce rights under this Agreement.” Id.
by Hermelin, but also “part[s] . . . (including claims and permissive counterclaims)” initiated by Hermelin.\(^{39}\) Even assuming that the Custodian of Records or the Post-Dispatch “initiated” the Jail Records Matter and that Hermelin’s lawsuit was a “defense” in that proceeding,\(^{40}\) Hermelin is not entitled to advancement for any “part” of the Jail Records Matter that he initiated. The Jail Records Matter, or, from Hermelin’s viewpoint, his “counterclaim” therein, therefore falls squarely within the exclusion in Section 3(b)(iv), an exclusion the parties bargained and contracted for. Whether such a contractual arrangement is good corporate policy is not a question before me.

In the alternative, Hermelin argues that his claim for injunctive relief embodied a compulsory counterclaim and that such claims are carved out of

\(^{39}\) Id. (emphasis added).

\(^{40}\) Although I rest my decision on alternative grounds, Hermelin’s argument that the Custodian of Records or the Post-Dispatch initiated the Jail Records Matter is not persuasive. Hermelin conceives of the records request and his action for injunctive relief as occurring within a continual “Proceeding,” as that term is defined in Section 1(g) of the Indemnification Agreement, initiated by the Post-Dispatch. This argument fails to recognize the distinction between an act that gives rise to a chose in action and an act that actually initiates a proceeding. Just as a person threatening to disclose a trade secret does not initiate a proceeding by his former employer to enjoin that disclosure, just as an assault does not initiate an actual proceeding by the victim for tort damages, and just as the breach of a contract does not initiate a proceeding by the non-breaching party for specific performance, the records request did not initiate Hermelin’s action for injunctive relief. Under Hermelin’s interpretation, the Indemnitee could never be seen as having “initiated” a proceeding, even as a plaintiff, so long as he had in the first place a chose in action that he wished to vindicate. Although the records request may indeed have been a “Proceeding” under the broad definition of Section 1(g) of the Indemnification Agreement, Hermelin initiated a new “Proceeding” when he filed his claim for injunctive relief.
Section 3(b)(iv)’s exception. Assuming for the purposes of my analysis that Section 3(b)(iv) mandates advancement for compulsory counterclaims, I find that Hermelin’s actions for injunctive relief are not sufficiently comparable to compulsory counterclaims to warrant advancement. The Court of Chancery Rules require a party to state in its pleading as a counterclaim any claim that that party has against the opposing party arising out of the transaction or occurrence that is the subject matter of the opposing party's claim. Hermelin essentially argues that because his claim for injunctive relief arose out of the same transaction or occurrence as the request for the jail records, and because he would have lost his ability to vindicate his rights if he had not filed his claim, I should find that his claim for injunctive relief was akin to a compulsory counterclaim, and thus outside the ambit of Section 3(b)(iv).

This argument ignores the inherent framework within which a counterclaim becomes compulsory. Neither the Custodian of Records nor the Post-Dispatch filed a claim requiring a responsive pleading from Hermelin. Thus, there is no "subject matter of the opposing party’s claim" from which Hermelin’s purported compulsory counterclaim could arise. Hermelin’s situation was no different than that of any other person whose

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41 See Ch. Ct. R. 13(a).
42 See id.
rights are infringed in such a way that warrants injunctive relief. Indeed, because courts do not grant injunctions without a showing of irreparable harm, any individual suing for injunctive relief by definition is faced with a situation where he must file for an injunction or lose the opportunity to vindicate his rights. Hermelin’s proffered reading would thus in effect remove all claims for injunctive relief from the reach of Section 3(b)(iv).

I find it clear, however, that Section 3(b)(iv) covers and proscribes indemnification for such claims. Hermelin’s abstract construction of “compulsory counterclaim” is simply unsupported by the contractual language, and the case law he cites does not support an extension of that term’s definition beyond its definition in the Court of Chancery and Federal Rules. Because Section 3(b)(iv) covers Hermelin’s claim for injunctive relief, he was required to obtain permission from KV’s Board to pursue that action in order to receive advancement. Hermelin requested such permission and did not receive it; accordingly, his claim for advancement for the Jail Records Matter is denied.\(^{43}\)

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\(^{43}\) Because I find that Hermelin’s action for injunctive relief clearly falls within the exception to indemnification carved out by Section 3(b)(iv), I need not reach the issue, hotly contested by counsel, of whether Hermelin was made a party to the Jail Records Matter “by reason of” his Official Capacity.
B. Fees for Fees

Having determined that Hermelin is precluded by Section 3(b)(iv) from receiving advancement for the Jail Records Matter, Hermelin will ultimately be required to reimburse KV for any advancements made by KV to Hermelin for the prosecution of the Jail Records Matter portion of Count I of the Complaint. I leave it to the parties to reach an agreement as to what portion of the fees for fees advanced thus far, if any, covered the prosecution of Hermelin’s attempted enforcement of his advancement right for the Jail Records Matter. If the parties are unable to resolve this issue, they should so notify me.

C. Indemnification Claims

Hermelin seeks mandatory indemnification for the Criminal Matter, the HHS Exclusion Matter, and the FDA Consent Decree Matter. As discussed below, the central issue for mandatory indemnification is whether Hermelin was “successful on the merits or otherwise” in those matters. I find that Hermelin was successful only as to the FDA Consent Decree Matter, for which he is entitled to mandatory indemnification. For the remaining two matters—the Criminal Matter and the HHS Exclusion Matter—as well as the Audit Committee Matter (for which Hermelin does not seek mandatory indemnification), Hermelin may be entitled to permissive indemnification;
however, as I discuss later in this Opinion, I cannot reach a determination on that issue on the present record.

1. Mandatory Indemnification

Section 145 of the DGCL generally empowers corporations with the discretion to determine when to advance expenses to or indemnify a corporate officer or director. Nonetheless, Section 145(c) of the DGCL mandates indemnification where “a present or former director or officer of a corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding”\textsuperscript{44} in which that director or officer was made a party to such action “by reason of the fact that the person is or was a director [or] officer . . . of the corporation.”\textsuperscript{45} Section 1(c) of Article IX of KV’s Bylaws tracks the language of DGCL § 145(c) almost exactly.

Section 5 of the Indemnification Agreement, entitled “Indemnification for Expenses for Successful Party,” also tracks the language of DGCL § 145(c) and Article IX, Section 1(c), of KV’s Bylaws:

Notwithstanding the limitations of any other provisions of this Agreement, to the extent that Indemnitee is successful on the merits or otherwise in defense of any Proceeding, or in defense of any claim, issue or matter therein, including, without limitation, the dismissal of any action without prejudice, or if it is ultimately determined that Indemnitee is otherwise entitled to be indemnified against Expenses, Indemnitee shall be

\textsuperscript{44} 8 Del. C. § 145(c).

\textsuperscript{45} Id. § 145(a).
indemnified against all Expenses actually and reasonably incurred in connection therewith. If Indemnitee is partially successful on the merits or otherwise in defense of any Proceeding, Indemnitee shall be indemnified against all Expenses actually and reasonably incurred in connection with each claim, issue, or matter that is successfully resolved on the merits or otherwise to the fullest extent permitted by law. 46

For the purposes of this proceeding, the parties do not dispute that the three matters for which Hermelin seeks mandatory indemnification are covered “Proceedings.” The key issue for mandatory indemnification under the DGCL, KV’s Bylaws, and the Indemnification Agreement, is therefore whether Hermelin was “successful on the merits or otherwise” in these matters. If Hermelin was not “successful on the merits or otherwise,” he will still be entitled to indemnification unless KV can show that his conduct underlying the matters for which he seeks indemnification does not satisfy the good faith standard required by DGCL § 145(a).

46 Indemnification Agreement § 5 (emphasis added).
47 See 8 Del. C. § 145(a) (permitting indemnification so long as the person “acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe the person's conduct was unlawful”). Although I do not find it determinative in the matter before me, I note for completeness that the Indemnification Agreement presumes that Hermelin is entitled to indemnification and places the burden on KV to overcome that presumption. See Indemnification Agreement § 8(b) (stating that in a proceeding brought by the Indemnitee to enforce his right to indemnification, the “Indemnitee shall be presumed to be entitled to indemnification under this Agreement and the Company shall, to the fullest extent not prohibited by law, have the burden of proof to overcome that presumption”).
The Indemnification Agreement provides additional clarification of the phrase “success on the merits or otherwise.” Section 7(e)(iii) of the Agreement states:

The Company acknowledges that a settlement or other disposition short of final judgment may be successful if it permits a party to avoid expense, delay, distraction, disruption and uncertainty. In the event that any action, claim or proceeding to which Indemnitee is a party is resolved in any manner other than by adverse judgment against Indemnitee (including, without limitation, settlement of such action, claim or proceeding with or without payment of money or other consideration) it shall be presumed that Indemnitee has been successful on the merits or otherwise in such action, suit or proceeding. Anyone seeking to overcome this presumption shall have the burden of proof and the burden of persuasion by clear and convincing evidence.

The parties disagree on how closely a court must scrutinize the outcome of a proceeding to determine whether the indemninee was successful under Section 145(c). Both parties argue, in the first instance, that Hermelin’s success or failure can be determined solely from the outcomes that occurred in each proceeding. The parties contend in the alternative, however, that should I disagree with their respective positions on Hermelin’s success or failure, I must allow additional discovery into the underlying facts of Hermelin’s guilty plea in the Criminal Matter, the purpose of the FDA Consent Decree, and the negotiations behind the HHS Exclusion. KV even asserts that “whether the relevant governmental entity believed or intended
Mr. Hermelin to be successful in the final results of each of those proceedings” should factor into my analysis.\textsuperscript{48}

Such facts are beyond the scope of the inquiry required by Section 145(c). When determining success on the merits, this Court does not look “behind the result.”\textsuperscript{49} Rather, where the outcome of a proceeding signals that the indemnitee has avoided an adverse result, the indemnitee has succeeded “on the merits or otherwise,” and further inquiry into the “how” and “why” of the result is unnecessary.\textsuperscript{50} Whether the prosecution, plaintiff, or investigating government agency “intended” for the indemnitee to be “successful” is clearly irrelevant. One can only imagine the difficulty an indemnitee would face in eliciting testimony from a prosecutor that she intended for the defendant/indemnitee to “succeed” when she negotiated the plea agreement. Delaware law does not require such abstractions; instead, the only relevant consideration is “what the result was, not why it was.”\textsuperscript{51} In

\textsuperscript{48} Def.’s Opening Br. Addressing Mand. Indem. and Scope Disc. at 8 [hereinafter “Def.’s Opening Indem. Br. ___”].
\textsuperscript{50} See Stockman v. Heartland Indus. Partners, L.P., 2009 WL 2096213, at *10 n. 44 (Del. Ch. July 14, 2009) (“[S]uccess’ under § 145(c) does not mean moral exoneration. Escape from an adverse judgment or other detriment, for whatever reason, is determinative.” (quoting Waltuch, 88 F.3d at 96)); Zaman v. Amedeo Holdings, Inc., 2008 WL 2168397, at *22 (Del. Ch. May 23, 2008) (“The success on the ‘merits or otherwise’ standard is one that grants indemnification to corporate officials even when they have not been adjudged innocent in some ethical or moral sense.”).
\textsuperscript{51} Waltuch, 88 F.3d at 96 (citing Merritt-Chapman, 321 A.2d at 141). In Zaman v. Amedeo Holdings, Inc., this Court noted that some prior cases had held that “if similar
determining whether indemnification is mandatory under Section 145(c), this Court looks strictly at the outcome of the underlying action.\textsuperscript{52} This approach is consistent with the language of the DGCL and avoids, where possible, prolonged and expensive discovery into the facts behind a particular dismissal, settlement, or plea. Thus, in analyzing each of the indemnification matters here, I examine what Hermelin was charged with or formally accused of, and I compare that with the result Hermelin actually achieved.

a. Hermelin Is Not Entitled to Mandatory Indemnification for the Criminal Matter

It is clear that Hermelin was not successful in the Criminal Matter. The USAO charged Hermelin with two federal strict liability misdemeanors, claims are pending in two forums simultaneously, dismissal of one case so that the other case can go forward does not constitute success for purposes of § 145(c).” 2008 WL 2168397, at *22 (citing \textit{Galdi v. Berg}, 359 F. Supp. 698, 702 (D. Del. 1973)). This should not be read as an exception to the rule that this Court will not look beyond the outcome of a proceeding, but rather as a recognition of the identity between a dismissal on those grounds and a ruling short of a final disposition. Indeed, indemnification under any provision of the DGCL is improper pending the final disposition of the underlying proceeding. \textit{See Paolino v. Mace Sec. Int’l, Inc.}, 2009 WL 4652894, at *4 (Del. Ch. Dec. 8, 2009) (“It is generally premature to consider indemnification prior to the final disposition of the underlying action.”) (citing \textit{Sun-Times Media Group, Inc. v. Black}, 954 A.2d 380, 401-08 (Del. Ch. 2008); \textit{Simon v. Navellier Series Fund}, 2000 WL 1597890, at *9 (Del. Ch. Oct. 19, 2000)).

\textsuperscript{52} \textit{See Stockman}, 2009 WL 2096213, at *11 (concluding that the indemnitees were successful because they achieved a dismissal without prejudice); \textit{Zaman}, 2008 WL 2168397, at *21-*24 (determining that the indemnitee was successful on the merits because all of the counts in the complaint were dismissed); \textit{FGC Holdings Ltd. v. Teltronics, Inc.}, 2007 WL 241384, at *10 (Del. Ch. Jan. 22, 2007) (finding that “[a] fair reading of the Memorandum Opinion shows that [the indemnitee] did succeed ‘on the merits or otherwise’”).
and Hermelin pled guilty to both charges.\textsuperscript{53} Because of Hermelin’s guilty plea, the Court ordered Hermelin to pay $1.9 million in fines and forfeitures and sentenced him to a maximum of thirty days in jail. Hermelin argues that a guilty plea, even if accepted by a court, is not an adverse judgment and that by pleading guilty, he was able to “avoid expense, delay, distraction, disruption, and uncertainty,” and that he was therefore “successful” by the terms of Section 7(e)(iii) of the Indemnification Agreement.\textsuperscript{54}

It is well-settled that, in a criminal proceeding, anything less than a conviction constitutes “success” for the purposes of DGCL § 145(c).\textsuperscript{55} Here, however, Hermelin pled guilty to every charge against him, paid a substantial fine, and served time in the St. Louis County Jail. This was not a successful outcome.

Additionally, I find Hermelin’s invocation of Section 7(e)(iii) to be unpersuasive. That provision states that a disposition short of final judgment may be successful in some circumstances. Section 7(e)(iii) is a reflection of

\textsuperscript{53} See Pl.’s Opening Indem. Mem. Exs. 7, 8.
\textsuperscript{54} The indemnification-promoting provisions of Section 7(e)(iii) relied on by Hermelin and discussed below provide the Indemnitee with the presumption of success only where the matter is resolved “in any manner other than by adverse judgment against Indemnitee.” Indemnification Agreement § 7(e)(iii). Although I find that, in any case, the result for Hermelin here was not a success, I note that a guilty plea accepted by the court thereby becomes a conviction and an adverse judgment.
\textsuperscript{55} See Stockman, 2009 WL 2096213, at *10 (“An indemnitee in a criminal proceeding is successful any time she avoids a conviction . . . .”); Merritt-Chapman, 321 A.2d at 141 (“Success is vindication. In a criminal action, any result other than conviction must be considered success.”).
established Delaware precedent that “success” under DGCL § 145(c) “does not mean moral exoneration. Escape from adverse judgment or other detriment, for whatever reason, is determinative.”\textsuperscript{56} For example, in \textit{Merritt-Chapman & Scott Corp. v. Wolfson}, the Court found that the indemnitees were successful on the merits of and entitled to partial indemnification for the charges against them that had been dismissed, even though those dismissals occurred as part of a plea deal where the indemnitees pled guilty to another charge.\textsuperscript{57}

Hermelin is unsuccessful in drawing a parallel between his case and \textit{Merritt-Chapman}. Unlike the indemnitees in \textit{Merritt-Chapman}, Hermelin did not achieve the dismissal of some charges against him for the price of pleading guilty to other charges. Rather, Hermelin was charged with two strict liability misdemeanors, and he pled guilty to both charges. Hermelin insists that the USAO could have charged him with more serious crimes, an assertion he bases on the charges leveled against ETHEX, but that due to successful negotiations between Hermelin’s counsel and the USAO, the USAO only charged Hermelin with two misdemeanors. The substance of these negotiations, if in fact they occurred, is beyond the scope of a determination of success on the merits under Section 145(c). Just as this

\textsuperscript{56} \textit{Stockman}, 2009 WL 2096213, at *10, n.44 (quoting \textit{Waltuch}, 88 F.3d at 96).

\textsuperscript{57} \textit{Merritt-Chapman}, 321 A.2d at 140-41.
Court will not look behind the result of a dismissal, it will not judge the actual outcome of a proceeding against the universe of crimes with which the indemnitee could have been charged. The proper analysis instead considers the outcome achieved by the indemnitee in light of the formal charges or claims against him.

In the criminal context, the dismissal of a charge equates with success in most instances, while a conviction (including a conviction resulting from a plea of guilty or nolo contendere) equates with failure. Here, Hermelin pled guilty to all charged offenses, paid a large fine, and received a jail sentence. Although by pleading guilty Hermelin conceivably avoided some “expense, delay, distraction, disruption, [or] uncertainty,” he cannot be said to have “succeeded” simply because of that fact. If an indemnitee could “succeed” by pleading guilty on all counts, those indemnitees utterly without a defense to any charge would nonetheless be “successful” on the merits, thus circumventing the permissive indemnification provisions of DGCL §§ 145(a)-(b). Hermelin did not achieve success on any of the charges against him, and for that reason, he is not entitled to mandatory indemnification for the Criminal Matter.
b. Hermelin Is Not Entitled to Mandatory Indemnification for the HHS Exclusion Matter

Hermelin also did not succeed on the merits in the HHS Exclusion Matter. In a May 19, 2010, letter, the OIG informed Hermelin that it was considering excluding him from federal healthcare programs, and the OIG invited him to submit information in his defense.58 After considering the information submitted by Hermelin in his defense, the OIG decided to exclude Hermelin for twenty years from federal healthcare programs. Hermelin concedes that, because of his age, this was effectively a lifetime ban.59 Comparing the potential outcome Hermelin faced (effectively a lifetime exclusion from federal healthcare programs) and the actual outcome of the proceeding (Hermelin’s twenty-year exclusion from federal healthcare programs), Hermelin clearly did not succeed on the merits of the HHS Exclusion Matter.

Hermelin nonetheless contends that he was successful on the merits because the OIG’s determination did not require Hermelin to make any payment. Additionally, Hermelin argues that he entered into the settlement agreement with the OIG to prevent the exclusion of KV, and that because of this it would be inequitable to find that by doing so he forfeited his right to

59 Compl. ¶ 53.
mandatory indemnification. Finally, Hermelin asserts that his settlement with the OIG, in which he purportedly gave up his right to appeal his exclusion in return for the OIG’s agreement not to exclude KV, allowed Hermelin to “avoid expense, delay, distraction, disruption, and uncertainty,” and thus the settlement was the type of “disposition short of final judgment” for which the Indemnification Agreement mandates indemnification.

All of these arguments attempt to sidestep what is in actuality a very simple inquiry: in the proceeding in which the OIG threatened Hermelin with exclusion from federal healthcare programs, did Hermelin “succeed” when the OIG decided to exclude him for twenty years (effectively, for life)? It is clear that he did not. Moreover, I find irrelevant the fact that Hermelin purportedly gave up his right to appeal his exclusion and divested himself of his KV stock in return for the OIG’s promise not to exercise permissive exclusion of KV. Hermelin argues that equity should mandate indemnification in this context, but his right to indemnification, if it exists, arises from statute and contract, not equity.

Admittedly, although the divestiture of Hermelin’s ownership in KV appears to have been necessary to avoid the mandatory exclusion of KV, the record also provides some support for the inference that the OIG sought a waiver of Hermelin’s right to appeal his exclusion only in exchange for its
promise not to *permissively* exclude KV. Furthermore, good corporate policy may support the indemnification of officers who, in good faith, “take one for the company” to avoid bringing down the whole enterprise. My task here, however, is not to pass judgment on KV’s corporate policy, but rather to determine, as a matter of law, whether Hermelin is entitled to *statutorily-mandated* indemnification on the basis of his having “succeeded on the merits.” That determination is limited to the action the OIG took against Hermelin and the outcome of that action. It is clear from the timing and content of the letters from the OIG to Hermelin that the OIG’s plan to exclude Hermelin was independent of any action it took toward KV. Thus, Hermelin’s voluntary agreement to undergo additional hardship to protect KV is irrelevant. Even if such an agreement were relevant to my analysis, and regardless of what sound corporate policy may dictate, “taking one for the team” and “falling on one’s sword” do not equate to “success on the merits or otherwise” for the indemnitee. On the contrary, it is the company that “succeeds” in such an instance, albeit at the indemnitee’s expense. Whether the company chooses to indemnify its officer in such cases is a matter of corporate policy, and DGCL §§ 145(a)-(b) authorize corporations to establish that policy should they so desire.
c. Hermelin Is Entitled to Mandatory Indemnification for the FDA Consent Decree Matter

I find that Hermelin was “successful on the merits or otherwise” with respect to the FDA Consent Decree Matter. As discussed above, in determining “success” for the purposes of Section 145(c), I compare the charges Hermelin faced with the outcome he achieved, and I do not look “behind the result.” In essence, the Consent Decree imposed no new restrictions, obligations, or penalties against Hermelin, and thus, in avoiding an adverse result, Hermelin achieved “success.”

The FDA’s Complaint for Permanent Injunction sought an injunction generally prohibiting KV, ETHERX, Hermelin, and other defendants from manufacturing, holding, or distributing any drug until the defendants brought their operations into conformity with cGMP and the FDCA. Although the FDA’s Complaint sought to impose these restrictions on Hermelin, the restrictions contained in the Consent Decree entered into by the parties did not place any additional restrictions on Hermelin. The only reference to Hermelin in the body of the Consent Decree occurs at Paragraph 24, which states that the provisions of the Consent Decree do not apply to Hermelin.

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60 See Waltuch, 88 F.3d at 96 (“Escape from an adverse judgment or other detriment, for whatever reason, is determinative.”); Merritt-Chapman, 321 A.2d at 141 (“Going behind the result . . . is [not] authorized by subsection (c) . . .”).

unless KV’s Board alters its resolutions terminating Hermelin’s employment or Hermelin otherwise “assume[s] any role in the decisionmaking, management, or operation of KV that could affect the company’s compliance with the Act, its implementing regulations, or [the] Decree.”

KV mischaracterizes Paragraph 24 of the Consent Decree as imposing a “perpetual ban” on Hermelin from any management or operational role in KV. What Paragraph 24 actually provides, however, is that if Hermelin resumes any management role that could affect KV’s compliance with the Consent Decree, the restrictions on KV and the other defendants also apply to Hermelin. This provision is practical and unsurprising. KV’s Board terminated Hermelin’s employment before the FDA filed its Complaint, and thus because Hermelin did not hold a managerial position in KV, there was no reason for the Consent Decree to apply to him. It would be absurd to exclude Hermelin from the restrictions of the Consent Decree yet nonetheless allow him to return to his old job free from the restrictions in place against the rest of KV and its managers. Paragraph 24 simply prevents this absurdity. In any event, in avoiding a personally negative result in connection with the Consent Decree, Hermelin succeeded in this Matter.

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62 Id. Ex. 9, at 23.
63 Def.’s Opening Indem. Br. at 7.
2. Evidence Relevant to Permissive Indemnification

The parties disagree on what evidence is relevant to a good faith analysis under Section 145(a) and have briefed the issue. In the interests of efficiency, I address the matter here. Where a corporate officer or director is not “successful on the merits or otherwise,” Sections 145(a) and (b) of the DGCL permit a corporation to indemnify that person so long as “the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe the person's conduct was unlawful.”

Here, however, KV’s Bylaws and the Indemnification Agreement mandate indemnification where it is permissive under the DGCL. Thus, the distinction is not “mandatory” versus “permissive” indemnification, but rather what standard I must employ in determining Hermelin’s entitlement.

While statutorily mandated indemnification looks only to “success on the merits or otherwise” and can usually be determined based on the relevant court documents of the underlying action, statutorily permissive

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64 8 Del. C. § 145(a) (emphasis added).
65 See KV Bylaws, art. IX, §§ 1(a)-(b) (following the language of DGCL §§ 145(a)-(b) except replacing “shall have the power to” with “shall”); Indemnification Agreement § 3(a) (“Except as otherwise provided in this Agreement, the Company shall indemnify Indemnitee to the fullest extent permitted by the General Corporation Law . . . .” (emphasis added)).
indemnification requires a determination as to whether Hermelin acted in good faith with respect to his conduct that led to the underlying action. The latter determination requires additional discovery to supplement the present record of this case, and I now address the scope of evidence relevant to the issue of Hermelin’s good faith.

Based on the briefs submitted by the parties and my own research, no Delaware case has squarely addressed what evidence is relevant to an inquiry into whether an indemnitee acted in good faith for the purposes of permissive indemnification under DGCL §§ 145(a) and (b). Section 7(e)(iii) of the Indemnification Agreement does, however, provide a starting point for my analysis:

The termination of any Proceeding or of any claim, issue or matter therein, by judgment, order, settlement or conviction, or upon a plea of nolo contendere or its equivalent, shall not . . . of itself adversely affect the right of Indemnitee to indemnification or create a presumption that Indemnitee did not act in good faith and in a manner which Indemnitee reasonably believed to be in or not opposed to the best interests of the

66 The scope of discovery is set forth in the Court of Chancery Rules and includes any matter, not privileged, which is relevant to the subject matter involved in the pending action, whether it relates to the claim or defense of the party seeking discovery or to the claim or defense of any other party, including the existence, description, nature, custody, condition and location of any books, documents or other tangible things and the identity and location of persons having knowledge of any discoverable matter.

Ch. Ct. R. 26(b)(1) (emphasis added). Here, I address the scope of evidence “relevant to the subject matter involved in the pending action,” i.e., Hermelin’s good faith or lack thereof.
Company or, with respect to any criminal Proceeding, that Indemnitee had reasonable cause to believe that Indemnitee’s conduct was unlawful.\textsuperscript{67}

This provision clearly establishes that the particular outcome of a proceeding does not itself create a presumption that the indemnitee had a “non-indemnifiable state of mind.”\textsuperscript{68} Nonetheless, if the prosecution or the plaintiff in the underlying proceeding established that the indemnitee acted in bad faith, particularly through a showing that the indemnitee knew that his actions were damaging to the company or that his conduct was unlawful, “that would be conclusive evidence that the [indemnitee] is not entitled to indemnification.”\textsuperscript{69} Treating a finding of “bad faith” in an underlying proceeding as conclusive evidence of a non-indemnifiable state of mind in the related proceeding for indemnification under DGCL § 145(a) is simply a fundamental application of \textit{res judicata}.

Beyond these basic formulations, there is a dearth of case law addressing the scope of relevant evidence with respect to good faith under Section 145(a). In \textit{Stockman v. Heartland Industrial Partners, L.P.}, then-Vice Chancellor Strine acknowledged that

\textsuperscript{67} \textit{Id.} § 7(e)(iii) (emphasis added). Section 7(e)(iii) tracks the language found at 8 \textit{Del. C.} § 145(a).
\textsuperscript{68} \textit{Cf. Sun-Times Media Group}, 954 A.2d at 401 n.83.
\textsuperscript{69} \textit{Id.}
[t]he language of §§ 145(a) and (b) applies comfortably only to cases where there has been a finding that the party seeking indemnification has violated some legal or equitable duty to someone, the party has made an admission of culpability, or the party has settled a case by making a payment. In the first two of these situations, there is a strong basis to believe the indemnitee acted against the interests of the corporation or society, and therefore providing indemnification would dampen the incentives of corporate officials to comply with their legal and fiduciary duties, a result at odds with public policy. Moreover, in these situations, there will be a judicial record developed in a plenary proceeding regarding the underlying conduct which can serve as a basis for evaluating whether the indemnitee met the §§ 145(a) and (b) standard for good faith and law compliance.\footnote{Stockman, 2009 WL 2096213, at *15.}

The third situation, settlement with a payment, is more problematic, as a settled case will rarely contain “a judicial record developed in a plenary proceeding.” Thus, additional discovery—in some instances mimicking the very litigation avoided by the settlement—may be required to permit a determination on whether the indemnitee acted in good faith. As the \textit{Stockman} Court noted, however, “there has been precious little application of the §§ 145(a) and (b) standard” in the case of settlements “because indemnitees typically work with the corporation, its lawyers, and insurers in resolving cases.”\footnote{Id. at *16.} Neither party in \textit{Stockman} could point to any cases in which this Court examined whether an indemnitee who settled a case
satisfied the good faith requirement of §§ 145(a) and (b).\textsuperscript{72} “After all,” the Vice Chancellor remarked, “parties seek to settle cases in order to obtain peace and end further costs, not to kick the litigation can down the road.”\textsuperscript{73}

The matters for which Hermelin seeks indemnification present similar challenges, as none of the matters contained a finding that Hermelin acted in bad faith or an admission of culpability by Hermelin. The Criminal Matter resulted in a guilty plea to two strict liability misdemeanors. Given the lack of culpability inherent in a guilty plea to a strict liability offense, and since Section 7(e)(iii) of the Indemnification Agreement precludes such a plea from creating, of itself, a presumption that Hermelin had a non-indemnifiable state of mind, the record is inadequate with respect to Hermelin’s conduct underlying the Criminal Matter. The HHS Exclusion Matter similarly did not contain a finding that Hermelin acted in bad faith; rather, Hermelin’s exclusion was based on his association with ETHEX. Finally, in regards to the Audit Committee Matter, although KV’s Board’s decision to terminate Hermelin’s employment “for cause” was allegedly based on Hermelin’s willful misconduct, the current record contains scant evidence in support of that allegation; thus, the parties must supplement the record before I can make a determination under Section 145(a).

\textsuperscript{72} \textit{Id.}  
\textsuperscript{73} \textit{Id.}
I find that a plenary trial is required on the issue of whether Hermelin “acted in good faith and in a manner [he] reasonably believed to be in or not opposed to the best interests of [KV], and, with respect to any criminal action or proceeding, had no reasonable cause to believe [his] conduct was unlawful.” The evidence relevant to that issue is limited to Hermelin’s conduct underlying the proceedings for which Hermelin seeks indemnification. Thus, for the Criminal and HHS Exclusion Matters, discovery is limited to facts related to KV’s and ETHER’s production of oversized tablets, including the morphine sulfate, dextroamphetamine sulfate, and propafenone tablets, as well as Hermelin’s actions in response to their production. For the Audit Committee Matter, however, the discoverable evidence includes facts related to the allegations made by KV employees that triggered the investigation of Hermelin as well as any other instances of misconduct on the part of Hermelin that factored into the Board’s decision to terminate Hermelin’s employment.

Facts unrelated to the aforementioned activities are outside the scope of relevant evidence. This should be fairly straightforward for the Criminal Matter and the HHS Exclusion Matter, as the relevant facts are those related

74 Hermelin shall be presumed to have satisfied the standard of conduct required for indemnification under Section 145(a), and KV “shall . . . have the burden of proof to overcome that presumption.” Indemnification Agreement § 8(b).
to the formal charges and allegations made against Hermelin in those matters. In a consistent fashion, I limit discovery into the Audit Committee Matter to facts related to Hermelin’s conduct underlying the Audit Committee’s investigation and KV’s Board’s decision with respect to Hermelin’s employment. Presumably there will be substantial overlap between Hermelin’s conduct underlying the Criminal and HHS Exclusion Matters and the complaints made by KV or ETHEX employees to KV’s Board, as those complaints purportedly focused on Hermelin’s failure to respond appropriately to KV’s manufacturing of oversized tablets, which of course brought about the Criminal and HHS Exclusion Matters. It appears, however, that the Audit Committee based its decision to terminate Hermelin’s employment on additional misconduct by Hermelin, such as past confrontations with the FDA. Yet unlike the other matters at issue, the Audit Committee Matter did not involve formal charges or civil allegations (beyond the employee complaints that triggered the investigation); likewise, the record does not demonstrate the considerations which led KV’s Board to terminate Hermelin’s employment. In order to show that Hermelin is not entitled to indemnification, it will be up to KV to demonstrate that, in

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75 See Pl.’s Opening Indem. Mem. Ex. 14 (reporting that the Audit Committee investigated “a range of specific allegations involving, among other things, FDA regulatory and other compliance matters and management misconduct”).
deciding to remove Hermelin, the Audit Committee relied on an incident in which Hermelin’s actions constituted actual bad faith. The facts of any such incidents relied upon by the Audit Committee are those relevant to whether Hermelin is entitled to indemnification for the Audit Committee Matter.76

In limning the relevancy issues as I have, I reject Hermelin’s argument that discovery on the issue of good faith should be limited to the records established in the matters for which he seeks indemnification. Hermelin’s suggested scope, which he generally limits to the papers and transcripts filed in the underlying proceedings, more closely resembles what this Court will consider in determining “success on the merits or otherwise” under Section 145(c). Unlike Section 145(c), Section 145(a) requires a finding that the indemnitee did not act in bad faith, a fact-intensive inquiry that will most likely require a trial and credibility determinations. The disparity between the relevant evidence, respectively, under Sections 145(a) and (c) is, of course, the reason I decided to resolve issues of mandatory indemnification in a summary fashion.

76 Hermelin contends that discovery “reaching back far before the underlying proceedings and relating to areas having nothing to do with the bases on which each of the subject proceedings was resolved, is inappropriate, unnecessary, and inconsistent with . . . a proper evidentiary record to evaluate the standard of conduct under Sections 145(a) and (b).” Pl.’s Opening Indem. Mem. at 46-47. To the extent that Hermelin’s alleged earlier incidents of misconduct factored into KV’s Board’s decision to fire Hermelin, however, those earlier incidents are directly relevant to whether Hermelin met the “good faith” standard of conduct.
Moreover, the cases Hermelin cites do not support his argument for limited discovery. To be sure, Stockman found that “a judicial record developed in a plenary proceeding . . . can serve as a basis for evaluating whether the indemnitee met the §§ 145(a) and (b) standard for good faith and law compliance.” Here, however, it is the very absence of such judicial records from the underlying proceedings that necessitates additional discovery. Stockman did not hold that discovery for permissive indemnification is limited to the judicial record of the underlying proceeding; rather, it simply provided that where a plenary judicial record exists for the underlying proceeding, re-litigation of the issue of good faith will often be unnecessary. The other cases cited by Hermelin do not support his argument for similar reasons.

77 Stockman, 2009 WL 2096213, at *15.
78 See Charter Commc’ns, Inc. v. McCall, 2005 WL 3107702, at *4 (E.D. Mo. Nov. 18, 2005) (finding that the indemnitee had not met the required standard of conduct for indemnification because he had admitted to “knowing[ ] and willful[ ] participat[ion] in a scheme to defraud” in his plea agreement); Maiss v. Bally Gaming Int’l, Inc., 1996 WL 732530, at *1 (E.D. La. Dec. 12, 1996) (entering summary judgment in favor of the indemnitee because the indemnitee presented, by way of a lengthy affidavit, “undisputed facts that [he] acted in good faith and in a manner he believed to be in and not opposed to the best interests of [the company] and that he had no reasonable cause to believe that his conduct was unlawful at all relevant times” (emphasis added)). An earlier ruling denying a motion to dismiss in the Maiss case actually supports broad discovery: [P]ermissive indemnification is dependent on [the indemnitee’s] good faith and knowledge and Section 145(a) prohibits a presumption arising from the fact of a conviction alone. . . . At the same time, [the indemnitee] has pleaded guilty to a crime with elements that include knowledge of the actual commission of a felony and an affirmative act to conceal the crime. . . . The indemnity agreement contemplates judicial determination
CONCLUSION

For the foregoing reasons, I find that the Plaintiff is not entitled to advancement for the Jail Records Matter; is not entitled to mandatory indemnification for the Criminal Matter or the HHS Exclusion Matter; is entitled to mandatory indemnification for the FDA Consent Decree Matter; and that the evidence relevant to the Plaintiff’s claims for permissive indemnification is limited to the Plaintiff’s conduct, and the facts related to that conduct, underlying the proceedings for which indemnification is sought.

Although I rule in favor of KV on most of the indemnification and advancement issues, it strikes me that it is KV who has won what may prove a Pyrrhic victory. As I have discussed above, there is limited Delaware case law addressing what evidence is relevant to the standard of conduct requirement in DGCL § 145(a). I suspect that this lack of case law is owed less to the fact that companies never face claims for permissive indemnification and more to the fact that, where, as here, it is clear that the employee’s right to indemnification turns on “good faith,” economics militate in favor of resolving the matter outside of court, given the costs

in such a situation, and such a determination must consider all the facts germane to the dispute.

associated with a plenary trial on the indemnitee’s conduct. The economic incentive to settle would seem particularly compelling where the parties have entered into an indemnification agreement, as they have here, that requires the company, at least initially, to foot both parties’ costs on its own.

If the parties wish, they can certainly conduct discovery and present evidence at trial on the issue of good faith. To be sure, we will essentially be conducting the litigation the parties have thus far avoided through settlements, consent decrees, and plea agreements. I leave it to the parties to determine whether the elusive joys and potential benefits of such litigation outweigh the substantial costs that will result.

Counsel shall confer and submit a form of order consistent with this Opinion.

79 In many instances, of course, the indemnitee remains an employee, and thus the interests involved are more nearly aligned than they are in this case.
IN THE SUPREME COURT OF THE STATE OF DELAWARE

AMERICAS MINING CORPORATION, et al.,

§

Defendants Below,

§

Appellants,

v.

MICHAEL THERIAULT, as Trustee for the Theriault Trust,

§

Plaintiff Below,

§

Appellee.

______________________________

SOUTHERN COPPER CORPORATION, formerly known as Southern Peru Copper Corporation,

§

Nominal Defendant Below,

§

Appellant,

v.

MICHAEL THERIAULT, as Trustee for the Theriault Trust,

§

Plaintiff Below,

§

Appellee.

Submitted: June 7, 2012
Decided: August 27, 2012
Reargument Denied: September 21, 2012

Before STEELE, Chief Justice, HOLLAND, BERGER and RIDGELY, Justices and VAUGHN, President Judge,\(^1\) constituting the Court en Banc.

\(^1\) Sitting by designation pursuant to Del. Const. art. IV, § 12 and Supr. Ct. R. 2 and 4.
Upon appeal from the Court of Chancery. **AFFIRMED.**


Stephen E. Jenkins, Esquire (argued), Richard L. Renck, Esquire, Andrew D. Cordo, Esquire and F. Troupe Mickler, IV, Esquire, Ashby & Geddes, Wilmington, Delaware, for appellant, Nominal Defendant Southern Copper Corporation, formerly known as Southern Peru Copper Corporation.

Ronald A. Brown, Jr., Esquire (argued) and Marcus E. Montejo, Esquire, Prickett, Jones & Elliott, P.A., Wilmington, Delaware, and Kessler Topaz Meltzer & Check, LLP, Radnor, Pennsylvania, for appellee.

**HOLLAND,** Justice, for the majority:
This is an appeal from a post-trial decision and final judgment of the Court of Chancery awarding more than $2 billion in damages and more than $304 million in attorneys’ fees. The Court of Chancery held that the defendants-appellants, Americas Mining Corporation (“AMC”), the subsidiary of Southern Copper Corporation’s (“Southern Peru”) controlling shareholder, and affiliate directors of Southern Peru (collectively, the “Defendants”), breached their fiduciary duty of loyalty to Southern Peru and its minority stockholders by causing Southern Peru to acquire the controller’s 99.15% interest in a Mexican mining company, Minera México, S.A. de C.V. (“Minera”), for much more than it was worth, i.e., at an unfair price.

The Plaintiff challenged the transaction derivatively on behalf of Southern Peru. The Court of Chancery found the trial evidence established that the controlling shareholder, Grupo México, S.A.B. de C.V. (“Grupo Mexico”), through AMC, “extracted a deal that was far better than market” from Southern Peru due to the ineffective operation of a special committee (the “Special Committee”). To remedy the Defendants’ breaches of loyalty, the Court of Chancery awarded the difference between the value Southern Peru paid for Minera ($3.7 billion) and the amount the Court of Chancery determined Minera was worth ($2.4 billion). The Court of Chancery
awarded damages in the amount of $1.347 billion plus pre- and post-judgment interest, for a total judgment of $2.0316 billion. The Court of Chancery also awarded the Plaintiff’s counsel attorneys’ fees and expenses in the amount of 15% of the total judgment, which amounts to more than $304 million.

**Issues on Appeal**

The Defendants have raised five issues on appeal. First, they argue that the Court of Chancery impermissibly denied the Defendants the opportunity to present a witness from Goldman, Sachs & Co. (“Goldman”) at trial to explain its valuation process, on the grounds that the witness constituted an “unfair surprise.” Second, they contend that the Court of Chancery committed reversible error by failing to determine which party bore the burden of proof before trial. They further claim the Court of Chancery erred by ultimately allocating the burden to the Defendants, because, they submit, the Special Committee was independent, well-functioning, and did not rely on the controlling shareholder for the information that formed the basis for its recommendation. Third, they argue that the Court of Chancery’s determination about the “fair” price for the transaction was arbitrary and capricious. Fourth, they assert that the Court of Chancery’s award of damages is not supported by evidence in the record,
but rather by impermissible speculation and conjecture. Finally, the
Defendants’ allege that the Court of Chancery’s award of attorneys’ fees of
more than $304 million is an abuse of discretion. Southern Peru also
appeals from the award of attorneys’ fees to the Plaintiff’s counsel.

We have determined that all of the Defendants’ arguments are without
merit. Therefore, the judgment of the Court of Chancery is affirmed.

**FACTUAL BACKGROUND**

The controlling stockholder in this case is Grupo México, S.A.B. de
C.V. The NYSE-listed mining company is Southern Peru Copper
Corporation. The Mexican mining company is Minera México, S.A. de
C.V.

In February 2004, Grupo Mexico proposed that Southern Peru buy its
99.15% stake in Minera. At the time, Grupo Mexico owned 54.17% of
Southern Peru’s outstanding capital stock and could exercise 63.08% of the
voting power of Southern Peru, making it Southern Peru’s majority
stockholder.

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2 The facts are taken almost verbatim from the post-trial decision by the Court of Chancery.
3 On October 11, 2005, Southern Peru changed its name to “Southern Copper Corporation” and is currently traded on the NYSE under the symbol “SCCO.”
4 Grupo Mexico held — and still holds — its interest in Southern Peru through its wholly-owned subsidiary Americas Mining Corporation (“AMC”). Grupo Mexico also held its 99.15% stake in Minera through AMC. AMC, not Grupo Mexico, is a defendant to this action, but I refer to them collectively as Grupo Mexico in this opinion because that more accurately reflects the story as it happened.
Grupo Mexico initially proposed that Southern Peru purchase its equity interest in Minera with 72.3 million shares of newly-issued Southern Peru stock. This “indicative” number assumed that Minera’s equity was worth $3.05 billion, because that is what 72.3 million shares of Southern Peru stock were worth then in cash. By stark contrast with Southern Peru, Minera was almost wholly owned by Grupo Mexico and therefore had no market-tested value.

Because of Grupo Mexico’s self-interest in the merger proposal, Southern Peru formed a “Special Committee” of disinterested directors to “evaluate” the transaction with Grupo Mexico. The Special Committee spent eight months in an awkward back and forth with Grupo Mexico over the terms of the deal before approving Southern Peru’s acquisition of 99.15% of Minera’s stock in exchange for 67.2 million newly-issued shares of Southern Peru stock (the “Merger”) on October 21, 2004. That same day, Southern Peru’s board of directors (the “Board”) unanimously approved the Merger and Southern Peru and Grupo Mexico entered into a definitive agreement (the “Merger Agreement”). On October 21, 2004, the market value of 67.2 million shares of Southern Peru stock was $3.1 billion. When the Merger closed on April 1, 2005, the value of 67.2 million shares of Southern Peru had grown to $3.75 billion.
This derivative suit was then brought against the Grupo Mexico subsidiary that owned Minera, the Grupo Mexico-affiliated directors of Southern Peru, and the members of the Special Committee, alleging that the Merger was entirely unfair to Southern Peru and its minority stockholders.

The crux of the Plaintiff’s argument is that Grupo Mexico received something demonstrably worth more than $3 billion (67.2 million shares of Southern Peru stock) in exchange for something that was not worth nearly that much (99.15% of Minera). The Plaintiff points to the fact that Goldman, which served as the Special Committee’s financial advisor, never derived a value for Minera that justified paying Grupo Mexico’s asking price, but instead relied on a “relative” valuation analysis that involved comparing the discounted cash flow (“DCF”) values of Southern Peru and Minera, and a contribution analysis that improperly applied Southern Peru’s own market EBITDA multiple (and even higher multiples) to Minera’s EBITDA projections, to determine an appropriate exchange ratio to use in the Merger. The Plaintiff claims that, because the Special Committee and Goldman abandoned the company’s market price as a measure of the true value of the give, Southern Peru substantially overpaid in the Merger.

5 The remaining plaintiff in this action is Michael Theriault, as trustee of and for the Theriault Trust.
The Defendants remaining in the case are Grupo Mexico and its affiliate directors who were on the Southern Peru Board at the time of the Merger. These Defendants assert that Southern Peru and Minera are similar companies and were properly valued on a relative basis. In other words, the defendants argue that the appropriate way to determine the price to be paid by Southern Peru in the Merger was to compare both companies’ values using the same set of assumptions and methodologies, rather than comparing Southern Peru’s market capitalization to Minera’s DCF value. The Defendants do not dispute that shares of Southern Peru stock could have been sold for their market price at the time of the Merger, but they contend that Southern Peru’s market price did not reflect the fundamental value of Southern Peru and thus could not appropriately be compared to the DCF value of Minera.

After this brief overview of the basic events and the parties’ core arguments, the Court of Chancery provided the following more detailed recitation of the facts as it found them after trial.

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6 These individual defendants are Germán Larrea Mota-Velasco, Genaro Larrea Mota-Velasco, Oscar González Rocha, Emilio Carrillo Gamboa, Jaime Fernandez Collazo Gonzalez, Xavier García de Quevedo Topete, Armando Ortega Gómez, and Juan Rebolledo Gout.
The Key Players

Southern Peru operates mining, smelting, and refining facilities in Peru, producing copper and molybdenum as well as silver and small amounts of other metals. Before the Merger, Southern Peru had two classes of stock: common shares that were traded on the New York Stock Exchange; and “Founders Shares” that were owned by Grupo Mexico, Cerro Trading Company, Inc., and Phelps Dodge Corporation (the “Founding Stockholders”). Each Founders Share had five votes per share versus one vote per share for ordinary common stock. Grupo Mexico owned 43.3 million Founders Shares, which translated to 54.17% of Southern Peru’s outstanding stock and 63.08% of the voting power.

Southern Peru’s certificate of incorporation and a stockholders’ agreement also gave Grupo Mexico the right to nominate a majority of the Southern Peru Board. The Grupo Mexico-affiliated directors who are defendants in this case held seven of the thirteen Board seats at the time of the Merger. Cerro owned 11.4 million Founders Shares (14.2% of the outstanding common stock) and Phelps Dodge owned 11.2 million Founders Shares (13.95% of the outstanding common stock). Among them, therefore, Grupo Mexico, Cerro, and Phelps Dodge owned over 82% of Southern Peru.
Grupo Mexico is a Mexican holding company listed on the Mexican stock exchange. Grupo Mexico is controlled by the Larrea family, and at the time of the Merger defendant Germán Larrea was the Chairman and CEO of Grupo Mexico, as well as the Chairman and CEO of Southern Peru. Before the Merger, Grupo Mexico owned 99.15% of Minera’s stock and thus essentially was Minera’s sole owner. Minera is a company engaged in the mining and processing of copper, molybdenum, zinc, silver, gold, and lead through its Mexico-based mines. At the time of the Merger, Minera was emerging from – if not still mired in – a period of financial difficulties, and its ability to exploit its assets had been compromised by these financial constraints. By contrast, Southern Peru was in good financial condition and virtually debt-free.

*Grupo Mexico Proposes That Southern Peru Acquire Minera*

In 2003, Grupo Mexico began considering combining its Peruvian mining interests with its Mexican mining interests. In September 2003, Grupo Mexico engaged UBS Investment Bank to provide advice with respect to a potential strategic transaction involving Southern Peru and Minera.

Grupo Mexico and UBS made a formal presentation to Southern Peru’s Board on February 3, 2004, proposing that Southern Peru acquire
Grupo Mexico’s interest in Minera from AMC in exchange for newly-issued shares of Southern Peru stock. In that presentation, Grupo Mexico characterized the transaction as “[Southern Peru] to acquire Minera [ ] from AMC in a stock for stock deal financed through the issuance of common shares; initial proposal to issue 72.3 million shares.” A footnote to that presentation explained that the 72.3 million shares was “an indicative number” of Southern Peru shares to be issued, assuming an equity value of Minera of $3.05 billion and a Southern Peru share price of $42.20 as of January 29, 2004.

In other words, the consideration of 72.3 million shares was indicative in the sense that Grupo Mexico wanted $3.05 billion in dollar value of Southern Peru stock for its stake in Minera, and the number of shares that Southern Peru would have to issue in exchange for Minera would be determined based on Southern Peru’s market price. As a result of the proposed merger, Minera would become a virtually wholly-owned subsidiary of Southern Peru. The proposal also contemplated the conversion of all Founders Shares into a single class of common shares.

*Southern Peru Forms A Special Committee*

In response to Grupo Mexico’s presentation, the Board met on February 12, 2004 and created a Special Committee to evaluate the proposal.
The resolution creating the Special Committee provided that the “duty and sole purpose” of the Special Committee was “to evaluate the [Merger] in such manner as the Special Committee deems to be desirable and in the best interests of the stockholders of [Southern Peru],” and authorized the Special Committee to retain legal and financial advisors at Southern Peru’s expense on such terms as the Special Committee deemed appropriate. The resolution did not give the Special Committee express power to negotiate, nor did it authorize the Special Committee to explore other strategic alternatives.

The Special Committee’s makeup as it was finally settled on March 12, 2004 was as follows:

- Harold S. Handelsman: Handelsman graduated from Columbia Law School and worked at Wachtell, Lipton, Rosen & Katz as an M&A lawyer before becoming an attorney for the Pritzker family interests in 1978. The Pritzker family is a wealthy family based in Chicago that owns, through trusts, a myriad of businesses. Handelsman was appointed to the Board in 2002 by Cerro, which was one of those Pritzker-owned businesses.

- Luis Miguel Palomino Bonilla: Palomino has a Ph.D in finance from the Wharton School at the University of Pennsylvania and worked as an economist, analyst and consultant for various banks and financial institutions. Palomino was nominated to the Board by Grupo Mexico upon the recommendation of certain Peruvian pension funds that held a large portion of Southern Peru’s publicly traded stock.
• Gilberto Perezalonso Cifuentes: Perezalonso has both a law degree and an MBA and has managed multi-billion dollar companies such as Grupo Televisa and AeroMexico Airlines. Perezalonso was nominated to the Board by Grupo Mexico.

• Carlos Ruiz Sacristán: Ruiz, who served as the Special Committee’s Chairman, worked as a Mexican government official for 25 years before co-founding an investment bank, where he advises on M&A and financing transactions. Ruiz was nominated to the Board by Grupo Mexico.

The Special Committee Hires Advisors And Seeks A Definitive Proposal From Grupo Mexico

The Special Committee began its work by hiring U.S. counsel and a financial advisor. After considering various options, the Special Committee chose Latham & Watkins LLP and Goldman. The Special Committee also hired a specialized mining consultant to help Goldman with certain technical aspects of mining valuation. Goldman suggested consultants that the Special Committee might hire to aid in the process; after considering these options, the Special Committee retained Anderson & Schwab (“A&S”).

After hiring its advisors, the Special Committee set out to acquire a “proper” term sheet from Grupo Mexico. The Special Committee did not view the most recent term sheet that Grupo Mexico had sent on March 25, 2004 as containing a price term that would allow the Special Committee to properly evaluate the proposal. For some reason the Special Committee did
not get the rather clear message that Grupo Mexico thought Minera was worth $3.05 billion.

Thus, in response to that term sheet, on April 2, 2004, Ruiz sent a letter to Grupo Mexico on behalf of the Special Committee in which he asked for clarification about, among other things, the pricing of the proposed transaction. On May 7, 2004, Grupo Mexico sent to the Special Committee what the Special Committee considered to be the first “proper” term sheet, making even more potent its ask.

**The May 7 Term Sheet**

Grupo Mexico’s May 7 term sheet contained more specific details about the proposed consideration to be paid in the Merger. It echoed the original proposal, but increased Grupo Mexico’s ask from $3.05 billion worth of Southern Peru stock to $3.147 billion. Specifically, the term sheet provided that:

> The proposed value of Minera [ ] is US$4,300 million, comprised of an equity value of US$3,147 million and US$1,153 million of net debt as of April 2004. The number of [Southern Peru] shares to be issued in respect to the acquisition of Minera [ ] would be calculated by dividing 98.84% of the equity value of Minera [ ] by the 20-day average closing share price of [Southern Peru] beginning 5 days prior to closing of the [Merger].

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7 At this point in the negotiation process, Grupo Mexico mistakenly believed that it only owned 98.84% of Minera. It later corrects this error, and the final Merger consideration reflected Grupo Mexico’s full 99.15% equity ownership stake in Minera.
In other words, Grupo Mexico wanted $3.147 billion in market-tested Southern Peru stock in exchange for its stake in Minera. The structure of the proposal, like the previous Grupo Mexico ask, shows that Grupo Mexico was focused on the dollar value of the stock it would receive.

Throughout May 2004, the Special Committee’s advisors conducted due diligence to aid their analysis of Grupo Mexico’s proposal. As part of this process, A&S visited Minera’s mines and adjusted the financial projections of Minera management (i.e., of Grupo Mexico) based on the outcome of their due diligence.

**Goldman Begins To Analyze Grupo Mexico’s Proposal**

On June 11, 2004, Goldman made its first presentation to the Special Committee addressing the May 7 term sheet. Although Goldman noted that due diligence was still ongoing, it had already done a great deal of work and was able to provide preliminary valuation analyses of the standalone equity value of Minera, including a DCF analysis, a contribution analysis, and a look-through analysis.

Goldman performed a DCF analysis of Minera based on long-term copper prices ranging from $0.80 to $1.00 per pound and discount rates ranging from 7.5% to 9.5%, utilizing both unadjusted Minera management projections and Minera management projections as adjusted by A&S. The
only way that Goldman could derive a value for Minera close to Grupo Mexico’s asking price was by applying its most aggressive assumptions (a modest 7.5% discount rate and its high-end $1.00/lb long-term copper price) to the unadjusted Minera management projections, which yielded an equity value for Minera of $3.05 billion. By applying the same aggressive assumptions to the projections as adjusted by A&S, Goldman’s DCF analysis yielded a lower equity value for Minera of $2.41 billion. Goldman’s mid-range assumptions (an 8.5% discount rate and $0.90/lb long-term copper price) only generated a $1.7 billion equity value for Minera when applied to the A&S-adjusted projections. That is, the mid-range of the Goldman analysis generated a value for Minera (the “get”) a full $1.4 billion less than Grupo Mexico’s ask for the give.

It made sense for Goldman to use the $0.90 per pound long term copper price as a mid-range assumption, because this price was being used at the time by both Southern Peru and Minera for purposes of internal planning. The median long-term copper price forecast based on Wall Street research at the time of the Merger was also $0.90 per pound.

Goldman’s contribution analysis applied Southern Peru’s market-based sales, EBITDA, and copper sales multiples to Minera. This analysis yielded an equity value for Minera ranging only between $1.1 and $1.7
billion. Goldman’s look-through analysis, which was a sum-of-the-parts analysis of Grupo Mexico’s market capitalization, generated a maximum equity value for Minera of $1.3 billion and a minimum equity value of only $227 million.

Goldman summed up the import of these various analyses in an “Illustrative Give/Get Analysis,” which made patent the stark disparity between Grupo Mexico’s asking price and Goldman’s valuation of Minera: Southern Peru would “give” stock with a market price of $3.1 billion to Grupo Mexico and would “get” in return an asset worth no more than $1.7 billion.

The important assumption reflected in Goldman’s June 11 presentation was that a bloc of shares of Southern Peru could yield a cash value equal to Southern Peru’s actual stock market price and was thus worth its market value was emphasized by the Court of Chancery. At trial, the Defendants disclaimed any reliance upon a claim that Southern Peru’s stock market price was not a reliable indication of the cash value that a very large bloc of shares – such as the 67.2 million paid to Grupo Mexico – could yield in the market. Thus, the price of the “give” was always easy to discern. The question thus becomes what was the value of the “get.” Unlike Southern Peru, Minera’s value was not the subject of a regular market test. Minera
shares were not publicly traded and thus the company was embedded in the overall value of Grupo Mexico.

The June 11 presentation clearly demonstrates that Goldman, in its evaluation of the May 7 term sheet, could not get the get anywhere near the give. Notably, that presentation marked the first and last time that a give-get analysis appeared in Goldman’s presentations to the Special Committee.

The Court of Chancery described what happened next as curious. The Special Committee began to devalue the “give” in order to make the “get” look closer in value. The DCF analysis of the value of Minera that Goldman presented initially caused concern. As Handelsman stated at trial, “when [the Special Committee] thought that the value of Southern Peru was its market value and the value of Minera [ ] was its discounted cash flow value. . . . those were very different numbers.”

But, the Special Committee’s view changed when Goldman presented it with a DCF analysis of the value of Southern Peru on June 23, 2004. In this June 23 presentation, Goldman provided the Special Committee with a preliminary DCF analysis for Southern Peru analogous to the one that it had provided for Minera in the June 11 presentation. But, the discount rates that Goldman applied to Southern Peru’s cash flows ranged from 8% to 10% instead of 7.5% to 9.5%. Based on Southern Peru management’s
projections, the DCF value generated for Southern Peru using mid-range assumptions (a 9% discount rate and $0.90/lb long-term copper price) was $2.06 billion. This was about $1.1 billion shy of Southern Peru’s market capitalization as of June 21, 2004 ($3.19 billion). Those values “comforted” the Special Committee.  

The Court of Chancery found that “comfort” was an odd word for the Special Committee to use in this context. What Goldman was basically telling the Special Committee was that Southern Peru was being overvalued by the stock market. That is, Goldman told the Special Committee that even though Southern Peru’s stock was worth an obtainable amount in cash, it really was not worth that much in fundamental terms. Thus, although Southern Peru had an actual cash value of $3.19 billion, its “real,” “intrinsic,” or “fundamental” value was only $2.06 billion, and giving $2.06 billion in fundamental value for $1.7 billion in fundamental value was something more reasonable to consider.

The Court of Chancery concluded that the more logical reaction of someone not in the confined mindset of directors of a controlled company may have been that it was a good time to capitalize on the market multiple.

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8 Tr. at 159 (Handelsman) (“I think the committee was somewhat comforted by the fact that the DCF analysis of Minera [ ] and the DCF analysis of [Southern Peru] were not as different as the discounted cash flow analysis of Minera [ ] and the market value of Southern Peru.”).
the company was getting and monetize the asset. The Court of Chancery opined that a third party in the Special Committee’s position might have sold at the top of the market, or returned cash to the Southern Peru stockholders by declaring a special dividend. For example, if it made long-term strategic sense for Grupo Mexico to consolidate Southern Peru and Minera, there was a logical alternative for the Special Committee: ask Grupo Mexico to make a premium to market offer for Southern Peru. Let Grupo Mexico be the buyer, not the seller.

In other words, the Court of Chancery found that by acting like a third-party negotiator with its own money at stake and with the full range of options, the Special Committee would have put Grupo Mexico back on its heels. Doing so would have been consistent with the financial advice it was getting and seemed to accept as correct. The Special Committee could have also looked to use its market-proven stock to buy a company at a good price (a lower multiple to earnings than Southern Peru’s) and then have its value rolled into Southern Peru’s higher market multiple to earnings. That could have included buying Minera at a price equal to its fundamental value using Southern Peru’s market-proven currency.

The Court of Chancery was chagrined that instead of doing any of these things, the Special Committee was “comforted” by the fact that they
could devalue that currency and justify paying *more* for Minera than they originally thought they should.

*Special Committee Moves Toward Relative Valuation*

After the June 23, 2004 presentation, the Special Committee and Goldman began to embrace the idea that the companies should be valued on a relative basis. In a July 8, 2004 presentation to the Special Committee, Goldman included both a revised standalone DCF analysis of Minera and a “Relative Discounted Cash Flow Analysis” in the form of matrices presenting the “indicative number” of Southern Peru shares that should be issued to acquire Minera based on various assumptions. The relative DCF analysis generated a vast range of Southern Peru shares to be issued in the Merger of 28.9 million to 71.3 million. Based on Southern Peru’s July 8, 2004 market value of $40.30 per share, 28.9 million shares of Southern Peru stock had a market value of $1.16 billion, and 71.3 million shares were worth $2.87 billion. In other words, even the highest equity value yielded for Minera by this analysis was short of Grupo Mexico’s actual cash value asking price.

The revised standalone DCF analysis applied the same discount rate and long-term copper price assumptions that Goldman had used in its June 11 presentation to updated projections. This time, by applying a 7.5%
discount rate and $1.00 per pound long-term copper price to Minera management’s projections, Goldman was only able to yield an equity value of $2.8 billion for Minera. Applying the same aggressive assumptions to the projections as adjusted by A&S generated a standalone equity value for Minera of only $2.085 billion. Applying mid-range assumptions (a discount rate of 8.5% and $0.90/lb long-term copper price) to the A&S-adjusted projections yielded an equity value for Minera of only $1.358 billion.

The Special Committee Makes A Counterproposal
Suggests A Fixed-Exchange Ratio

After Goldman’s July 8 presentation, the Special Committee made a counterproposal to Grupo Mexico. The Court of Chancery noted it was “oddly” not mentioned in Southern Peru’s proxy statement describing the Merger (the “Proxy Statement”). In this counterproposal, the Special Committee offered that Southern Peru would acquire Minera by issuing 52 million shares of Southern Peru stock with a then-current market value of $2.095 billion. The Special Committee also proposed implementation of a fixed, rather than a floating, exchange ratio that would set the number of Southern Peru shares issued in the Merger.

From the inception of the Merger, Grupo Mexico had contemplated that the dollar value of the price to be paid by Southern Peru would be fixed (at a number that was always north of $3 billion), while the number of
Southern Peru shares to be issued as consideration would float up or down based on Southern Peru’s trading price around the time of closing. But, the Special Committee was uncomfortable with having to issue a variable amount of shares in the Merger. Handelsman testified that, in its evaluation of Grupo Mexico’s May 7 term sheet, “it was the consensus of the [Special Committee] that a floating exchange rate was a nonstarter” because “no one could predict the number of shares that [Southern Peru] would have to issue in order to come up with the consideration requested.”

The Special Committee wanted a fixed exchange ratio, which would set the number of shares that Southern Peru would issue in the Merger at the time of signing. The dollar value of the Merger consideration at the time of closing would vary with the fluctuations of Southern Peru’s market price. According to the testimony of the Special Committee members, their reasoning was that both Southern Peru’s stock and the copper market had been historically volatile, and a fixed exchange ratio would protect Southern Peru’s stockholders from a situation in which Southern Peru’s stock price went down and Southern Peru would be forced to issue a greater number of shares for Minera in order to meet a fixed dollar value. The Court of Chancery found that position was hard to reconcile with the Special
Committee and Southern Peru’s purported bullishness about the copper market in 2004.

*Grupo Mexico Sticks To Its Demand*

In late July or early August, Grupo Mexico responded to the Special Committee’s counterproposal by suggesting that Southern Peru should issue in excess of 80 million shares of common stock to purchase Minera. It is not clear on the record exactly when Grupo Mexico asked for 80 million shares, but given Southern Peru’s trading history at that time, the market value of that consideration would have been close to $3.1 billion, basically the same place where Grupo Mexico had started. The Special Committee viewed Grupo Mexico’s ask as too high, which is not surprising given that the parties were apparently a full billion dollars in value apart, and negotiations almost broke down.

But, on August 21, 2004, after what is described as “an extraordinary effort” in Southern Peru’s Proxy Statement, Grupo Mexico proposed a new asking price of 67 million shares. On August 20, 2004, Southern Peru was trading at $41.20 per share, so 67 million shares were worth about $2.76 billion on the market, a drop in Grupo Mexico’s ask. Grupo Mexico’s new offer brought the Special Committee back to the negotiating table.
After receiving two term sheets from Grupo Mexico that reflected the 67 million share asking price, the second of which was received on September 8, 2004, when 67 million shares had risen to be worth $3.06 billion on the market, Goldman made another presentation to the Special Committee on September 15, 2004. In addition to updated relative DCF analyses of Southern Peru and Minera (presented only in terms of the number of shares of Southern Peru stock to be issued in the Merger), this presentation contained a “Multiple Approach at Different EBITDA Scenarios,” which was essentially a comparison of Southern Peru and Minera’s market-based equity values, as derived from multiples of Southern Peru’s 2004 and 2005 estimated (or “E”) EBITDA.

Goldman also presented these analyses in terms of the number of Southern Peru shares to be issued to Grupo Mexico, rather than generating standalone values for Minera. The range of shares to be issued at the 2004E EBITDA multiple (5.0x) was 44 to 54 million; at the 2005E multiple (6.3x) Goldman’s analyses yielded a range of 61 to 72 million shares of Southern Peru stock. Based on Southern Peru’s $45.34 share price as of September 15, 2004, 61 to 72 million shares had a cash value of $2.765 billion to $3.26 billion.
The Special Committee sent a new proposed term sheet to Grupo Mexico on September 23, 2004. That term sheet provided for a fixed purchase price of 64 million shares of Southern Peru (translating to a $2.95 billion market value based on Southern Peru’s then-current closing price). The Special Committee’s proposal contained two terms that would protect the minority stockholders of Southern Peru: (1) a 20% collar around the purchase price, which gave both the Special Committee and Grupo Mexico the right to walk away from the Merger if Southern Peru’s stock price went outside of the collar before the stockholder vote; and (2) a voting provision requiring that a majority of the minority stockholders of Southern Peru vote in favor of the Merger. Additionally, the proposal called for Minera’s net debt, which Southern Peru was going to absorb in the Merger, to be capped at $1.105 billion at closing, and contained various corporate governance provisions.

The Special Committee’s Proposed Terms Rejected But The Parties Work Out A Deal

On September 30, 2004, Grupo Mexico sent a counterproposal to the Special Committee, in which Grupo Mexico rejected the Special Committee’s offer of 64 million shares and held firm to its demand for 67 million shares. Grupo Mexico’s counterproposal also rejected the collar and the majority of the minority vote provision, proposing instead that the
Merger be conditioned on the vote of two-thirds of the outstanding stock. Grupo Mexico noted that conditioning the Merger on a two-thirds shareholder vote obviated the need for the walk-away right requested by the Special Committee, because Grupo Mexico would be prevented from approving the Merger unilaterally in the event the stock price was materially higher at the time of the stockholder vote than at the time of Board approval. Grupo Mexico did accept the Special Committee’s proposed $1.05 billion debt cap at closing. The Court of Chancery found that was not much of a concession in light of the fact that Minera was already contractually obligated to pay down its debt and was in the process of doing so.

After the Special Committee received Grupo Mexico’s September 30 counterproposal, the parties reached agreement on certain corporate governance provisions to be included in the Merger Agreement, some of which were originally suggested by Grupo Mexico and some of which were first suggested by the Special Committee. Without saying these provisions were of no benefit at all to Southern Peru and its outside investors, the Court of Chancery did say that they did not factor more importantly in its decision because they do not provide any benefit above the protections of default law that were economically meaningful enough to close the material dollar value gap that existed.
On October 5, 2004, members of the Special Committee met with Grupo Mexico to iron out a final deal. At that meeting, the Special Committee agreed to pay 67 million shares, dropped their demand for the collar, and acceded to most of Grupo Mexico’s demands. The Special Committee justified paying a higher price through what the Court of Chancery described as a series of economic contortions. The Special Committee was able to “bridge the gap” between the 64 million and the 67 million figures by decreasing Minera’s debt cap by another $105 million, and by getting Grupo Mexico to cause Southern Peru to issue a special dividend of $100 million, which had the effect of decreasing the value of Southern Peru’s stock. According to Special Committee member Handelsman, these “bells and whistles” made it so that “the value of what was being . . . acquired in the merger went up, and the value of the specie that was being used in the merger went down . . . ,” giving the Special Committee reason to accept a higher Merger price.

The closing share price of Southern Peru was $53.16 on October 5, 2004, so a purchase price of 67 million shares had a market value of $3.56 billion, which was higher than the dollar value requested by Grupo Mexico in its February 2004 proposal or its original May 7 term sheet.
At that point, the main unresolved issue was the stockholder vote that would be required to approve the Merger. After further negotiations, on October 8, 2004, the Special Committee gave up on its proposed majority of the minority vote provision and agreed to Grupo Mexico’s suggestion that the Merger require only the approval of two-thirds of the outstanding common stock of Southern Peru. Given the size of the holdings of Cerro and Phelps Dodge, Grupo Mexico could achieve a two-thirds vote if either Cerro or Phelps Dodge voted in favor of the Merger.

**Multi-Faceted Dimensions Of Controlling Power: Large Stockholders Who Want To Get Out Support A Strategic, Long-Term Acquisition As A Prelude To Their Own Exit As Stockholders**

One of the members of the Special Committee, Handelsman, represented a large Founding Stockholder, Cerro. The Court of Chancery noted that this might be seen in some ways to have ideally positioned Handelsman to be a very aggressive negotiator. But Handelsman had a problem to deal with, which did not involve Cerro having any self-dealing interest in the sense that Grupo Mexico had. Rather, Grupo Mexico had control over Southern Peru and thus over whether Southern Peru would take the steps necessary to make the Founding Stockholders’ shares marketable under applicable securities regulations. Cerro and Phelps Dodge wanted to monetize their investment in Southern Peru and get out.
Thus, while the Special Committee was negotiating the terms of the Merger, Handelsman was engaged in negotiations of his own with Grupo Mexico. Cerro and Phelps Dodge had been seeking registration rights from Grupo Mexico (in its capacity as Southern Peru’s controller) for their shares of Southern Peru stock, which they needed because of the volume restrictions imposed on affiliates of an issuer by SEC Rule 144.

The Court of Chancery found that it is not clear which party first proposed liquidity and support for the Founding Stockholders in connection with the Merger. But it is plain that the concept appears throughout the term sheets exchanged between Grupo Mexico and the Special Committee, and it is clear that Handelsman knew that registration rights would be part of the deal from the beginning of the Merger negotiations and that thus the deal would enable Cerro to sell as it desired. The Special Committee did not take the lead in negotiating the specific terms of the registration rights provisions – rather, it took the position that it wanted to leave the back-and-forth over the agreement details to Cerro and Grupo Mexico. Handelsman, however, played a key role in the negotiations with Grupo Mexico on Cerro’s behalf.

At trial, Handelsman explained that there were two justifications for pursuing registration rights – one offered benefits exclusive to the Founding Stockholders, and the other offered benefits that would inure to Southern
Peru’s entire stockholder base. The first justification was that Cerro needed the registration rights in order to sell its shares quickly, and Cerro wanted “to get out” of its investment in Southern Peru. The second justification concerned the public market for Southern Peru stock.

Granting registration rights to the Founding Stockholders would allow Cerro and Phelps Dodge to sell their shares, increasing the amount of stock traded on the market and thus increasing Southern Peru’s somewhat thin public float. This would in turn improve stockholder liquidity, generate more analyst exposure, and create a more efficient market for Southern Peru shares, all of which would benefit the minority stockholders. Handelsman thus characterized the registration rights situation as a “win-win,” because “it permitted us to sell our stock” and “it was good for [Southern Peru] because they had a better float and they had a more organized sale of shares.”

Handelsman’s tandem negotiations with Grupo Mexico culminated in Southern Peru giving Cerro registration rights for its shares on October 21, 2004, the same day that the Special Committee approved the Merger. In exchange for registration rights, Cerro expressed its intent to vote its shares in favor of the Merger if the Special Committee recommended it. If the Special Committee made a recommendation against the Merger, or withdrew
its recommendation in favor of it, Cerro was bound by the agreement to vote against the Merger.

Grupo Mexico’s initial proposal, which Handelsman received on October 18, 2004—a mere three days before the Special Committee was to vote on the Merger—was that it would grant Cerro registration rights in exchange for Cerro’s agreement to vote in favor of the Merger. The Special Committee and Handelsman suggested instead that Cerro’s vote on the Merger be tied to whether or not the Special Committee recommended the Merger. After discussing the matter with the Special Committee, Grupo Mexico agreed.

On December 22, 2004, after the Special Committee approved the Merger but well before the stockholder vote, Phelps Dodge entered into an agreement with Grupo Mexico that was similar to Cerro’s, but did not contain a provision requiring Phelps Dodge to vote against the Merger if the Special Committee did. By contrast, Phelps Dodge’s agreement only provided that, [t]aking into account that the Special Committee . . . did recommend . . . the approval of the [Merger], Phelps Dodge “express[es] [its] current intent, to [ ] submit its proxies to vote in favor of the [Merger] . . . .” Thus, in the event that the Special Committee later withdrew its recommendation to approve the Merger, Cerro would be contractually bound
to vote against it, but Grupo Mexico could still achieve the two-thirds vote required to approve the Merger solely with Phelps Dodge’s cooperation. Under the terms of the Merger Agreement, the Special Committee was free to change its recommendation of the Merger, but it was not able to terminate the Merger Agreement on the basis of such a change. Rather, a change in the Special Committee’s recommendation only gave Grupo Mexico the power to terminate the Merger Agreement.

This issue caused the Court of Chancery concern. Although it was not prepared on this record to find that Handelsman consciously agreed to a suboptimal deal for Southern Peru simply to achieve liquidity for Cerro from Grupo Mexico, it had little doubt that Cerro’s own predicament as a stockholder dependent on Grupo Mexico’s whim as a controller for registration rights influenced how Handelsman approached the situation. The Court of Chancery found that did not mean Handelsman consciously gave in, but it did mean that he was less than ideally situated to press hard. Put simply, Cerro was even more subject to the dominion of Grupo Mexico than smaller holders because Grupo Mexico had additional power over it because of the unregistered nature of its shares.

Most important to the Court of Chancery was that Cerro’s desires, when considered alongside the Special Committee’s actions, illustrate the
tendency of control to result in odd behavior. During the negotiations of the Merger, Cerro had no interest in the long-term benefits to Southern Peru of acquiring Minera, nor did Phelps Dodge. Certainly, Cerro did not want any deal so disastrous that it would tank the value of Southern Peru completely, but nor did it have a rational incentive to say no to a suboptimal deal if that risked being locked into its investments.

The Court of Chancery found that Cerro wanted to sell and sell then and there. But as a Special Committee member, Handelsman did not act consistently with that impulse for all stockholders. He did not suggest that Grupo Mexico make an offer for Southern Peru, but instead pursued a long-term strategic transaction in which Southern Peru was the buyer. Accordingly, the Court of Chancery concluded that a short-term seller of a company’s shares caused that company to be a long-term buyer.

*After One Last Price Adjustment, Goldman Makes Its Final Presentation*

On October 13, 2004, Grupo Mexico realized that it owned 99.15% of Minera rather than 98.84%, and the purchase price was adjusted to 67.2 million shares instead of 67 million shares to reflect the change in size of the interest being sold. On October 13, 2004, Southern Peru was trading at $45.90 per share, which meant that 67.2 million shares had a dollar worth of $3.08 billion.
On October 21, 2004, the Special Committee met to consider whether to recommend that the Board approve the Merger. At that meeting, Goldman made a final presentation to the Special Committee. The October 21, 2004 presentation stated that Southern Peru’s implied equity value was $3.69 billion based on its then current market capitalization at a stock price of $46.41 and adjusting for debt. Minera’s implied equity value is stated as $3.146 billion, which was derived entirely from multiplying 67.2 million shares by Southern Peru’s $46.41 stock price and adjusting for the fact that Southern Peru was only buying 99.15% of Minera.

No standalone equity value of Minera was included in the Goldman October 21 presentation. Instead, the presentation included a series of relative DCF analyses and a “Contribution Analysis at Different EBITDA Scenarios,” both of which were presented in terms of a hypothetical number of Southern Peru shares to be issued to Grupo Mexico for Minera. Goldman’s relative DCF analyses provided various matrices showing the

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9 During discovery, two Microsoft Excel worksheets were unearthed that appear to suggest the implied equity values of Minera and Southern Peru that underlie Goldman’s October 21 presentation. One worksheet, which contains the Minera model, indicates an implied equity value for Minera of $1.25 billion using a long-term copper price of $0.90/lb and a discount rate of 8.5%. The other worksheet, which contains the Southern Peru model, indicates an implied equity value for Southern Peru of $1.6 billion using a copper price of $0.90 and a discount rate of 9.0%, and assuming a royalty tax of 2%. Both the Plaintiff’s expert and the Defendants’ expert relied on the projections contained in these worksheets in their reports. The Defendants have also not contested the Plaintiff’s expert’s contention that these worksheets include Goldman’s discounted cash flow estimates as of October 21, 2004.
number of shares of Southern Peru that should be issued in exchange for Minera under various assumptions regarding the discount rate, the long-term copper price, the allocation of tax benefits, and the amount of royalties that Southern Peru would need to pay to the Peruvian government.

As it had in all of its previous presentations, Goldman used a range of long-term copper prices from $0.80 to $1.00 per pound. The DCF analyses generated a range of the number of shares to be issued in the Merger from 47.2 million to 87.8 million. Based on the then-current stock price of $45.92, this translated to $2.17 billion to $4.03 billion in cash value. Assuming the mid-range figures of a discount rate of 8.5% and a long-term copper price of $0.90 per pound, the analyses yielded a range of shares from 60.7 to 78.7 million.

Goldman’s contribution analysis generated a range of 42 million to 56 million shares of Southern Peru to be issued based on an annualized 2004E EBITDA multiple (4.6x) and forecasted 2004E EBITDA multiple (5.0x), and a range of 53 million to 73 million shares based on an updated range of estimated 2005E EBITDA multiples (5.6x to 6.5x). Notably, the 2004E EBITDA multiples did not support the issuance of 67.2 million shares of Southern Peru stock in the Merger. But, 67.2 million shares falls at the
higher end of the range of shares calculated using Southern Peru’s 2005E EBITDA multiples.

As notable, these multiples were not the product of the median of the 2005E EBITDA multiples of comparable companies identified by Goldman (4.8x). Instead, the multiples used were even higher than Southern Peru’s own higher 2005E EBITDA Wall Street consensus (5.5x)—an adjusted version of which was used as the bottom end of the range. These higher multiples were then attributed to Minera, a non-publicly traded company suffering from a variety of financial and operational problems.

Goldman opined that the Merger was fair from a financial perspective to the stockholders of Southern Peru, and provided a written fairness opinion.

**Special Committee And Board Approve The Merger**

After Goldman made its presentation, the Special Committee voted 3-0 to recommend the Merger to the Board. At the last-minute suggestion of Goldman, Handelsman decided not to vote in order to remove any appearance of conflict based on his participation in the negotiation of Cerro’s registration rights, despite the fact that he had been heavily involved in the negotiations from the beginning and his hands had been deep in the
dough of the now fully baked deal. The Board then unanimously approved the Merger and Southern Peru entered into the Merger Agreement.

*Market Reacts To The Merger*

The market reaction to the Merger was mixed and the parties have not presented any reliable evidence about it. That is, neither party had an expert perform an event study analyzing the market reaction to the Merger. Southern Peru’s stock price traded down by 4.6% when the Merger was announced. When the preliminary proxy statement, which provided more financial information regarding the Merger terms, became public on November 22, 2004, Southern Peru’s stock price again declined by 1.45%. But the stock price increased for two days after the final Proxy Statement was filed.

The Court of Chancery found that determining what effect the Merger itself had on this rise is difficult because, as the Plaintiff pointed out, this was not, as the Defendants contended, the first time that Southern Peru and Minera’s financials were presented together. Rather, the same financial statements were in the preliminary Proxy Statement and the stock price fell. However, the Court of Chancery noted that the Plaintiff offered no evidence that these stock market fluctuations provided a reliable basis for assessing the fairness of the deal because it did not conduct a reliable event study.
The Court of Chancery found, in fact, against a backdrop of strong copper prices, the trading price of Southern Peru stock increased substantially by the time the Merger closed. By April 1, 2005, Southern Peru’s stock price had a market value of $55.89 per share, an increase of approximately 21.7% over the October 21, 2004 closing price. The Court of Chancery found this increase could not be attributed to the Merger because other factors were in play. That included the general direction of copper prices, which lifted the market price of not just Southern Peru, but those of its publicly traded competitors. Furthermore, Southern Peru’s own financial performance was very strong.

**Goldman Does Not Update Its Fairness Analysis**

Despite rising Southern Peru share prices and performance, the Special Committee did not ask Goldman to update its fairness analysis at the time of the stockholder vote on the Merger and closing—nearly five months after the Special Committee had voted to recommend it. At trial, Handelsman testified that he called a representative at Goldman to ask whether the transaction was still fair, but the Court of Chancery found that Handelsman’s phone call hardly constitutes a request for an updated fairness analysis. The Court of Chancery also found that the Special Committee’s
failure to determine whether the Merger was still fair at the time of the Merger vote and closing was curious for two reasons.

First, for whatever the reason, Southern Peru’s stock price had gone up substantially since the Merger was announced in October 2004. In March 2005, Southern Peru stock was trading at an average price of $58.56 a share. The Special Committee had agreed to a collarless fixed exchange ratio and did not have a walk-away right. The Court of Chancery noted an adroit Special Committee would have recognized the need to re-evaluate the Merger in light of Southern Peru’s then-current stock price.

Second, Southern Peru’s actual 2004 EBITDA became available before the stockholder vote on the Merger took place, and Southern Peru had smashed through the projections that the Special Committee had used for it. In the October 21 presentation, Goldman used a 2004E EBITDA for Southern Peru of $733 million and a 2004E EBITDA for Minera of $687 million. Southern Peru’s actual 2004 EBITDA was $1.005 billion, 37% more and almost $300 million more than the projections used by Goldman. Minera’s actual 2004 EBITDA, by contrast, was $681 million, 0.8% less than the projections used by Goldman.

The Court of Chancery noted that earlier, in Goldman’s contribution analysis it relied on the values (measured in Southern Peru shares) generated
by applying an aggressive range of Southern Peru’s 2005E EBITDA multiples to Minera’s A&S-adjusted and unadjusted projections, not the 2004E EBITDA multiple, and that the inaccuracy of Southern Peru’s estimated 2004 EBITDA should have given the Special Committee serious pause. If the 2004 EBITDA projections of Southern Peru—which were not optimized and had been prepared by Grupo Mexico-controlled management—were so grossly low, it provided reason to suspect that the 2005 EBITDA projections, which were even lower than the 2004 EBITDA projections, were also materially inaccurate, and that the assumptions forming the basis of Goldman’s contribution analysis should be reconsidered.

Moreover, Southern Peru made $303.4 million in EBITDA in the first quarter of 2005, over 52% of the estimate in Goldman’s fairness presentation for Southern Peru’s 2005 full year performance. Although the first-quarter 2005 financial statements, which covered the period from January 1, 2005 to March 31, 2005, would not have been complete by the time of the stockholder vote, the Court of Chancery reasonably assumed that, as directors of Southern Peru, the Special Committee had access to non-public information about Southern Peru’s monthly profit and loss statements. Southern Peru later beat its EBITDA projections for 2005 by a
very large margin, 135%, a rate well ahead of Minera’s 2005 performance, which beat the deal estimates by a much lower 45%.

The Special Committee’s failure to get a fairness update was even more of a concern to the Court of Chancery because Cerro had agreed to vote against the Merger if the Special Committee changed its recommendation. The Special Committee failed to obtain a majority of the minority vote requirement, but it supposedly agreed to a two-thirds vote requirement instead because a two-thirds vote still prevented Grupo Mexico from unilaterally approving the Merger. This out was only meaningful, however, if the Special Committee took the recommendation process seriously. If the Special Committee maintained its recommendation, Cerro had to vote for the Merger, and its vote combined with Grupo Mexico’s vote would ensure passage. By contrast, if the Special Committee changed its recommendation, Cerro was obligated to vote against the Merger.

The Court of Chancery found the tying of Cerro’s voting agreement to the Special Committee’s recommendation was somewhat odd, in another respect. In a situation involving a third-party merger sale of a company without a controlling stockholder, the third party will often want to lock up some votes in support of a deal. A large blockholder and the target board might therefore negotiate a compromise, whereby the blockholder agrees to
vote yes if the target board or special committee maintains a recommendation in favor of the transaction. In this situation, however, there is a factor not present here. In an arm’s-length deal, the target usually has the flexibility to change its recommendation or terminate the original merger upon certain conditions, including if a superior proposal is available, or an intervening event makes the transaction impossible to recommend in compliance with the target’s fiduciary duties.

Here, by contrast, Grupo Mexico faced no such risk of a competing superior proposal because it controlled Southern Peru. Furthermore, the fiduciary out that the Special Committee negotiated for in the Merger agreement provided only that the Special Committee could change its recommendation in favor of the Merger, not that it could terminate the Merger altogether or avoid a vote on the Merger. The only utility therefore of the recommendation provision was if the Special Committee seriously considered the events between the time of signing and the stockholder vote and made a renewed determination of whether the deal was fair. The Court of Chancery found there is no evidence of such a serious examination, despite important emerging evidence that the transaction’s terms were skewed in favor of Grupo Mexico.
Southern Peru’s Stockholders Approve The Merger

On March 28, 2005, the stockholders of Southern Peru voted to approve the Merger. More than 90% of the stockholders voted in favor of the Merger. The Merger then closed on April 1, 2005. At the time of closing, 67.2 million shares of Southern Peru had a market value of $3.75 billion.

Cerro Sells Its Shares

On June 15, 2005, Cerro, which had a basis in its stock of only $1.32 per share, sold its entire interest in Southern Peru in an underwritten offering at $40.635 per share. Cerro sold its stock at a discount to the then-current market price, as the low-high trading prices for one day before the sale were $43.08 to $44.10 per share. The Court of Chancery found that this illustrated Cerro’s problematic incentives.

Plaintiff Sues Defendants and Special Committee

This derivative suit challenging the Merger, first filed in late 2004, moved too slowly, and it was not until June 30, 2010 that the Plaintiff moved for summary judgment. On August 10, 2010, the Defendants filed a cross-motion for summary judgment, or in the alternative, to shift the burden of proof to the Plaintiff under the entire fairness standard. On August 11, 2010, the individual Special Committee defendants cross-moved for
summary judgment on all claims under Southern Peru’s exculpatory provision adopted under title 8, section 102(b)(7) of the Delaware Code.

At a hearing held on December 21, 2010, the Court of Chancery dismissed the Special Committee defendants from the case because the plaintiff had failed to present evidence supporting a non-exculpated breach of their fiduciary duty of loyalty. It denied all other motions for summary judgment. The Court of Chancery noted that this, of course, did not mean that the Special Committee had acted adroitly or that the remaining defendants, Grupo Mexico and its affiliates, were immune from liability.

In contrast to the Special Committee defendants, precisely because the remaining directors were employed by Grupo Mexico, which had a self-dealing interest directly in conflict with Southern Peru, the exculpatory charter provision was of no benefit to them at that stage, given the factual question regarding their motivations. At trial, these individual Grupo Mexico-affiliated director defendants made no effort to show that they acted in good faith and were entitled to exculpation despite their lack of independence. In other words, the Grupo Mexico-affiliated directors did nothing to distinguish each other and none of them argued that he should not bear liability for breach of the duty of loyalty if the transaction was unfairly advantageous to Grupo Mexico, which had a direct self-dealing interest in
the Merger. Accordingly, the Court of Chancery concluded that their liability would rise or fall with the issue of fairness.

In dismissing the Special Committee members on the summary judgment record, the Court of Chancery necessarily treated the predicament faced by Cerro and Handelsman, which involved facing additional economic pressures as a minority stockholder as a result of Grupo Mexico’s control, differently than a classic self-dealing interest. The Court of Chancery continued to hold that view. Although it believed that Cerro, and therefore Handelsman, were influenced by Cerro’s desire for liquidity as a stockholder, it seemed counterproductive to the Court of Chancery to equate a legitimate concern of a stockholder for liquidity from a controller into a self-dealing interest.

Therefore, the Court of Chancery concluded that there had to be a triable issue regarding whether Handelsman acted in subjective bad faith to force him to trial. The Court of Chancery concluded then on that record that no such issue of fact existed and even on the fuller trial record (where the Plaintiff actually made much more of an effort to pursue this angle), it still could not find that Handelsman acted in bad faith to purposely accept an unfair deal.
Nevertheless, the Court of Chancery found that Cerro, and therefore Handelsman, did have the sort of economic concern that ideally should have been addressed upfront and forthrightly in terms of whether the stockholder’s interest well positioned its representative to serve on a special committee. Thus, although the Court of Chancery continued to be unpersuaded that it could label Handelsman as having acted with the state of mind required to expose him to liability, given the exculpatory charter protection to which he is entitled, it was persuaded that Cerro’s desire to sell influenced how Handelsman approached his duties and compromised his effectiveness.

**TRIAL SCHEDULE PROPERLY MAINTAINED**

The Defendants’ first argument is that the Court of Chancery erred by excluding the testimony of James Del Favero regarding the advice given to the Special Committee by its financial advisor, Goldman, on the ground that Del Favero was identified too late and allowing him to testify would be unfair to the Plaintiff. The Plaintiff contends that the Court of Chancery exercised sound discretion by refusing to modify the stipulated trial schedule in order to permit a new Goldman witness (Del Favero) to be deposed and testify weeks after the trial was scheduled to have concluded, when a video-taped deposition of the Special Committee’s actual Goldman advisor was
already in the record. Both parties agree, however, that whether the trial judge’s ruling is characterized as an exclusion of evidence or a refusal to change the trial scheduling order, either action is reviewed on appeal for an abuse of discretion.\textsuperscript{10}

The record reflects that the Plaintiff obtained commissions for deposing three of the six members of the Goldman team identified in Goldman’s pitch book to the Special Committee. By agreement of the parties, the Plaintiff deposed Martin Sanchez (“Sanchez”) who was the head member of the Goldman team that advised the Special Committee. Sanchez was apparently the Goldman person to whom the Special Committee spoke most often.

Sanchez was deposed on October 21, 2009. He had not worked at Goldman since 2006. Accordingly, at the time of Sanchez’s 2009 deposition, the Defendants were aware that neither they nor Goldman could control whether Sanchez would appear at trial. Sanchez’s deposition was videotaped. Therefore, it was not simply a cold transcript.

The June 20, 2011 trial date was stipulated to by the parties and set by order of the Court of Chancery on February 10, 2011. On May 31, 2011, the Defendants notified the Plaintiff that Sanchez may not appear to testify at

\textsuperscript{10} Barrow v. Abramowicz, 931 A.2d 424, 429 (Del. 2007); Sammons v. Doctors for Emergency Servs., P.A., 913 A.2d 519, 528 (Del. 2006).
trial. The Defendants assert that they immediately began a search—three weeks before trial—for an alternative Goldman witness who would be available to testify. Their initial choice, however, was not Del Favero.

On June 9, 2011, when the Defendants informed the Plaintiff that Sanchez was “definitely not showing up” for trial, they identified Martin Werner (“Werner”), another Goldman member of the Special Committee advisory team, as their witness for trial. The Plaintiff did not object to the late identification of Werner but did seek to confirm that he would be able to depose Werner before trial. The Defendants’ attorney responded, “Of course. I am not optimistic that we will get him to trial, in which case we will have no live Goldman witness.”

On Monday, June 13, 2011, just twenty-four hours before the pretrial stipulation was due and one week before trial was scheduled to commence, the Defendants proposed for the first time that they call Del Favero as their live Goldman witness at trial. Unlike Sanchez or Werner, Del Favero was not offered to testify about the advice Goldman provided to the Special Committee, but rather about Goldman’s internal processes relating to issuing fairness opinions. In proposing to call Del Favero as a witness, the Defendants stated: “We know that Your Honor had commented on[,] at the summary judgment hearing[,] the fairness opinion review process at
Goldman Sachs and had some questions about that. We believe that he would be in a position to answer those questions.”

Del Favero was not available to either testify during the long-established June trial dates or to be deposed before trial began on June 20. The Defendants suggested that Del Favero be deposed after every other trial witness had testified, and that the trial schedule be modified to reconvene sometime in July to allow Del Favero to testify several weeks after the trial was scheduled to conclude.

At the pretrial conference, the Plaintiff objected to the Defendants’ proposal regarding Del Favero for several reasons. First, the Plaintiff argued that allowing Del Favero to be deposed and then testify after every other trial witness had testified, and the trial was otherwise concluded, would be unfair. Second, the Plaintiff objected to Del Favero’s testimony because it was not directly relevant to the issues to be presented at trial since Del Favero was not a member of the Goldman team that advised the Special Committee, and had only attended one Special Committee meeting, during which Goldman only pitched its services. Third, the Plaintiff objected to the subject matter to which Del Favero would testify because it was the same subject matter on which counsel for Goldman and the Special Committee had precluded the Plaintiff from inquiring about at Sanchez’s deposition.
The Court of Chancery held that Del Favero’s inability to testify during the scheduled trial dates, or even to be deposed before the trial began, would unfairly prejudice the Plaintiff. In the Court of Chancery and on appeal, the Defendants assert that a live Goldman witness was central to their defense in light of the trial judge’s comments made at the December 2010 summary judgment argument. In denying the Defendants’ request to depose and to call Del Favero as a witness several weeks after the trial was scheduled to end, the trial judge noted that if his comments six months earlier at the summary judgment argument had caused the Defendants to reconsider their witness selection,

[T]hen I expect that you would have promptly identified this gentleman as a relevant witness and made him available for deposition. It’s simply not fair to the plaintiffs.

Because the other thing about people who want to be witnesses is they get deposed, and when they get deposed, you learn things, and you might ask other people or shape your trial strategy differently. It just adds an unfair element of surprise. And in the 1930s, we decided with the Rules of Civil Procedure to eliminate surprise, at least insofar as your opponent was diligent and asked questions.

It’s regrettable that the lead banker [Sanchez] for a client, even with the passage of time, would decline coming to testify. I understand he may be at a different institution, but, you know, he was the lead banker.

So I’ll watch the [Sanchez] video and we’ll deal with it then. Otherwise, we have a fairly truncated set-up of live witnesses; correct?
On appeal, the Defendants assert that “[i]t is difficult to see any harm – let alone unfair harm” if the bench trial had to be reconvened after several weeks to permit Del Favero to be deposed and to testify because the Plaintiff “allowed this case to languish unprosecuted for many years.” The Defendants also argue, for the first time on appeal, that if deposing Del Favero after all “other trial testimony would have been problematic, the only fair solution would have been to postpone [commencement] of the trial for a short period to avoid prejudicing the Defendants.”

Accordingly, the Defendants contend that the Court of Chancery’s refusal to either postpone the commencement of the trial or to reconvene the trial should be reversed because “[a]llowing a proposed trial schedule to dictate which testimony can and cannot be presented by the parties would be the ‘tail wagging the dog.’” That argument reflects a fundamental misunderstanding of both fact and law. First, as a matter of fact, the June 20 start date for the trial was not proposed. It had been fixed by court order months earlier in February, with the agreement of the parties. Second, as a matter of law, to use the Defendants’ analogy, a trial scheduling order is the dog and not the tail.

This Court has stated that “[p]arties must be mindful that scheduling orders are not merely guidelines but have [the same] full force and effect” as
any other court order. Once the trial dates are set, the trial judge (the dog’s handler) determines whether there is a manifest necessity for amending the trial scheduling order (changing the pace or direction of the dog). That determination is entrusted to the trial judge’s discretion.

The record reflects that the trial judge refused to change the trial scheduling order to accommodate Del Favero’s availability. The trial judge did not exclude Del Favero’s testimony. Nor did the trial judge exclude trial testimony from any other Goldman witness. Sanchez was deposed, and the trial judge specifically stated he would “watch the video” of Sanchez’s deposition. Because the trial judge excluded no testimony, this case is significantly different from the facts in the two cases relied upon by the Defendants, Drejka v. Hitchens Tire Service, Inc., and Sheehan v. Oblates of St. Francis de Sales.

The Defendants’ contention that the Court of Chancery committed reversible error because Del Favero’s availability “could easily be accommodated during a bench trial” continues its misconception of the judicial process. Trial judges are vested with the discretion to resolve

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12 Id.
scheduling matters and to control their own docket.\textsuperscript{15} When an act of judicial discretion is at issue on appeal, this Court cannot substitute its opinion of what is right for that of the trial judge, if the trial judge’s opinion was based upon conscience and reason, as opposed to arbitrariness or capriciousness.\textsuperscript{16}

The Court of Chancery’s decision was neither arbitrary nor capricious. The Defendants sought to modify the stipulated trial schedule at the eleventh hour by requesting that the trial proceed on June 20, as scheduled, but then be continued until “sometime” in July, and that Del Favero be deposed and testify after every other trial witness had testified. The Court of Chancery ruled this was “simply not fair to the plaintiffs.” The Court of Chancery noted that when witnesses “get deposed, you learn things, and you might ask other people or shape your trial strategy differently.” The Court of Chancery also noted that if the Defendants had truly been concerned about having a live Goldman witness testify at trial, they could “have promptly identified this gentleman as a relevant witness and made him available for deposition.”

The Defendants’ assertion that they were prejudiced by not being able to present Del Favero’s live testimony at trial is undermined by the record. First, several days before the trial was scheduled to commence, the

\textsuperscript{15} \textit{Drejka v. Hitchens Tire Serv., Inc.}, 15 A.3d at 1222-24.

\textsuperscript{16} \textit{Sammons v. Doctors for Emergency Servs., P.A.}, 913 A.2d at 528.
 Defendants acknowledged that they might not have a live Goldman witness to present at trial. Therefore, they would have to rely on the videotaped deposition of Sanchez. Second, in making their post-trial entire fairness arguments to the Court of Chancery, the Defendants stated “the record here is replete with evidence showing what Goldman Sachs did and why.”

Del Favero was not available to be deposed, let alone to offer trial testimony, until weeks after the testimony of every other trial witness concluded. The Court of Chancery found the nature of the Defendants’ eleventh-hour request to modify the long-standing trial dates would have been unfair to the Plaintiff. That finding is supported by the record and the product of a logical deductive reasoning process. We hold that the Court of Chancery properly exercised its discretion by refusing to modify the stipulated trial scheduling order to accommodate Del Favero’s availability.

**BURDEN SHIFTING ANALYSIS**

The Defendants’ second argument on appeal is that the Court of Chancery committed reversible error by failing to determine which party bore the burden of proof before trial. The Defendants submit that the Court of Chancery further erred by ultimately allocating the burden to the Defendants, because the Special Committee was independent, was well-
functioning, and did not rely on the controlling shareholder for the information that formed the basis for its recommendation.

When a transaction involving self-dealing by a controlling shareholder is challenged, the applicable standard of judicial review is entire fairness, with the defendants having the burden of persuasion. In other words, the defendants bear the burden of proving that the transaction with the controlling stockholder was entirely fair to the minority stockholders. In the Court of Chancery and on appeal, both the Plaintiff and the Defendants agree that entire fairness is the appropriate standard of judicial review for the Merger.18

The entire fairness standard has two parts: fair dealing and fair price. Fair dealing “embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained.”20 Fair price “relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value,

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18 See Emerald Partners v. Berlin, 726 A.2d 1215, 1221 (Del. 1999); Kahn v. Tremont Corp., 694 A.2d at 428-29.
19 Weinberger v. UOP, Inc., 457 A.2d at 711.
20 Id.
earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company’s stock.”

In *Kahn v. Lynch Communication Systems, Inc.*, this Court held that when the entire fairness standard applies, the defendants may shift the burden of persuasion by one of two means: first, they may show that the transaction was approved by a well-functioning committee of independent directors; or second, they may show that the transaction was approved by an informed vote of a majority of the minority shareholders. Nevertheless, even when an interested cash-out merger transaction receives the informed approval of a majority of minority stockholders or a well-functioning committee of independent directors, an entire fairness analysis is the only proper standard of review. Accordingly, “[r]egardless of where the burden lies, when a controlling shareholder stands on both sides of the transaction the conduct of the parties will be viewed under the more exacting standard of entire fairness as opposed to the more deferential business judgment standard.”

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21 *Id.* (citations omitted).
23 *See id.* at 1117 (citation omitted).
24 *Id*.
25 *Kahn v. Tremont Corp.*, 694 A.2d at 428 (citation omitted).
In *Emerald Partners v. Berlin*,\(^{26}\) we noted that “[w]hen the standard of review is entire fairness, *ab initio*, director defendants can move for summary judgment on either the issue of entire fairness or the issue of burden shifting.”\(^{27}\) In this case, the Defendants filed a summary judgment motion, arguing that the Special Committee process shifted the burden of persuasion under the preponderance standard to the Plaintiff. The Court of Chancery found the summary judgment record was insufficient to determine that question of burden shifting prior to trial.

*Lynch* and its progeny\(^{28}\) set forth what is required of an independent committee for the defendants to obtain a burden shift. In this case, the Court of Chancery recognized that, in *Kahn v. Tremont Corp.*,\(^{29}\) this Court held that “[t]o obtain the benefit of a burden shifting, the controlling shareholder must do more than establish a perfunctory special committee of outside directors.”\(^{30}\) Rather, the special committee must “function in a manner which indicates that the controlling shareholder did not dictate the terms of

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\(^{27}\) *Id.* at 98-99.

\(^{28}\) See *Emerald Partners v. Berlin*, 726 A.2d 1215, 1222-23 (Del. 1999) (describing that the special committee must exert “real bargaining power” in order for defendants to obtain a burden shift); see also *Beam v. Stewart*, 845 A.2d 1040, 1055 n.45 (Del. 2004) (noting that the test articulated in *Tremont* requires a determination as to whether the committee members “*in fact*” functioned independently (citing *Kahn v. Tremont Corp.*, 694 A.2d 422, 429-30 (Del. 1997))).

\(^{29}\) *Kahn v. Tremont Corp.*, 694 A.2d 422 (Del. 1997).

\(^{30}\) *Id.* at 429 (citation omitted).
the transaction and that the committee exercised real bargaining power ‘at an arms-length.’”\textsuperscript{31} In this case, the Court of Chancery properly concluded that:

A close look at \textit{Tremont} suggests that the [burden shifting] inquiry must focus on how the special committee actually negotiated the deal — was it “well functioning”\textsuperscript{32} — rather than just how the committee was set up. The test, therefore, seems to contemplate a look back at the substance, and efficacy, of the special committee’s negotiations, rather than just a look at the composition and mandate of the special committee.\textsuperscript{33}

The Court of Chancery expressed its concern about the practical implications of such a factually intensive burden shifting inquiry because it is “deeply enmeshed” in the ultimate entire fairness analysis.

Subsuming within the burden shift analysis questions of whether the special committee was substantively effective in its negotiations with the controlling stockholder—questions fraught with factual complexity—will, absent unique circumstances, guarantee that the burden shift will rarely be determinable on the basis of the pretrial record alone.\textsuperscript{34} If we take seriously the notion, as I do, that a standard of review is meant to serve as the framework through which the court evaluates the parties’ evidence and trial testimony in reaching a decision, and, as important, the framework through which the litigants determine

\textsuperscript{31} \textit{Id.} (citation omitted).
\textsuperscript{32} \textit{Id.} at 428.
\textsuperscript{33} \textit{Accord Kahn v. Lynch Commc’n Sys., Inc.}, 638 A.2d at 1121 (“[U]nless the controlling or dominating shareholder can demonstrate that it has not only formed an independent committee but also replicated a process ‘as though each of the contending parties had in fact exerted its bargaining power at arm’s length,’ the burden of proving entire fairness will not shift.” (citing \textit{Weinberger v. UOP, Inc.}, 457 A.2d 701, 709-10 n.7 (Del. 1983))).
\textsuperscript{34} \textit{Cf. In re Cysive, Inc. S’holders Litig.}, 836 A.2d 531, 549 (Del. Ch. 2003).
how best to prepare their cases for trial,\textsuperscript{35} it is problematic to adopt an analytical approach whereby the burden allocation can only be determined in a post-trial opinion, after all the evidence and all the arguments have been presented to the court.

We agree with these thoughtful comments. However, the general inability to decide burden shifting prior to trial is directly related to the reason why entire fairness remains the applicable standard of review even when an independent committee is utilized, \textit{i.e.}, “because the underlying factors which raise the specter of impropriety can never be completely eradicated and still require careful judicial scrutiny.”\textsuperscript{36}

This case is a perfect example. The Court of Chancery could not decide whether to shift the burden based upon the pretrial record. After hearing all of the evidence presented at trial, the Court of Chancery found that, although the independence of the Special Committee was not challenged, “from inception, the Special Committee fell victim to a controlled mindset and allowed Grupo Mexico to dictate the terms and structure of the merger.” The Court of Chancery concluded that “although

\begin{footnotes}
\item[35] See William T. Allen et al., \textit{Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law}, 56 Bus. L. 1287, 1303-04 n.63 (2001) (noting the practical problems litigants face when the burden of proof they are forced to bear is not made clear until after the trial); \textit{cf. In re Cysive, Inc. S’holders Litig.}, 836 A.2d at 549.
\item[36] \textit{Kahn v. Tremont Corp.}, 694 A.2d at 428 (citing \textit{Weinberger v. UOP, Inc.}, 457 A.2d at 710). \textit{See also In re Cox Commc’ns, Inc. S’holders Litig.}, 879 A.2d 604, 617 (Del. Ch. 2005) (“All in all, it is perhaps fairest and more sensible to read \textit{Lynch} as being premised on a sincere concern that mergers with controlling stockholders involve an extraordinary potential for the exploitation by powerful insiders of their informational advantages and their voting clout.”).
\end{footnotes}
the Special Committee members were competent businessmen and may have had the best of intentions, they allowed themselves to be hemmed in by the controlling stockholder’s demands.”

We recognize that there are practical problems for litigants when the issue of burden shifting is not decided until after the trial.37 For example, “in order to prove that a burden shift occurred because of an effective special committee, the defendants must present evidence of a fair process. Because they must present this evidence affirmatively, they have to act like they have the burden of persuasion throughout the entire trial court process.”38 That is exactly what happened in this case.

Delaware has long adhered to the principle that the controlling shareholders have the burden of proving an interested transaction was entirely fair.39 However, in order to encourage the use of procedural devices that foster fair pricing, such as special committees and minority stockholder approval conditions, this Court has provided transactional proponents with what has been described as a “modest procedural benefit – the shifting of the burden of persuasion on the ultimate issue of entire fairness to the plaintiffs – if the transaction proponents proved, in a factually intensive way, that the

38 In re Cysive, Inc. S’holders Litig., 836 A.2d at 549.
39 Kahn v. Tremont Corp., 694 A.2d at 428-29.
procedural devices had, in fact, operated with integrity.”\footnote{In re Cox Commc’ns, Inc. S’holders Litig., 879 A.2d at 617 (emphasis added).} We emphasize that in \textit{Cox}, the procedural benefit of burden shifting was characterized as “modest.”

Once again, in this case, the Court of Chancery expressed uncertainty about whether “there is much, if any, practical implication of a burden shift.” According to the Court of Chancery, “[t]he practical effect of the \textit{Lynch} doctrine’s burden shift is slight. One reason why this is so is that shifting the burden of persuasion under a preponderance standard is not a major move, if one assumes . . . that the outcome of very few cases hinges on what happens if . . . the evidence is in equipoise.”\footnote{In re Cysive, Inc. S’holders Litig., 836 A.2d at 548.}

In its post-trial opinion, the Court of Chancery found that the burden of persuasion remained with the Defendants, because the Special Committee was not “well functioning.”\footnote{Kahn v. Tremont Corp., 694 A.2d at 428.} The trial judge also found, “however, that this determination matters little because I am not stuck in equipoise about the issue of fairness. Regardless of who bears the burden, I conclude that the Merger was unfair to Southern Peru and its stockholders.”

Nothing in the record reflects that a different outcome would have resulted if either the burden of proof had been shifted to the Plaintiff, or the
Defendants had been advised prior to trial that the burden had not shifted. The record reflects that, by agreement of the parties, each witness other than the Plaintiff’s expert was called in direct examination by the Defendants, and then was cross-examined by the Plaintiff. The Defendants have not identified any decision they might have made differently, if they had been advised prior to trial that the burden of proof had not shifted.

The Court of Chancery concluded that this is not a case where the evidence of fairness or unfairness stood in equipoise. It found that the evidence of unfairness was so overwhelming that the question of who had the burden of proof at trial was irrelevant to the outcome. That determination is supported by the record. The Court of Chancery committed no error by not allocating the burden of proof before trial, in accordance with our prior precedents. In the absence of a renewed request by the Defendants during trial that the burden be shifted to the Plaintiff, the burden of proving entire fairness remained with the Defendants throughout the trial.43 The record reflects that is how the trial in this case was conducted.

Nevertheless, we recognize that the purpose of providing defendants with the opportunity to seek a burden shift is not only to encourage the use

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of special committees, but also to provide a reliable pretrial guide for the parties regarding who has the burden of persuasion. Therefore, which party bears the burden of proof must be determined, if possible, before the trial begins. The Court of Chancery has noted that, in the interest of having certainty, “it is unsurprising that few defendants have sought a pretrial hearing to determine who bears the burden of persuasion on fairness” given “the factually intense nature of the burden-shifting inquiry” and the “modest benefit” gained from the shift.

The failure to shift the burden is not outcome determinative under the entire fairness standard of review. We have concluded that, because the only “modest” effect of the burden shift is to make the plaintiff prove unfairness under a preponderance of the evidence standard, the benefits of clarity in terms of trial presentation outweigh the costs of continuing to decide either during or after trial whether the burden has shifted.

44 See, e.g., In re Cysive, Inc. S’holders Litig., 836 A.2d at 548 (“Because these devices are thought, however, to be useful and to incline transactions towards fairness, the Lynch doctrine encourages them by giving defendants the benefits of a burden shift if either one of the devices is employed.”).
45 See William T. Allen et al., Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law, 56 Bus. L. 1287, 1297 (2001) (explaining that standards of review should be functional, in that they should serve as a “useful tool that aids the court in deciding the fiduciary duty issue” rather than merely “signal the result or outcome”).
46 See In re Cysive, Inc. S’holders Litig., 836 A.2d at 549 (noting that it is inefficient for defendants to seek a pretrial ruling on the burden-shift unless the discovery process has generated a sufficient factual record to make such a determination).
Accordingly, we hold prospectively that, if the record does not permit a pretrial determination that the defendants are entitled to a burden shift, the burden of persuasion will remain with the defendants throughout the trial to demonstrate the entire fairness of the interested transaction.

The Defendants argue that if the Court of Chancery rarely determines the issue of burden shifting on the basis of a pretrial record, corporations will be dissuaded from forming special committees of independent directors and from seeking approval of an interested transaction by an informed vote of a majority of the minority shareholders. That argument underestimates the importance of either or both actions to the process component—fair dealing—of the entire fairness standard. This Court has repeatedly held that any board process is materially enhanced when the decision is attributable to independent directors.47 Accordingly, judicial review for entire fairness of how the transaction was structured, negotiated, disclosed to the directors, and approved by the directors will be significantly influenced by the work product of a properly functioning special committee of independent directors.48 Similarly, the issue of how stockholder approval was obtained

47 See, e.g., Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985); Weinberger v. UOP, Inc., 457 A.2d at 709 n.7.
48 Weinberger v. UOP, Inc., 457 A.2d at 709 n.7.
will be significantly influenced by the affirmative vote of a majority of the
minority stockholders.\textsuperscript{49}

A fair process usually results in a fair price. Therefore, the
proponents of an interested transaction will continue to be incentivized to
put a fair dealing process in place that promotes judicial confidence in the
entire fairness of the transaction price. Accordingly, we have no doubt that
the effective use of a properly functioning special committee of independent
directors and the informed conditional approval of a majority of minority
stockholders will continue to be integral parts of the best practices that are
used to establish a fair dealing process.

\textbf{UNFAIR DEALING PRODUCES UNFAIR PRICE}

Although the entire fairness standard has two components, the entire
fairness analysis is “not a bifurcated one as between fair dealing and fair
price. All aspects of the issue must be examined as a whole since the
question is one of entire fairness.”\textsuperscript{50} In a non-fraudulent transaction, “price
may be the preponderant consideration outweighing other features of the
merger.”\textsuperscript{51} Evidence of fair dealing has significant probative value to

\textsuperscript{49} Id. at 712, 714.
\textsuperscript{50} Id. at 711.
\textsuperscript{51} Id.
demonstrate the fairness of the price obtained. The paramount consideration, however, is whether the price was a fair one.\textsuperscript{52}

The Court of Chancery found that the process by which the Merger was negotiated and approved was not fair and did not result in the payment of a fair price. Because the issues relating to fair dealing and fair price were so intertwined, the Court of Chancery did not separate its analysis, but rather treated them together in an integrated examination. That approach is consistent with the inherent non-bifurcated nature of the entire fairness standard of review.\textsuperscript{53}

The independence of the members of the Special Committee was not challenged by the Plaintiff. The Court of Chancery found that the Special Committee members were competent, well-qualified individuals with business experience. The Court of Chancery also found that the Special Committee was “given the resources to hire outside advisors, and it hired not only respected, top tier of the market financial and legal counsel, but also a mining consultant and Mexican counsel.” Nevertheless, the Court of Chancery found that, although the Special Committee members had their “hands . . . on the oars[.],” the boat went “if anywhere, backward[.].”

\textsuperscript{53} Weinberger v. UOP, Inc., 457 A.2d at 711.
The Special Committee began its work with a narrow mandate, to “evaluate a transaction suggested by the majority stockholder.” The Court of Chancery found that “the Special Committee members’ understanding of their mandate . . . evidenced their lack of certainty about whether the Special Committee could do more than just evaluate the Merger.” The Court of Chancery concluded that, although the Special Committee went beyond its limited mandate and engaged in negotiations, “its approach to negotiations was stilted and influenced by its uncertainty about whether it was actually empowered to negotiate.”

Accordingly, the Court of Chancery determined that “from inception, the Special Committee fell victim to a controlled mindset and allowed Grupo Mexico to dictate the terms and structure of the Merger.” The Special Committee did not ask for an expansion of its mandate to look at alternatives. Instead, the Court of Chancery found that the Special Committee “accepted that only one type of transaction was on the table, a purchase of Minera by Southern Peru.”

In its post-trial opinion, the Court of Chancery stated that this “acceptance” influenced the ultimate determination of unfairness, because “it took off the table other options that would have generated a real market check and also deprived the Special Committee of negotiating leverage to
extract better terms.” The Court of Chancery summarized these dynamics as follows:

In sum, although the Special Committee members were competent businessmen and may have had the best of intentions, they allowed themselves to be hemmed in by the controlling stockholder’s demands. Throughout the negotiation process, the Special Committee’s and Goldman’s focus was on finding a way to get the terms of the Merger structure proposed by Grupo Mexico to make sense, rather than aggressively testing the assumption that the Merger was a good idea in the first place.

Goldman made its first presentation to the Special Committee on June 11, 2004. Goldman’s conclusions were summarized in an “Illustrative Give/Get Analysis.” The Court of Chancery found this analysis “made patent the stark disparity between Grupo Mexico’s asking price and Goldman’s valuation of Minera: Southern Peru would ‘give’ stock with a market price of $3.1 billion to Grupo Mexico and would ‘get’ in return an asset worth no more than $1.7 billion.”

According to the Court of Chancery, the Special Committee’s controlled mindset was illustrated by what happened after Goldman’s initial analysis could not value the “get”—Minera—anywhere near Grupo Mexico’s asking price, the “give”:

From a negotiating perspective, that should have signaled that a strong response to Grupo Mexico was necessary and incited some effort to broaden, not narrow, the lens. Instead, Goldman and the Special Committee went to strenuous lengths to
equalize the values of Southern Peru and Minera. The onus should have been on Grupo Mexico to prove Minera was worth $3.1 billion, but instead of pushing back on Grupo Mexico’s analysis, the Special Committee and Goldman devalued Southern Peru and topped up the value of Minera. The actions of the Special Committee and Goldman undermine the defendants’ argument that the process leading up to the Merger was fair and lend credence to the plaintiff’s contention that the process leading up to the Merger was an exercise in rationalization.

The Court of Chancery found that, following Goldman’s first presentation, the Special Committee abandoned a focus on whether Southern Peru would get $3.1 billion in value in an exchange. Instead, the Special Committee moved to a “relative valuation” methodology that involved comparing the values of Southern Peru and Minera. On June 23, 2004, Goldman advised the Special Committee that Southern Peru’s DCF value was $2.06 billion and, thus, approximately $1.1 billion below Southern Peru’s actual NYSE market price at that time.

The Court of Chancery was troubled by the fact that the Special Committee did not use this valuation gap to question the relative valuation methodology. Instead, the Special Committee was “comforted” by the analysis, which allowed them to conclude that DCF value of Southern Peru’s stock (the “give”) was not really worth its market value of $3.1 billion. The Court of Chancery found that:
A reasonable special committee would not have taken the results of those analyses by Goldman and blithely moved on to relative valuation, without any continuing and relentless focus on the actual give-get involved in real cash terms. But, this Special Committee was in the altered state of a controlled mindset. Instead of pushing Grupo Mexico into the range suggested by Goldman’s analysis of Minera’s fundamental value, the Special Committee went backwards to accommodate Grupo Mexico’s asking price—an asking price that never really changed.

The Court of Chancery concluded “[a] reasonable third-party buyer free from a controlled mindset would not have ignored a fundamental economic fact that is not in dispute here—in 2004, Southern Peru stock could have been sold for [the] price at which it was trading on the New York Stock Exchange.”

In this appeal, the Defendants contend that the Court of Chancery did not understand Goldman’s analysis and rejected their relative valuation of Minera without an evidentiary basis. According to the Defendants, a relative valuation analysis is the appropriate way to perform an accurate comparison of the value of Southern Peru, a publicly-traded company, and Minera, a private company. In fact, the Defendants continue to argue that relative valuation is the only way to perform an “apples-to-apples” comparison of Southern Peru and Minera.

Moreover, the Defendants assert that Goldman and the Special Committee did actually believe that Southern Peru’s market price accurately
reflected the company’s value. According to the Defendants, however, there were certain assumptions reflected in Southern Peru’s market price that were not reflected in its DCF value, i.e., the market’s view of future copper price increases. Therefore, the Defendants submit that:

If the DCF analysis was missing some element of value for [Southern Peru], it would also miss that very same element of value for Minera. In short, at the time that Goldman was evaluating Minera, its analysis of [Southern Peru] demonstrated that mining companies were trading at a premium to their DCF values. The relative valuation method allowed Goldman to account for this information in its analysis and value Minera fairly.

Accordingly, the Defendants argue that the Court of Chancery failed to recognize that the difference between Southern Peru’s DCF and market values also implied a difference between Minera’s DCF value and its market value.

The Defendants take umbrage at the Court of Chancery’s statement that “the relative valuation technique is not alchemy that turns a sub-optimal deal into a fair one.” The Court of Chancery’s critical comments regarding a relative value methodology were simply a continuation of its criticism about how the Special Committee operated. The record indicates that the Special Committee’s controlled mindset was reflected in its assignments to Goldman. According to the Court of Chancery, “Goldman appears to have
helped its client rationalize the one strategic option available within the controlled mindset that pervaded the Special Committee’s process.”

The Defendants continue to argue that the Court of Chancery would have understood that “relative valuation” was the “appropriate way” to compare the values of Southern Peru and Minera if a Goldman witness (Del Favero) had testified at trial. As noted earlier, that argument is inconsistent with the Defendants’ post-trial assertion that the record was replete with evidence of what Goldman did (a relative valuation analysis) and why that was done. That argument also disregards the trial testimony of the Defendants’ expert witness, Professor Schwartz, who used the same relative valuation methodology as Goldman.

Prior to trial, the Defendants represented that Professor Schwartz would be called at trial to “explain that the most reliable way to compare the value of [Southern Peru] and Minera for purposes of the Merger was to conduct a relative valuation.” In their pretrial proffer, the Defendants also represented that Professor Schwartz’s testimony would demonstrate that “based on relative valuations of Minera and [Southern Peru] using a reasonable range of copper prices . . . the results uniformly show that the Merger was fair to [Southern Peru] and its stockholders.”
At trial, Professor Schwartz attributed the difference between Southern Peru’s DCF value and its market value to the fact that the market was valuing Southern Peru’s stock “at an implied copper price of $1.30.” Professor Schwartz testified, “if I use $1.30, it gives me the market price of [Southern Peru] and it gives me a market price of Minera Mexico which still makes the transaction fair.” In other words, it was fair to “give” Grupo Mexico $3.75 billion of Southern Peru stock because Minera’s DCF value, using an assumed long-term copper price of $1.30, implied a “get” of more than $3.7 billion.

The Court of Chancery found that Professor Schwartz’s conclusion that the market was assuming a long-term copper price of $1.30 in valuing Southern Peru was based entirely on post-hoc speculation, because there was no credible evidence in the record that anyone at the time of the Merger contemplated a $1.30 long-term copper price. In fact, Southern Peru’s own public filings referenced $0.90 per pound as the appropriate long-term copper price. The Court of Chancery summarized its findings as follows:

Thus, Schwartz’s conclusion that the market was assuming a long-term copper price of $1.30 in valuing Southern Peru appears to be based entirely on post-hoc speculation. Put simply, there is no credible evidence of the Special Committee, in the heat of battle, believing that the long-term copper price was actually $1.30 per pound but using $0.90 instead to give Southern Peru an advantage in the negotiation process.
The Court of Chancery also noted that Professor Schwartz did not produce a standalone equity value for Minera that justified issuing shares of Southern Peru stock worth $3.1 billion at the time the Merger Agreement was signed.

The record reflects that the Court of Chancery did understand the Defendants’ argument and that its rejection of the Defendants’ “relative valuation” of Minera was the result of an orderly and logical deductive reasoning process that is supported by the record. The Court of Chancery acknowledged that relative valuation is a valid valuation methodology. It also recognized, however, that since “relative valuation” is a comparison of the DCF values of Minera and Southern Peru, the result is only as reliable as the input data used for each company. The record reflects that the Court of Chancery carefully explained its factual findings that the data inputs Goldman and Professor Schwartz used for Southern Peru in the Defendants’ relative valuation model for Minera were unreliable.

The Court of Chancery weighed the evidence presented at trial and set forth in detail why it was not persuaded that “the Special Committee relied on truly equal inputs for its analyses of the two companies.” The Court of Chancery found that “Goldman and the Special Committee went to strenuous lengths to equalize the value of Southern Peru and Minera.” In particular, the Court of Chancery found that “when performing the relative
valuation analysis, the cash flows for Minera were optimized to make Minera an attractive acquisition target, but no such dressing up was done for Southern Peru.”

The Court of Chancery also noted that Goldman never advised the Special Committee that Minera was worth $3.1 billion, or that Minera could be acquired at, or would trade at, a premium to its DCF value if it were a public company. Nevertheless, the Court of Chancery found “the Special Committee did not respond to its intuition that Southern Peru was overvalued in a way consistent with its fiduciary duties or the way that a third-party buyer would have.” Accordingly, the Court of Chancery concluded:

The Special Committee’s cramped perspective resulted in a strange deal dynamic, in which a majority stockholder kept its eye on the ball – actual value benchmarked to cash – and a Special Committee lost sight of market reality in an attempt to rationalize doing a deal of the kind the majority stockholder proposed. After this game of controlled mindset twister and the contortions it involved, the Special Committee agreed to give away over $3 billion worth of actual cash value in exchange for something worth demonstrably less, and to do so on terms that by consummation made the value gap even worse, without using any of its contractual leverage to stop the deal or renegotiate its terms. Because the deal was unfair, the defendants breached their fiduciary duty of loyalty.

Entire fairness is a standard by which the Court of Chancery must carefully analyze the factual circumstances, apply a disciplined balancing
test to its findings, and articulate the bases upon which it decides the ultimate question of entire fairness. The record reflects that the Court of Chancery applied a “disciplined balancing test,” taking into account all relevant factors. The Court of Chancery considered the issues of fair dealing and fair price in a comprehensive and complete manner. The Court of Chancery found the process by which the Merger was negotiated and approved constituted unfair dealing and that resulted in the payment of an unfair price.

The Court of Chancery’s post-trial determination of entire fairness must be accorded substantial deference on appeal. The Court of Chancery’s factual findings are supported by the record and its conclusions are the product of an orderly and logical deductive reasoning process. Accordingly, the Court of Chancery’s judgment, that the Merger consideration was not entirely fair, is affirmed.

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55 See Nixon v. Blackwell, 626 A.2d at 1373.
56 Cinerama, Inc. v. Technicolor, Inc., 663 A.2d at 1180; Rosenblatt v. Getty Oil Co., 493 A.2d at 937.
57 Cinerama, Inc. v. Technicolor, Inc., 663 A.2d at 1180.
58 Id.
DAMAGE AWARD PROPER

In the Court of Chancery, the Plaintiff sought an equitable remedy that cancelled or required the Defendants to return to Southern Peru the shares that Southern Peru issued in excess of Minera’s fair value. In the alternative, the Plaintiff asked for rescissory damages in the amount of the then present market value of the excess number of shares that Grupo Mexico held as a result of Southern Peru paying an unfair price in the Merger.

In the Court of Chancery and on appeal, the Defendants argue that no damages are due because the Merger consideration was more than fair. In support of that argument, the Defendants rely on the fact that Southern Peru stockholders should be grateful, because the market value of Southern Peru’s stock continued on a generally upward trajectory in the years after the Merger. Alternatively, the Defendants argue that any damage award should be at most a fraction of the amount sought by the Plaintiff, and, in particular, that the Plaintiff has waived the right to seek rescissory damages because of “his lethargic approach to litigating the case.”

The Court of Chancery rejected the Defendants’ argument that the post-Merger performance of Southern Peru’s stock eliminates the need for damages. It noted that the Defendants did not “present a reliable event study about the market’s reaction to the Merger, and there is evidence that the
market did not view the Merger as fair in spite of material gaps in disclosure about the fairness of the Merger.” The trial judge was of the opinion that a “transaction like the Merger can be unfair, in the sense that it is below what a real arms-length deal would have been priced at, while not tanking a strong company with sound fundamentals in a rising market, such as the one in which Southern Peru was a participant. That remains my firm sense here . . . .” The Court of Chancery’s decision to award some amount of damages is supported by the record and the product of a logical deductive reasoning process.

Nevertheless, the Court of Chancery did agree with the Defendants’ argument that the Plaintiff’s delay in litigating the case rendered it inequitable to use a rescission-based approach in awarding damages. 59 The Court of Chancery reached that determination because “[r]escissory damages are the economic equivalent of rescission and[,] therefore[,] if rescission itself is unwarranted because of the plaintiff’s delay, so are rescissory damages.” 60 Instead of entering a rescission-based remedy, the Court of Chancery decided to craft a damage award, as explained below:

[The award] approximates the difference between the price that the Special Committee would have approved had the Merger

been entirely fair (i.e., absent a breach of fiduciary duties) and the price that the Special Committee actually agreed to pay. In other words, I will take the difference between this fair price and the market value of 67.2 million shares of Southern Peru stock as of the Merger date. That difference, divided by the average closing price of Southern Peru stock in the 20 trading days preceding the issuance of this opinion, will determine the number of shares that the defendants must return to Southern Peru. Furthermore, because of the plaintiff’s delay, I will only grant simple interest on that amount, calculated at the statutory rate since the date of the Merger.61

After determining the nature of the damage award, the Court of Chancery determined the appropriate valuation for the price that the Special Committee should have paid. To calculate a fair price for remedy purposes, the Court of Chancery balanced three separate values. The first value was a standalone DCF value of Minera. Using defendant-friendly modifications to the Plaintiff’s expert’s DCF valuation, the Court of Chancery calculated that a standalone equity value for Minera as of October 21, 2004 was $2.452 billion. The second value was the market value of the Special Committee’s 52 million share counteroffer made in July 2004, “which was sized based on months of due diligence by Goldman about Minera’s standalone value, calculated as of the date on which the Special Committee approved the Merger.” Because Grupo Mexico wanted a dollar value of stock, the Court of Chancery fixed the value at what 52 million Southern Peru shares were

61 (citations omitted).
worth as of October 21, 2004, the date on which the Special Committee approved the Merger, at $2.388 billion, giving Minera credit for the price growth to that date. The third value was the equity value of Minera derived from a comparable companies analysis using the companies identified by Goldman. Using the median premium for merger transactions in 2004, calculated by Mergerstat to be 23.4%, and applying that premium to the value derived from the Court of Chancery’s comparable companies analysis yielded a value of $2.45 billion.

The Court of Chancery gave those three separate values equal weight in its damages equation: (($2.452 billion + $2.388 billion + $2.45 billion)/3). The result was a value of $2.43 billion. It then made an adjustment to reflect the fact that Southern Peru bought 99.15%, not 100%, of Minera, which yielded a value of $2.409 billion. The value of 67.2 million Southern Peru shares as of the Merger Date was $3.756 billion. Therefore, the base damage award by the Court of Chancery amounted to $1.347 billion. The Court of Chancery then added interest from the Merger Date, at the statutory rate, without compounding and with that interest to run until time of the judgment and until payment.

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62 $55.89 closing price x 67,200,000 = $3,755,808,000.
63 $3.756 billion - $2.409 billion = $1.347 billion.
The Court of Chancery stated that Grupo Mexico could satisfy the judgment by agreeing to return to Southern Peru such number of its shares as are necessary to satisfy this remedy. The Court of Chancery also ruled that any attorneys’ fees would be paid out of the award.

The Defendants’ first objection to the Court of Chancery’s calculation of damages is that its methodology included the Special Committee’s counteroffer of July 2004 as a measure of the true value of Minera. The Defendants assert that the counteroffer was “based only on Goldman’s preliminary analyses of the companies before the completion of due diligence. And there was no evidence this was anything other than what it appears to be – a negotiating position.”

The Court of Chancery explained its reason for including the counteroffer in its determination of damages, as follows:

In fact, you know, the formula I used, one of the things that I did to be conservative was actually to use a bargaining position of the special committee. And I used it not because I thought it was an aggressive bargaining position of the special committee, but to give the special committee and its advisors some credit for thinking. It was one of the few indications in the record of something that they thought was actually a responsible value.

And so it was actually not put in there in any way to inflate. It was actually to give some credit to the special committee. If I had thought that it was an absurd ask, I would have never used it. I didn’t think it was any, really, aggressive bargaining move. I didn’t actually see any aggressive bargaining moves by the
special committee. I saw some innovative valuation moves, but I didn’t see any aggressive bargaining moves.

The record reflects that the value of Minera pursuant to the counteroffer ($2.388 billion) was very close to the other two values used by the Court of Chancery ($2.452 billion and $2.45 billion). The Court of Chancery properly exercised its discretion—for the reasons it stated—by including the Special Committee’s counteroffer as one of the component parts in its calculation of damages. Therefore, the Defendants’ argument to the contrary is without merit.

The Defendants also argue that the Court of Chancery “essentially became its own expert witness regarding damages by basing its valuation, at least in part, on its own computer models.” In support of that argument, the Defendants rely upon the following statement by the trial judge during oral argument on the fee award: “I’m not going to disclose everything that we got on our computer system, but I can tell you that there are very credible remedial approaches in this case that would have resulted in a much higher award.” The Defendants submit that “[i]n the absence of proof from [the] Plaintiff, this speculation and outside-the-record financial modeling is impermissible.”

In making a decision on damages, or any other matter, the trial court must set forth its reasons. This provides the parties with a record basis to
challenge the decision. It also enables a reviewing court to properly discharge its appellate function.

In this case, the Court of Chancery explained the reasons for its calculation of damages with meticulous detail. That complete transparency of its actual deliberative process provided the Defendants with a comprehensive record to use in challenging the Court of Chancery’s damage award on appeal and for this Court to review. Accordingly, any remedial approaches that the Court of Chancery may have considered and rejected are irrelevant.

The Court of Chancery has the historic power “to grant such . . . relief as the facts of a particular case may dictate.”64 Both parties agree that an award of damages by the Court of Chancery after trial in an entire fairness proceeding is reviewed on appeal for abuse of discretion.65 It is also undisputed that the Court of Chancery has greater discretion when making an award of damages in an action for breach of duty of loyalty than it would when assessing fair value in an appraisal action.66

64 Weinberger v. UOP, Inc., 457 A.2d at 714; see also Glanding v. Industrial Trust Co., 45 A.2d 553, 555 (Del. 1945) (“[T]he Court of Chancery of the State of Delaware inherited its equity jurisdiction from the English Courts.”); 1 Victor B. Woolley, Woolley on Delaware Practice § 56 (1906).
66 Id. at 441.
In this case, the Court of Chancery awarded damages based on the difference in value between what was paid (the “give”) and the value of what was received (the “get”). In addition to an actual award of monetary relief, the Court of Chancery had the authority to grant pre- and post-judgment interest, and to determine the form of that interest.\(^{67}\) The record reflects that the Court of Chancery properly exercised its broad historic discretionary powers in fashioning a remedy and making its award of damages. Therefore, the Court of Chancery’s judgment awarding damages is affirmed.

**ATTORNEYS’ FEE AWARD**

The Plaintiff petitioned for attorneys’ fees and expenses representing 22.5% of the recovery plus post-judgment interest. The Court of Chancery awarded 15% of the $2.031 billion judgment, or $304,742,604.45, plus post-judgment interest until the attorneys’ fee and expense award is satisfied (“Fee Award”). The Court of Chancery found that the Fee Award “fairly implements the most important factors our Supreme Court has highlighted under *Sugarland*,\(^{68}\) including the importance of benefits,” and “creates a healthy incentive for plaintiff’s lawyers to actually seek real achievement for

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\(^{67}\) *Summa Corp. v. Trans World Airlines, Inc.*, 540 A.2d 403, 409 (Del. 1988).

\(^{68}\) *Sugarland Indus., Inc. v. Thomas*, 420 A.2d 142 (Del. 1980).
the companies that they represent in derivative actions and the classes that
they represent in class actions.”

On appeal, the Defendants contend “the Court of Chancery abuse[d]
its discretion by granting an unreasonable fee award of over $304 million
that pays the Plaintiff’s counsel over $35,000 per hour worked and 66 times
the value of their time and expenses.” Specifically, they argue the Court of
Chancery gave the first Sugarland factor, i.e. the benefit achieved,
“dispositive weight,” and that the remaining factors do not support the Fee
Award. The Defendants also argue that the Court of Chancery erred by
failing to assess the reasonableness of the Fee Award. They submit that the
Court of Chancery did not: correctly apply a declining percentage analysis
given the size of the judgment; consider whether the resulting hourly rate
was reasonable under the circumstances; and evaluate whether the Fee
Award conformed to the Delaware Rules of Professional Conduct.69 The
Defendants further contend that the Court of Chancery committed reversible
error by “[a]llowing Plaintiff’s attorneys to collect fees premised upon the

69 This argument is without merit. Rule 1.5(c) of the Rules of Professional Conduct
expressly contemplates fees that are based on a percentage. Comment [3] to the Rule
provides that the determination of whether a particular contingent fee is reasonable is to
be based on the relevant factors and applicable law. In this case, the Court of Chancery
made that reasonableness determination based on the relevant factors and applicable law
set forth in Sugarland by this Court.
nearly $700 million in prejudgment interest . . . even in spite of the fact that
the delay impeded a full presentation of the evidence.”

Common Fund Doctrine

Under the common fund doctrine, “a litigant or a lawyer who recovers
a common fund for the benefit of persons other than himself or his client is
entitled to a reasonable attorney’s fee from the fund as a whole.” The
common fund doctrine is a well-established basis for awarding attorneys’
fees in the Court of Chancery. It is founded on the equitable principle that
those who have profited from litigation should share its costs.

“As typically, successful derivative or class action suits which result in
the recovery of money or property wrongfully diverted from the corporation
. . . are viewed as fund creating actions.” In this case, the record supports
the Court of Chancery’s finding that Defendants breached their duty of
loyalty by exchanging over $3 billion worth of actual cash value for
something that was worth much less. The record also supports the Court of
Chancery’s determination that the $2.031 billion judgment resulted in the

70 Boeing Co. v. Van Gemert, 444 U.S. 472, 478 (1980) (citations omitted). See also
Goodrich v. E.F. Hutton Group, Inc., 681 A.2d 1039, 1049 (Del. 1996) (“[T]he condition precedent to invoking the common fund doctrine is a demonstration that a common benefit has been conferred.”).
71 Goodrich v. E.F. Hutton Group, Inc., 681 A.2d at 1044 (citations omitted).
72 Id. (citing Boeing Co. v. Van Gemert, 444 U.S. at 478; Maurer v. Int’l Re-Insurance
Corp., 95 A.2d 827, 830 (Del. 1953)).
73 Tandycrafts, Inc. v. Initio Partners, 562 A.2d 1162, 1164-65 (Del. 1989) (citing CM &
M Group, Inc. v. Carroll, 453 A.2d 788, 795 (Del. 1982).
creation of a common fund. Accordingly, Plaintiff’s counsel, whose efforts resulted in the creation of that common fund, are entitled to receive a reasonable fee and reimbursement for expenses from that fund.\textsuperscript{74}

\textit{Calculating Common Fund Attorneys’ Fees}

In the United States, there are two methods of calculating fee awards in common fund cases: the percentage of the fund method and the lodestar method.\textsuperscript{75} Under a percentage of the fund method, courts calculate fees based on a reasonable percentage of the common fund.\textsuperscript{76} The lodestar method multiplies hours reasonably expended against a reasonable hourly rate to produce a “lodestar,” which can then be adjusted through application of a “multiplier,” to account for additional factors such as the contingent nature of the case and the quality of an attorney’s work.\textsuperscript{77}

Beginning in 1881, fees were calculated and awarded from a common fund based on a percentage of that fund.\textsuperscript{78} Fees continued to be calculated on a percentage approach for almost 100 years. During the 1970s, however,

\textsuperscript{74} \textit{Goodrich v. E.F. Hutton Group, Inc.}, 681 A.2d at 1045 (citing \textit{Weinberger v. UOP, Inc.}, 517 A.2d 653, 654-55 (Del. Ch. 1986); \textit{Chrysler Corp. v. Dann}, 223 A.2d 384, 386 (Del. 1966)).

\textsuperscript{75} \textit{See Goodrich v. E.F. Hutton Group, Inc.}, 681 A.2d at 1046-47; Federal Judicial Center, \textsc{MANUAL FOR COMPLEX LITIGATION (FOURTH)} § 14.121 at 187 (2004).

\textsuperscript{76} \textit{See Goodrich v. E.F. Hutton Group, Inc.}, 681 A.2d at 1046.

\textsuperscript{77} \textit{Id.} (citations omitted).

courts began to use the lodestar method to calculate fee awards in common fund cases.\textsuperscript{79}

In the 1980s, two events led to the reconsideration of the lodestar method. First, in 1984, the United States Supreme Court suggested that an award in a common fund case should be based upon a percentage of the fund.\textsuperscript{80} By that time, “the point that ‘under the common fund doctrine . . . a reasonable fee is based on a percentage of the fund bestowed on the class’ was so well settled that no more than a footnote was needed to make it.”\textsuperscript{81} Second, in 1985, a Third Circuit Task Force issued a report concluding that all attorney fee awards in common fund cases should be structured as a percentage of the fund.\textsuperscript{82} The report criticized the use of the lodestar method for determining the reasonableness of attorneys’ fees in common fund class actions and listed nine deficiencies in the lodestar method.\textsuperscript{83} “Ultimately, the Third Circuit allowed district court judges to exercise discretion in employing the percentage of the fund method, the lodestar method, or some combination of both, but the concerns voiced in the 1985 report, as well as


\textsuperscript{83} Id. at 246-50.
in other publications, were not fully answered.”84 Today, after several years of experimentation with the lodestar method, “the vast majority of courts of appeals now permit or direct courts to use the percentage method in common-fund cases.”85

**Delaware’s Sugarland Standard**

In *Sugarland Industries, Inc. v. Thomas*, this Court rejected any mechanical approach to determining common fund fee awards.86 In particular, we explicitly disapproved the Third Circuit’s “lodestar method.”87 Therefore, Delaware courts are not required to award fees based on hourly rates that may not be commensurate with the value of the common fund created by the attorneys’ efforts. Similarly, in *Sugarland*, we did not adopt an inflexible percentage of the fund approach.

Instead, we held that the Court of Chancery should consider and weigh the following factors in making an equitable award of attorney fees: 1) the results achieved; 2) the time and effort of counsel; 3) the relative complexities of the litigation; 4) any contingency factor; and 5) the standing

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84 *Seinfeld v. Coker*, 847 A.2d 330, 335 (Del. Ch. 2000) (citing *In re General Motors Corp. Pick-Up Truck Fuel Tank Products Liability Litig.*, 55 F.3d 768, 821 (3d Cir. 1995)).


86 *Sugarland Indus., Inc. v. Thomas*, 420 A.2d at 149-50.

87 *Id.* at 150
and ability of counsel involved.\textsuperscript{88} Delaware courts have assigned the greatest weight to the benefit achieved in litigation.\textsuperscript{89}

**Sugarland Factors Applied**

The determination of any attorney fee award is a matter within the sound judicial discretion of the Court of Chancery.\textsuperscript{90} In this case, the Court of Chancery considered and applied each of the *Sugarland* factors. In rendering its decision on the Fee Award, the Court of Chancery began with the following overview:

When the efforts of a plaintiff on behalf of a corporation result in the creation of a common fund, the Court should award reasonable attorneys’ fees and expenses incurred by the plaintiff in achieving the benefit. Typically a-percentage-of-the-benefit approach is used if the benefit achieved is quantifiable . . . . And determining the percentage of the fund to award is a matter within the Court’s discretion.

\textsuperscript{88} Id. at 149. See also *Loral Space & Commc’ns, Inc. v. Highland Crusader Offshore Partners, L.P.*, 977 A.2d 867, 870 (Del. 2009).


\textsuperscript{90} *Johnston v. Arbitrium (Cayman Islands) Handels AG*, 720 A.2d 542, 547 (Del. 1998).
The aptly-named *Sugarland* factor[s], perhaps never more aptly-named than today, tell us to look at the benefit achieved, the difficulty and complexity of the litigation, the effort expended, the risk-taking, [and] the standing and ability of counsel. But the most important factor, the cases suggest, is the benefit. In this case it’s enormous—a common fund of over 1.3 billion plus interest.

The Court of Chancery then addressed each of the *Sugarland* factors. The result was its decision to award the Plaintiff’s counsel attorneys’ fees and expenses equal to 15% of the amount of the common fund.

**Benefit Achieved**

With regard to the first and most important of the *Sugarland* factors, the benefit achieved, the Court of Chancery found that “[t]he plaintiffs here indisputably prosecuted this action through trial and secured an immense economic benefit for Southern Peru.” The Court of Chancery stated that “this isn’t small and this isn’t monitoring. This isn’t a case where it’s rounding, where the plaintiffs share credit.” The Court of Chancery concluded that “anything that was achieved . . . by this litigation [was] by these plaintiffs.” With pre-judgment interest, the benefit achieved through the litigation amounts to more than $2 billion. Post-judgment interest

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91 *Cf. In re Cox Commc’ns, Inc. S’holders Litig.*, 879 A.2d at 609-612 (awarding a “substantially smaller [attorney] fee” than that requested by plaintiffs for settlement of claims challenging a fully negotiable merger proposal where no appreciable risk was taken and credit was “shared” with special committee).
accrues at more than $212,000 per day. The extraordinary benefit that was achieved in this case merits a very substantial award of attorneys’ fees.

The Defendants take issue with the fact that the Fee Award was based upon the total damage award, which included pre-judgment interest. They contend that including such interest in the damage award is reversible error because the Plaintiff took too long to litigate this matter. The record reflects that the Court of Chancery considered the slow pace of the litigation in making the Fee Award. In response to the Defendants’ arguments, the trial judge stated: “I’m not going to . . . exclude interest altogether. I get that argument . . . . The interest I awarded is fairly earned by the plaintiffs. It’s a lower amount. And, again, I’ve taken that [pace of litigation] into account by the percentage that I’m awarding.” The Court of Chancery’s decision to include pre-judgment interest in its determination of the benefit achieved was not arbitrary or capricious, but rather was the product of a logical and deductive reasoning process.

**Difficulty and Complexity**

The Court of Chancery carefully considered the difficulty and complexity of the case. It noted that the Plaintiff’s attorneys had succeeded in presenting complex valuation issues in a persuasive way before a skeptical court:
They advanced a theory of the case that a judge of this court, me, was reluctant to embrace. I denied their motion for summary judgment. I think I gave [Plaintiff’s counsel] a good amount of grief that day about the theory. I asked a lot of questions at trial because I was still skeptical of the theory. It faced some of the best lawyers I know and am privileged to have come before me, and they won. . . .

I think when you talk about *Sugarland* and you talk about the difficulty of the litigation, was this difficult? Yes, it was. Were the defense counsel formidable and among the best that we have in our bar? They were. Did the plaintiffs have to do a lot of good work to get done and have to push back against a judge who was resistant to their approach? They did.

The Plaintiff’s attorneys established at trial that Southern Peru had agreed to overpay its controlling shareholder by more than fifty percent ($3.7 billion compared to $2.4 billion). In doing so, the Court of Chancery found that the Plaintiff had to “deal with very complex financial and valuation issues” while being “up against major league, first-rate legal talent.” This factor supports a substantial award of attorneys’ fees.

**Contingent Representation**

The Plaintiff’s attorneys pursued this case on a contingent fee basis. They invested a significant number of hours and incurred more than one million dollars in expenses. The Defendants litigated vigorously and forced the Plaintiff to go to trial to obtain any monetary recovery. Accordingly, in undertaking this representation, the Plaintiff’s counsel incurred all of the classic contingent fee risks, including the ultimate risk—no recovery
whatsoever. The Court of Chancery acknowledged that the fee award was “going to be a lot per hour to people who get paid by the hour,” but that in this case, the Plaintiff’s attorneys’ compensation was never based on an hourly rate. Therefore, the Court of Chancery found that an award representing 15% of the common fund was reasonable in light of the absolute risk taken by Plaintiff’s counsel in prosecuting the case through trial on a fully contingent fee basis.

**Standing and Ability of Counsel**

The Court of Chancery acknowledged that it was familiar with Plaintiff’s counsel and had respect for their skills and record of success. The Defendants do not contest the skill, ability or reputation of the Plaintiff’s counsel. They argue, however, that the Court of Chancery “should have weighed more heavily Plaintiff’s counsel’s undoubted ability against the causal manner in which this case was litigated.” The record does not support that argument.

First, the Court of Chancery credited the Defendants’ arguments that a rescission-based remedy was inappropriate because of the Plaintiff’s delay in litigating the case. Second, the Court of Chancery noted that the record could justify a much larger award of attorneys’ fees, but it ultimately applied a “conservative metric because of Plaintiff’s delay.” Accordingly, the
record reflects that the Court of Chancery’s Fee Award took into account the length of time involved in getting this case to trial.

**Time and Effort of Counsel**

The effort by the Plaintiff’s attorneys was significant. The Plaintiff’s attorneys reviewed approximately 282,046 pages in document production and traveled outside the United States to take multiple depositions. They also engaged in vigorously contested pretrial motion practice. They invested their firms’ resources by incurring over a million dollars of out-of-pocket expenses. Most significantly, however, the Plaintiff’s attorneys took this case to trial and prevailed. We repeat the Court of Chancery’s statement: “anything that was achieved . . . by this litigation [was] by [the Plaintiff’s attorneys].”

The primary focus of the Defendants’ challenge to the Court of Chancery’s Fee Award is on the hourly rate that it implies, given that Plaintiff’s counsel spent 8,597 hours on this case. They argue that the Court of Chancery abused its discretion by failing to consider the hourly rate implied by the Fee Award as a “backstop check” on the reasonableness of the fee. The Court of Chancery recognized the implications of this argument: “I get it. It’s approximately—on what I awarded, approximately
$35,000 an hour, if you look at it that way.” However, the Court of Chancery did not look at it that way.

Sugarland does not require, as the Defendants argue, courts to use the hourly rate implied by a percentage fee award, rather than the benefit conferred, as the benchmark for determining a reasonable fee award. To the contrary, in Sugarland, this Court refused to adopt the Third Circuit’s lodestar approach, which primarily focuses on the time spent.92 There, we summarized that methodology, as follows:

Under Lindy I, the Court’s analysis must begin with a calculation of the number of hours to be credited to the attorney seeking compensation. The total hours multiplied by the approved hourly rate is the “lodestar” in the Third Circuit’s formulation. It has, indeed, been said that the time approach is virtually the sole consideration in making a fee ruling under Lindy I.93

In rejecting the lodestar methodology, we held the Court of Chancery judges “should not be obliged to make the kind of elaborate analyses called for by the several opinions in Lindy I and Lindy II.”94

Moreover, in Sugarland, this Court rejected an argument that was almost identical to the one the Defendants make in this case. There, the corporation asserted on appeal that in assessing the reasonableness of the fee

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92 Sugarland Indus., Inc. v. Thomas, 420 A.2d at 150.
93 Id.
94 Id.
the Court of Chancery should have given more weight to the plaintiffs’ counsel’s hours and hourly rate.\textsuperscript{95} This Court expressly rejected the use of time expended as the principal basis for determining fees awarded to plaintiff’s counsel.\textsuperscript{96} Instead, we held that the \textit{benefit achieved} by the litigation is the “common yardstick by which a plaintiff’s counsel is compensated in a successful derivative action.”\textsuperscript{97}

In applying that “common yardstick,” we affirmed the Court of Chancery’s determination that the plaintiffs’ attorneys were “entitled to a \textit{fair percentage of the benefit} inuring to Sugarland and its stockholders . . . .”\textsuperscript{98} We also affirmed the Court of Chancery’s determination that 20\% of the benefit achieved was a reasonable award.\textsuperscript{99} Our only disagreement with the Court of Chancery in \textit{Sugarland} was the “benefit” to which the percentage of 20\% should be applied.\textsuperscript{100}

In this case, the Court of Chancery properly realized that “[m]ore important than hours is ‘effort, as in what Plaintiffs’ counsel actually

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\textsuperscript{95} \textit{Id.} at 149-50.
\textsuperscript{96} \textit{Id.} at 150.
\textsuperscript{98} \textit{Sugarland Indus., Inc. v. Thomas}, 420 A.2d at 150 (emphasis added).
\textsuperscript{99} \textit{Id.} at 151.
\textsuperscript{100} \textit{Id.} at 150-51.
\end{flushright}
In applying *Sugarland*, the Court of Chancery understood that it had to look at the hours and effort expended, but recognized the general principle from *Sugarland* that the hours that counsel worked is of secondary importance to the benefit achieved. In this case, the Court of Chancery was aware of the hourly rate that its Fee Award implied and nonetheless properly concluded that, in accordance with *Sugarland*, the Plaintiff’s attorneys were entitled to a *fair percentage* of the benefit, *i.e.*, common fund. It then found that “an award of 15 percent of the revised judgment, inclusive of expenses . . . is appropriate.”

The Defendants’ alternative to their hourly argument is a challenge to the fairness of the percentage awarded by the Court of Chancery. The Defendants contend that the Court of Chancery erred by failing to apply a declining percentage analysis in its fee determination. According to the Defendants, this Court’s decision in *Goodrich v. E.F. Hutton Group, Inc.* supports the *per se* use of a declining percentage. We disagree.

In *Goodrich*, we discussed the declining percentage of the fund concept, noting that the Court of Chancery rightly “acknowledged the merit of the emerging judicial consensus that the percentage of recovery awarded

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102 *Sugarland Indus., Inc. v. Thomas*, 420 A.2d at 147.
should ‘decrease as the size of the [common] fund increases.’”\footnote{Id. at 1048 (citations omitted).} We also emphasized, however, that the multiple factor \textit{Sugarland} approach to determining attorneys’ fee awards remained adequate for purposes of applying the equitable common fund doctrine.\footnote{Id. at 1050.} Therefore, the use of a declining percentage, in applying the \textit{Sugarland} factors in common fund cases, is a matter of discretion and is not required \textit{per se}.

In this case, the record does not support the Defendants’ argument that the Court of Chancery failed to apply a “declining percentage.” In exercising its discretion and explaining the basis for the Fee Award, the Court of Chancery reduced the award from the 22.5\% requested by the Plaintiff to 15\% based, at least in part, on its consideration of the Defendants’ argument that the percentage should be smaller in light of the size of the judgment:

Now, I gave a percentage of only 15 percent rather than 20 percent, 22 1/2 percent, or even 33 percent because the amount that’s requested is large. I did take that into account. \textit{Maybe I am embracing what is a declining thing.} I’ve tried to take into account all the factors, the delay, what was at stake, and what was reasonable. And I gave defendants credit for their arguments by going down to 15 percent. The only basis for some further reduction is, again, envy or there’s just some level of too much, there’s some natural existing limit on what lawyers as a class should get when they do a deal.\footnote{Emphasis added.}
Thus, the record reflects that the Court of Chancery did reduce the percentage it awarded due to the large amount of the judgment. The Defendants are really arguing that the Fee Award percentage did not “decline” enough.

**Fee Award Percentage Discretionary**

In determining the amount of a reasonable fee award, our holding in *Sugarland* assigns the greatest weight to the benefit achieved in the litigation. When the benefit is quantifiable, as in this case, by the creation of a common fund, *Sugarland* calls for an award of attorneys’ fees based upon a percentage of the benefit. The *Sugarland* factor that is given the greatest emphasis is the size of the fund created, because a “common fund is itself the measure of success . . . [and] represents the benchmark from which a reasonable fee will be awarded.”

Delaware case law supports a wide range of reasonable percentages for attorneys’ fees, but 33% is “the very top of the range of percentages.” The Court of Chancery has a history of awarding lower percentages of the

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107 *See Sugarland Indus., Inc. v. Thomas*, 420 A.2d at 149-50.
benefit where cases have settled before trial.\textsuperscript{110} When a case settles early, the Court of Chancery tends to award 10-15\% of the monetary benefit conferred.\textsuperscript{111} When a case settles after the plaintiffs have engaged in meaningful litigation efforts, typically including multiple depositions and some level of motion practice, fee awards in the Court of Chancery range from 15-25\% of the monetary benefits conferred.\textsuperscript{112} “A study of recent Delaware fee awards finds that the average amount of fees awarded when derivative and class actions settle for both monetary and therapeutic consideration is approximately 23\% of the monetary benefit conferred; the


median is 25%.”

Higher percentages are warranted when cases progress to a post-trial adjudication.

The reasonableness of the percentage awarded by the Court of Chancery is reviewed for an abuse of discretion. The question presented in this case is how to properly determine a reasonable percentage for a fee award in a megafund case. A recent study by the economic consulting firm National Economic Research Associates (“NERA”) demonstrates that overall as the settlement values increase, the amount of fee percentages and expenses decrease. The study reports that median attorneys’ fees awarded from settlements in securities class actions are generally in the range of 22%


115 See Sugarland Indus., Inc. v. Thomas, 420 A.2d at 149.

116 See Dr. Renzo Comolli et al., Recent Trends in Securities Class Action Litigation: 2012 Mid-Year Review, NERA Econ. Consulting, July 2012, at p.31. For an example, the study finds fee awards in securities class actions amount to 27% in cases where the settlement is between $25 million and $100 million, 22.4% in cases where the settlement is between $100 million and $500 million, and 11.1% in cases where the settlement is above $500 million. Id. Figure 31. See also Federal Judicial Center, MANUAL FOR COMPLEX LITIGATION § 14.121 at 187 (2004) (“Attorney fees awarded under the percentage method are often between 25% and 30% of the fund.”).
to 30% of the recovery until the recovery approaches approximately $500 million.\textsuperscript{117} Once in the vicinity of over $500 million, the median attorneys’ fees falls to 11%.\textsuperscript{118}

Appellate courts that have examined a “megafund rule” requiring a fee percentage to be capped at a low figure when the recovery is quite high, have rejected it as a blanket rule. It is now accepted that “[a] mechanical, a \textit{per se} application of the ‘megafund rule’ is not necessarily reasonable under the circumstances of a case.”\textsuperscript{119} For example, although the Third Circuit recognized that its jurisprudence confirms the use of a sliding scale as “appropriate” for percentage fee awards in large recovery cases, it has held that trial judges are not required to use a declining percentage approach in every case involving a large settlement.\textsuperscript{120} The Third Circuit reasoned that it has “generally cautioned against overly formulaic approaches in assessing and determining the amounts and reasonableness of attorneys’ fees,” and that “the declining percentage concept does not trump the fact-intensive


\textsuperscript{118} \textit{Id}.

\textsuperscript{119} \textit{In re Enron Corp. Sec., Deriv. & ERISA Litig.}, 586 F.Supp.2d 732, 753-54 (S.D. Tex. 2008) (citing cases and concluding that “[a] mechanical, a \textit{per se} application of the ‘megafund rule’ is not necessarily reasonable under the circumstances of a case.”).

\textsuperscript{120} \textit{In re Rite Aid Corp. Sec. Litig.}, 396 F.3d 294, 302-03 (3d Cir. 2005) (“[T]here is no rule that a district court must apply a declining percentage reduction in every settlement involving a sizable fund.”).
Prudential/Gunter [factors,]"\textsuperscript{121} which are similar to this Court’s Sugarland factors.

Although several courts have recognized the declining percentage principle, none have imposed it as a \textit{per se} rule.\textsuperscript{122} In Goodrich, we held the Court of Chancery did not abuse its discretion by rejecting a “\textit{per se} rule that awarded attorney’s fees as a percentage in relation to the maximum common fund available, without regard to the benefits actually realized by class members.”\textsuperscript{123} We reasoned that “[t]he adoption of a mandatory methodology or particular mathematical model for determining attorney’s fees in common fund cases would be the antithesis of the equitable principles from which the concept of such awards originated.”\textsuperscript{124} That \textit{ratio decidendi} equally applies in this case.

Therefore, we decline to impose either a cap or the mandatory use of any particular range of percentages for determining attorneys’ fees in megafund cases. As we stated in Goodrich, “[n]ew mechanical guidelines are neither appropriate nor needed for the Court of Chancery.”\textsuperscript{125} We

\textsuperscript{121} \textit{Id} at 303.
\textsuperscript{122} \textit{Id.} at 302-03 (3d Cir. 2005).
\textsuperscript{123} \textit{Goodrich v. E.F. Hutton Group, Inc.}, 681 A.2d at 1049.
\textsuperscript{124} \textit{Id.} at 1050.
\textsuperscript{125} \textit{Id.}
reaffirm that our holding in *Sugarland* sets forth the proper factors for determining attorneys’ fee awards in all common fund cases.\(^{126}\)

**Fee Award Reasonable Percentage**

The percentage awarded as attorneys’ fees from a common fund is committed to the sound discretion of the Court of Chancery.\(^{127}\) In determining the amount of a fee award, the Court of Chancery must consider the unique circumstances of each case. Its reasons for the selection of a given percentage must be stated with particularity.

The Court of Chancery quantified the Fee Award as 15% of the common fund.\(^{128}\) The Court of Chancery addressed the *Sugarland* factors and how those factors caused it to arrive at that percentage, as follows:

The plaintiffs here indisputably *prosecuted this action through trial* and secured an *immense economic benefit* for Southern Peru. I’ve already said—and I’m going to take into account—I already encouraged the plaintiffs to be conservative in their application because they weren’t as rapid in moving this as I would have liked. I don’t think, though, that you can sort of ignore them, to say because they didn’t invest six years on this case on an *entirely contingent basis*, deal with very *complex financial and valuation issues*, and ignore the fact that they were *up against major league, first-rate legal talent*.

\(^{126}\) *Sugarland Indus., Inc. v. Thomas*, 420 A.2d 142 (Del. 1980).
\(^{127}\) *Chrysler Corp. v. Dann*, 223 A.2d 384, 386 (Del. 1966).
“[O]ne of the things . . . the defendants got credit for in this case is that the plaintiffs were slow. . . . I also took that into account in how I approach interest in the case. . . . [I] also . . . have to take that into account in the percentage I award for the plaintiffs[,] . . . [a]nd I took that into account. I took some cap factors into account, setting the interest in what I did . . . . I have to take some away from the plaintiff’s . . . lawyers on that . . . frankly, there were grounds for me to award more to the company. And I didn’t. And—and so that is going to impel me to reduce the percentage that I’m awarding . . . ." 129

We repeat the Court of Chancery’s conclusion:

Now, I gave a percentage of only 15 percent rather than 20 percent, 22 1/2 percent, or even 33 percent because the amount that’s requested is large. I did take that into account. Maybe I am embracing what is a declining thing. I’ve tried to take into account all the factors, the delay, what was at stake, and what was reasonable. And I gave defendants credit for their arguments by going down to 15 percent. The only basis for some further reduction is, again, envy or there’s just some level of too much, there’s some natural existing limit on what lawyers as a class should get when they do a deal.

We review an award of attorneys’ fees for an abuse of discretion.130

When an act of judicial discretion is under appellate review, this Court may not substitute its notions of what is right for those of the trial judge, if his or her judgment was the product of reason and conscience, as opposed to being either arbitrary or capricious.131 As we recently stated, the challenge of quantifying fee awards is entrusted to the trial judge and will not be

129 Emphasis added.
130 Sugarland Indus., Inc. v. Thomas, 420 A.2d at 149.
disturbed on appeal in the absence of capriciousness or factual findings that are clearly wrong.\footnote{Emak Worldwide, Inc. v. Kurz, ___ A.3d ___, 2012 WL 1319771, at *3 (Del. Ch. Apr. 17, 2012).}

In this case, the Court of Chancery carefully weighed and considered all of the Sugarland factors. The record supports its factual findings and its well-reasoned decision that a reasonable attorneys’ fee is 15% of the benefit created. Accordingly, we hold that the Fee Award was a proper exercise of the Court of Chancery’s broad discretion in applying the Sugarland factors under the circumstances of this case.

\textit{Conclusion}

The judgment of the Court of Chancery, awarding more than $2 billion in damages and more than $304 million in attorneys’ fees, is affirmed.

\textbf{BERGER,} Justice, concurring and dissenting:

I concur in the majority’s decision on the merits, but I would find that the trial court did not properly apply the law when it awarded attorneys’ fees, and respectfully dissent on that issue.

The majority finds no abuse of discretion in the trial court’s decision to award more than $304 million in attorneys’ fees. The majority says that
the trial court applied the settled standards set forth in Sugarland Industries, Inc. v. Thomas, and that this Court may not substitute its notions of what is right for those of the trial court. But the trial court did not apply Sugarland, it applied its own world views on incentives, bankers’ compensation, and envy.

To be sure, the trial court recited the Sugarland standards. Its analysis, however, focused on the perceived need to incentivize plaintiffs’ lawyers to take cases to trial. The trial court hypothesized that a stockholder plaintiff would be happy with a lawyer who says, “If you get really rich because of me, I want to get rich, too.” Then, the trial court talked about how others get big payouts without comment, but that lawyers are not viewed the same way:

[T]here’s an idea that when a lawyer or law firms are going to get a big payment, that there’s something somehow wrong about that, just because it’s a lawyer. I’m sorry, but investment banks have hit it big . . . . They’ve hit it big many times. And to me, envy is not an appropriate motivation to take into account when you set an attorney fee.

The trial court opined that a declining percentage for “mega” cases would not create a healthy incentive system, and that the trial court would not embrace such an approach. Rather, the trial court repeatedly pointed out

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133 Sugarland Indus., Inc. v. Thomas, 420 A.2d 142 (Del. 1980).
134 Appellant Southern Copper Corporation’s Opening Brief, Exhibit A at 74.
135 Id. at 82.
that “plenty of market participants make big fees when their clients win,” and that if this were a hedge fund manager or an investment bank, the fee would be okay.\textsuperscript{136} In sum, the trial court said that the fundamental test for reasonableness is whether the fee is setting a good incentive, and that the only basis for reducing the fee would be envy.\textsuperscript{137} That is not a decision based on \textit{Sugarland}.

\textbf{Reargument Unanimously Denied}

The appellants, Americas Mining Corporation (“AMC”) and nominal defendant, Southern Copper Corporation, have filed a motion for reargument. The issue raised on reargument is the narrow question of whether the relevant “benefit achieved” for calculating attorneys’ fees in a derivative case, against a majority stockholder and other defendants, is properly defined as the entire judgment paid to the corporation, or, in this case, 19\% of the entire judgment paid to the corporation, because the majority stockholder defendant owns 81\% of the corporation that will receive the judgment.

This Court has carefully considered the motion for reargument filed by the Defendants, and the response filed by the Plaintiff. We have determined that the motion for reargument is procedurally barred under

\textsuperscript{136} \textit{Id.} at 81-83.
\textsuperscript{137} \textit{Id.} at 83-84.
Delaware law, because the issue raised on reargument was not fully and fairly presented in the Defendants’ opening briefs, and alternatively, because it is substantively without merit, as a matter of Delaware law.

**Waiver Constitutes Procedural Bar**

This Court’s rules specifically require an appellant to set forth the issues raised on appeal and to fairly present an argument in support of those issues in their opening brief. If an appellant fails to comply with these requirements on a particular issue, the appellant has abandoned that issue on appeal. Supreme Court Rule 14(b)(vi)(A)(3) states that “[t]he merits of any argument that is not raised in the body of the opening brief shall be deemed waived and will not be considered by the Court on appeal.”

Neither of the Defendants’ opening briefs properly raised the issue set forth in the limited motion for reargument. AMC’s opening brief did not mention the issue at all and Southern Copper Corporation’s opening brief only mentioned the issue indirectly in a footnote. Arguments in footnotes do not constitute raising an issue in the “body” of the opening brief.

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140 *Roca v. E.I. du Pont de Nemours & Co.*, 842 A.2d at 1242.

141 See Supreme Court Rule 14(d) (“Footnotes shall not be used for argument ordinarily included in the body of a brief . . . .”).
Therefore, the issue raised in the limited motion for reargument is procedurally barred, as a matter of Delaware law, because it has been waived. On that basis alone the motion must be denied.\textsuperscript{142}

\textit{Argument Without Substantive Merit}

Alternatively, and as an independent basis for denying the limited motion for reargument, we conclude that the Court of Chancery properly rejected the “look through” approach to awarding attorneys’ fees in a derivative action. The derivative suit has been characterized as “one of the most interesting and ingenious of accountability mechanisms for large formal organizations.”\textsuperscript{143} It enables a stockholder to bring suit on behalf of the corporation for harm done to the corporation.\textsuperscript{144}

Because a derivative suit is being brought on behalf of the corporation, any recovery must go to the corporation.\textsuperscript{145} In addition, a stockholder who is directly injured retains the right to bring an individual action for those injuries affecting his or her legal rights as a stockholder.\textsuperscript{146} Such an individual injury is distinct from an injury to the corporation alone.

\textsuperscript{143} \textit{Kramer v. W. Pac. Indus., Inc.}, 546 A.2d 348, 351 (Del. 1988) (quoting R. Clark, \textit{Corporate Law} 639-40 (1986)).
\textsuperscript{144} \textit{Kramer v. W. Pac. Indus., Inc.}, 546 A.2d at 351.
\textsuperscript{145} \textit{Tooley v. Donaldson, Lu\'kin, & Jenrette, Inc.}, 845 A.2d at 1036.
\textsuperscript{146} \textit{Id.}
“In such individual suits, the recovery or other relief flows directly to the stockholders, not to the corporation.”\textsuperscript{147}

In \textit{Tooley v. Donaldson, Lufkin, & Jenrette, Inc.}, this Court held that whether a claim is derivative or direct depends solely upon two questions: “(1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?”\textsuperscript{148} It is undisputed that this is a derivative proceeding. In this case, the corporation was harmed and the total recovery is awarded to the corporation, Southern Copper Corporation – not “nominally” but actually.

In assessing the “benefit achieved,” the Court of Chancery held, and this Court affirmed, that the benefit achieved in a derivative action is the benefit to the corporation. The “look through” approach to awarding attorneys’ fees in a derivative case was properly rejected by the Court of Chancery long ago in \textit{Wilderman v. Wilderman}.\textsuperscript{149} Similarly, in rejecting the Defendants’ “look-through” argument in this derivative action, the Court of Chancery stated:

There’s also this argument that I should only award – I should basically look at it like it’s a class action case and that the

\textsuperscript{147} \textit{Id.}
\textsuperscript{148} \textit{Id.} at 1033.
\textsuperscript{149} \textit{Wilderman v. Wilderman}, 328 A.2d at 458.
benefit is only to the minority stockholders. I don’t believe that’s our law. And this is a corporate right. And, you know, if you look going back to 1974 . . . there was Wilderman versus Wilderman, 328 A.2d 456, which talks about not disregarding the corporate form in a derivative action and looking at the benefit to the corporation, to the more recent Carlton – Carlson case, which is now reported, in 925 A.2d 506 does the same.

No stockholder, including the majority stockholder, has a claim to any particular assets of the corporation. Accordingly, Delaware law does not analyze the “benefit achieved” for the corporation in a derivative action, against a majority stockholder and others, as if it were a class action recovery for minority stockholders only. Therefore, the limited motion for reargument is substantively without merit. On that alternative basis alone the motion must also be denied.

Now, therefore, this 21st day of September 2012, it is hereby ordered that the motion for reargument is unanimously denied.

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150 Norte & Co. v. Manor Healthcare Corp., 1985 WL 44684, at *3 (Del. Ch.) (“[T]he corporation is the legal owner of its property and the stockholders do not have any specific interest in the assets of the corporation.”).

151 Michigan v. Long, 463 U.S. at 1044.