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RadLAX Decision: Supreme Court Holds That Debtors Must Permit Credit-Bidding Under A Chapter 11 Plan

By Danielle Spinelli and Craig Goldblatt

On May 29, 2012, the Supreme Court issued its decision in *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, No. 11-166, 2012 WL 1912197 (U.S. May 29, 2012), resolving a controversial issue that had divided the courts of appeals: whether a Chapter 11 debtor may bar a secured creditor from credit-bidding its claim when its collateral is sold under a plan of reorganization. The Court held unanimously (8–0; Justice Kennedy did not participate) that the Bankruptcy Code does not permit a debtor to bar credit-bidding at such a sale.

RadLAX ensures that secured creditors will retain one of the central protections afforded them in a Chapter 11 cram-down: the right, when their collateral is sold, to bid up to the full amount they are owed and obtain the collateral, if they value it more highly than other bidders, without being required to put up additional cash. That right to credit-bid helps preserve the benefit of the bargain the secured creditor made outside bankruptcy—either to be paid what it is owed, or to take its collateral.

RadLAX is thus important for its holding alone. As discussed below, however, the Supreme Court's reasoning and the general approach it took to the case are also instructive, particularly in light of the route the credit-bidding issue took to the Court.

The Credit-Bidding Issue in a Nutshell

Section 1129(b)(2)(A) of the Bankruptcy Code provides three alternative routes through which a debtor can confirm a Chapter 11 plan that crams down the claims of secured creditors. Under clause (i), the plan may provide that each secured creditor will keep its lien and receive a stream of payments with a face value of the full amount of the creditor's claim and a net present value equal to the present value of the creditor's security interest. Under clause (ii), the plan may provide for the sale of collateral free and clear of a secured creditor's lien, with the lien attaching to the proceeds of the sale, subject to the requirement that the creditor is entitled to credit-bid its entire claim. Or, under clause (iii), the plan may provide that the secured creditor will receive "the indubitable equivalent" of its claim.

The question confronting the Supreme Court in RadLAX was whether a Chapter 11 cram-down plan could be confirmed if it provided for the sale of collateral free and clear of a secured creditor's lien without permitting credit bidding, as clause (ii) would require, but also purported to provide that the secured creditor would receive the indubitable equivalent of its claim under clause (iii). The debtor contended that it was required to satisfy only one of the three alternatives, and that so long as its plan gave the secured creditor the indubitable equivalent of its claim, the debtor was not required to allow credit-bidding. The creditor countered that, under the debtor's interpretation of the statute, clause (ii)'s credit-bidding requirement would be rendered essentially meaningless, and that a free-and-clear sale of collateral that barred credit-bidding was inconsistent with the overall structure of protections the Bankruptcy Code provides for secured creditors.

The Split Among the Courts of Appeals

The question presented in RadLAX had divided the courts of appeals. The Third and Fifth Circuits sided with debtors, holding that credit-bidding was not required in a free-and-clear sale of collateral under a plan if the plan provided the secured creditors with the indubitable equivalent of their claims. See In re Philadelphia Newspapers, LLC, 599 F.3d 298 (3d Cir. 2010); In re Pacific Lumber Co., 584 F.3d 229 (5th Cir. 2009). In RadLAX itself, however, the Seventh Circuit came to the opposite conclusion.

Philadelphia Newspapers illustrates the interpretation of the statute that is favorable to debtors. That case involved a debtor that wanted to sell its main assets, two daily Philadelphia newspapers, to a stalking-horse bidder it had selected, and thus wanted to bar its secured lenders from credit-bidding. A divided panel of the Third Circuit examined the language, context, and purpose of the cram-down provisions. The panel majority concluded that the statutory language was "unambiguous": "The use of the word 'or' in this provision operates to provide alternatives—a debtor may proceed under [clause] (i), (ii), or (iii), and need not satisfy more than one." Judge Smith, concurring, added: "I simply cannot look past the statutory text . . . . Section 1129(b)(2)(A) uses the word 'or' to separate its [clauses] . . . . Thus, satisfaction of any of the three [clauses] is sufficient." Accordingly, the majority reasoned, the statute plainly allowed a debtor to proceed under clause (iii)'s indubitable equivalent standard with a free-and-clear sale of collateral that bars credit-bidding.

The Philadelphia Newspapers majority drew a spirited dissent from Judge Ambro, a former bankruptcy practitioner, who contended that the statute had more than one plausible interpretation, but that the better reading favored the secured creditors. He argued that "Congress did not list the three alternatives as routes to cram-down confirmation that were universally applicable to any plan, but instead as distinct rules that apply specific requirements depending on how a given plan proposes to treat the claims of secured creditors." That is, in Judge Ambro's view, clause (ii) governed all free-and-clear sales of collateral under a plan, and clause (iii) was simply inapplicable to such plans. While either reading of the language was plausible when the statutory text was viewed in isolation, Judge Ambro contended that canons of statutory interpretation—in particular, the canon that specific provisions prevail over general ones—and the context provided by the Code as a whole supported his construction. After examining in detail the interlocking provisions of the Code governing secured claims, Judge Ambro concluded that credit-bidding was an integral "part of a comprehensive arrangement enacted by Congress to avoid the pitfalls of undervaluation" of secured claims, "and thereby ensure that the rights of secured creditors are protected while maximizing the value of the collateral to the estate."

Following on the heels of Philadelphia Newspapers, debtors in RadLAX—developers of a hotel at the Los Angeles airport who had borrowed heavily and then run out of funds—proposed a very similar plan. Debtors proposed to sell the hotel and related assets free and clear of its lenders' liens in an auction with a stalking-horse bidder and no credit-bidding, and to provide the lenders with the "indubitable equivalent" of their claims out of the sale proceeds. The Seventh Circuit concluded that, although the statutory language was not plain, the better reading of the statute barred such a plan for the reasons articulated in Judge Ambro's Philadelphia Newspapers dissent.

The Supreme Court's Decision

The Supreme Court granted certiorari to resolve the circuit split. The parties and their amici presented arguments focusing not only on the text of the cram-down provisions, but also on the overall structure of the Bankruptcy Code's protections for secured creditors and the role credit-bidding plays in that structure. The Court, however, confined its analysis to the text of section 1129(b)(2)(A). Like the Third Circuit majority, the Supreme Court concluded that the text of section 1129(b)(2)(A) was unambiguous. Unlike the Third Circuit, the Court concluded that the statutory text unambiguously precluded debtors from attempting to bar credit-bidding at a free-and-clear sale of creditors' collateral.

In an opinion written by Justice Scalia, the Court rejected the debtors' reading of the statute as "hyperliteral and contrary to common sense." Relying on the "commonplace of statutory construction that the specific governs the general," the Court reasoned that "clause (ii) is a detailed provision that spells out the requirements for selling collateral free of liens, while clause (iii) is a broadly worded provision that says nothing about such a sale. . . . [T]he 'general language' of clause (iii), 'although broad enough to include it, will not be held to apply to a matter specifically dealt with' in clause (ii)." That is, of section 1129(b)(2)(A)'s three clauses, "(i) is the rule for plans under which the creditor's lien remains on the property, (ii) is the rule for plans under which the property is sold free and clear of the creditor's lien, and (iii) is a residual provision covering dispositions under all other plans." Accordingly, the Court concluded that "debtors may not sell their property free of liens under § 1129(b)(2)(A) without allowing lienholders to credit-bid, as required by clause (ii)."

The Court briskly rejected the Third Circuit majority's reasoning, under which the word "or" was dispositive, explaining that "the question here is not whether debtors must comply with more than one clause, but rather which one of the three they must satisfy. Debtors seeking to sell their property free of liens under § 1129(b)(2)(A) must satisfy the requirements of clause (ii), not the requirements of both clauses (ii) and (iii)."

The Court declined to consider "the purposes of the Bankruptcy Code, pre-Code practices, and the merits of credit-bidding," concluding that the statute contains "no textual ambiguity" and that the analysis thus did not need to proceed beyond the text. It concluded by commenting: "The Bankruptcy Code standardizes an expansive (and sometimes unruly) area of law, and it is our obligation to interpret the Code clearly and predictably using well-established principles of statutory construction. Under that approach, this is an easy case."

Conclusion

The Supreme Court rarely has the opportunity to resolve issues of importance to business bankruptcies, and credit-bidding is such an issue. For that reason alone, *RadLAX* is a significant—though in some respects narrow—decision.

From debtors' perspective, *RadLAX*

may limit their flexibility in structuring asset sales under a plan: All free-and-clear sales of collateral under a plan must now comply with clause (ii), absent the secured creditors' consent.

From secured creditors' perspective, *RadLAX* reaffirms a key bankruptcy protection. One of the critical concerns for an undersecured creditor in bankruptcy is the valuation of its security interest. The Bankruptcy Code bifurcates undersecured claims into secured and unsecured portions, with very different treatment accorded to each. Certain undersecured creditors may choose to have their entire claim treated as secured and relinquish the unsecured deficiency claim. By doing so, they protect themselves against undervaluation of their security interests. But undersecured creditors whose collateral is to be sold lack that option. Instead, they have the right to credit-bid at the sale of their collateral. Legal restrictions and transaction costs associated with cash bidding may sometimes preclude a secured creditor from bidding at all if it cannot credit-bid. The right to credit-bid thus ensures that creditors can get their collateral whenever they value it more highly than other bidders, rather than being cashed out for whatever the highest cash bidder thinks the collateral is worth.

RadLAX declined to look beyond the text of section 1129(b)(2)(A), and offered no broader statements about the structure or purpose of the Bankruptcy Code. But the Supreme Court's closing comments are suggestive of the approach the Court will take to similar questions in the future. The Bankruptcy Code is a statute, and questions that arise under it are questions of statutory interpretation. They cannot be resolved by the invocation of broad, general bankruptcy policy—whether the policy is protecting secured creditors or encouraging reorganization. Rather, they should be analyzed through the traditional tools of statutory construction, which should be applied in a way that produces clear and predictable rules. As long as it is informed by an understanding of the Bankruptcy Code's overall design—itself a traditional part of statutory construction—that approach may in fact help to tame "unruly" bankruptcy law.

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Additional Resources

For other materials on *Philadelphia Newspapers*, please refer to the following.

Business Law Today

Absence of Legislative History Obscures Plain Meaning of Bankruptcy Code Section 503(b)(1)(A)

By Teddy M. Kapur
January 2010

Third Circuit Denies Secured Lenders Right to Credit Bid in Plan Sale

By William P. Weintraub, Gregory W. Fox, and Kizzy L. Jarashow
October 2010

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Building the Section 11 "Due Diligence" Defense for Outside Directors

By D. Anthony Rodriguez

Section 11 of the Securities Act of 1933 (15 U.S.C. § 77k(a)) imposes civil liability when a securities registration statement filed with the Securities and Exchange Commission contains a false or misleading material statement or material omission. Among those who may be a defendant in a section 11 claim are anyone who was a director or performing similar functions when the registration statement was filed, or who was named in the registration statement as about to become a director.

A section 11 claim can be particularly difficult to defend because, other than for certain forward-looking statements, it does not include a scienter element, unlike section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. Nor does section 11 require an investor who lost money on his or her securities purchase to prove that the false statement caused his or her loss, again in contrast to section 10(b).

Section 11, however, gives defendants other than the issuer a powerful defense—the "due diligence" defense. Outside directors should be exceptionally well-positioned to establish this defense, but their counsel must be mindful of potential complications.

The Due Diligence Defense

A non-issuer defendant who establishes that he or she believed the challenged statements were true and did not contain any material omissions, had reasonable grounds for that belief, and undertook a reasonable "investigation" into the truth of the challenged statements, is not liable for the challenged statements. Section 11 defines the standard for "what constitutes reasonable investigation and reasonable ground for belief" as "that required of a prudent man in the management of his own property." When applying the defense, "[t]he defense is calibrated to the objective reasonable person in each defendant's position." *In re Countrywide Fin. Corp. Sec. Litig.,* 588 F. Supp. 2d 1132, 1174 (C.D. Cal. 2008). The diligence standard is higher for inside directors and underwriters than for outside directors.

The word "investigation" in section 11 requires a showing that the outside director received or sought out information of reasonable scope and from reliable sources, not a showing of forensic or detective work. *See Weinberger v. Jackson*, No. 89-2301-CAL, 1990 U.S. Dist. LEXIS 18394, at *10 (N.D. Cal. Oct. 12, 1990). An outside director may rely "upon the reasonable representations of management, if his own conduct and level of inquiry were reasonable under the circumstances." In *Weinberger,* the director showed that he "was reasonably familiar with the company's business and operations," and that he "regularly attended board meetings at which the board discussed every aspect of the company's business." The director had "reviewed the company's financial statements" and drafts of the challenged statements, and discussed "certain aspects" of the challenged statements with management. The director also established that he was "given comfort by the fact that the prospectus and the information in it were reviewed by underwriters, counsel and accountants." Finally, he had seen nothing in the challenged statements that was "inconsistent with the knowledge he had acquired as a director." The court held that the outside director therefore "met the standards of due diligence."

Similar steps established an outside director's due diligence in *Avante-Guarde Computing Securities Litigation*, No. 85-4149, 1989 U.S. Dist. LEXIS 10483 (D.N.J. Sept. 5, 1989). In *Avante-Guarde*, the court granted summary judgment on due diligence grounds to an outside director who had joined the board approximately three months before the company's initial public offering (and had resigned five months after the offering). The outside director established that, during his three months on the board before the offering, he had participated in four board meetings, read the draft prospectus, and met with company personnel to ask them about the business. The director also had learned that the outside auditors had reviewed the company's financial statements, though he failed to learn that the previous audi-

tors had been replaced after they had made critical statements. Even outside directors whose work was "imperfect" have established their due diligence on summary judgment. In *Laven v. Flanagan*, 695 F. Supp. 800 (D.N.J. 1988), the court granted summary judgment to outside directors who established that they had worked to bring themselves "up to speed" about the company in the approximately eight months between joining the board and signing the offering documents. The court held that the outside directors' reliance on management representations "cannot be characterized as unreasonable," particularly when it was "confirmed" by the company's independent auditors. The court described the outside directors' work as "imperfect," but granted them summary judgment on due diligence grounds, distinguishing their "activities [as] a far cry from the passive and total reliance on company management that defeated the due diligence defense in *Escott v. Bar-Chris Construction Corp.*, 283 F. Supp. 643, 688-89 (S.D.N.Y. 1968)."

Bar-Chris is an oft-cited case on due diligence. In that case, the court ruled on outside directors' due diligence defense after a bench trial. The court found that one director had spent "about ten minutes" reading the filing that was at issue, and the other had only "glanced" at the document. The court found these directors "made no investigation" of the accuracy of the statements in the prospectus, but instead relied solely on assurances from the founders of the company, whom the court described as "men of limited education" who were not "equipped to handle financial matters." The court held that the outside directors' "minimal conduct" did not support a due diligence defense. The court in *In re Worldcom, Inc. Securities Litigation,* No. 02 Civ. 3288 (DLC), 2005 U.S. Dist. LEXIS 4193 (S.D.N.Y. Mar. 21, 2005), denied an outside director's motion for summary judgment on due diligence grounds. *Worldcom*, however, is by no means a death-knell to the due diligence defense for outside directors. Indeed, the *Worldcom* court stated that a "careful examination" of management presentations could be enough to win summary judgment on due diligence grounds. Moreover, the court noted that it was not clear that the moving director, who was a former CEO of MCI, which Worldcom acquired in a transaction that led to him becoming a Worldcom director, was an outside director. The court held the distinction was irrelevant in that case, because the director had, like the outside directors in *Bar-Chris*, shown only "passive and total reliance on company management." The director had failed to demonstrate that he had "conducted *any* sort of investigation, much less a reasonable investigation." Nor did the director show that he had engaged in "active dialogue" with the company's management or with its outside auditors, even in the face of abnormal information that was related to the most critical aspect of the company's business, and which ultimately was the key to a "massive" restatement (the largest corporate restatement in history to that date). *Worldcom* could pose a problem to an outside director who was passive, engaged in no dialogue, even in the face of abnormal information about a critically important topic, and does not show that he or she conducted "any sort of investigation," but such a person also would be unlikely to be able to invoke *Weinberger*, *Avante-Guarde*, or *Laven*.

Showing Due Diligence

As the above discussion shows, to build a strong due diligence defense to present at summary judgment, an outside director will establish his or her attendance at board and committee meetings; dialogue with management about key policies and practices, the state of the business, and unusual developments; reasonable reliance on management, the company's retained professionals, and other sources; and that he or she believed the challenged statements were consistent with his or her knowledge of the company at the time. The outside director may also choose to present his or her motion as unnecessary to reach, because the challenged statements were not false or material, or because section 11(e)'s "negative loss causation" defense applies.

In building his or her due diligence defense, the outside director should marshal facts from his or her recollection and files, and from materials that the company and others produce in discovery, such as from board and committee packets, memoranda and presentations to the board or its committees, and communications with directors, management, and retained professionals (such as auditors, consultants, and experts). The outside director should show his or her attendance at board and committee meetings, how he or she prepared for those meetings, and information (relevant to the case) to which he or she paid particular attention.

Each outside director also should describe what he or she did over the course of his or her tenure, before the statement at issue was made, to become familiar with the company. This could include showing his or her awareness of relevant policies (e.g., anti-bribery policies in overseas operations and related monitoring) and principles (e.g., an oft-stated commitment not to sacrifice product quality for growth in market share) that he or she understood the company followed, including when management or a third party communicated about those policies or principles to the board. The outside director also should describe processes within the company, particularly those that he or she was aware of, for drafting and verifying the statement at issue before it reached the outside director. On this point, before litigation, outside directors should consider requesting an annual briefing on how the company prepares its SEC filings.

Dealing with Complications

In building the due diligence defense for outside directors, counsel should be aware of potential complications, such as the following.

Information Contrary to the Challenged Statement

The due diligence defense, by definition, requires a showing that the outside director believed the challenged statement was true and not misleading, and had a reasonable basis for that belief. If a defendant

argues that information that corrected the statement, or that supplied allegedly omitted information, was publicly available, this embedded concession that the statement was incorrect or incomplete could complicate the outside director's due diligence defense.

Outside directors will want to be careful about joining in another defendant's brief that argues corrective or complete information was available to the market when the statement was made. The outside director will have to assess whether that argument is consistent with his or her due diligence showing. If the additional information supplements the challenged statement by containing detail that does not contradict the statement, or provides statements of opinion or forecasts, it should not pose a problem to the outside director's due diligence defense.

If, however, the other defendant is expressly or tacitly conceding that the challenged statement was false or materially incomplete, but that the correct or missing information was supplied elsewhere, this could be in tension with the outside director's assertions that his or her reasonable "investigation" led him or her to believe the statement was true. How can it be, plaintiffs will argue, that one defendant says he or she investigated and reasonably believed a statement that another defendant expressly or implicitly concedes was incorrect or misleading? If the outside director was not aware of, or did not consider, the information that the other defendant is citing, plaintiffs might argue that this shows the cited information was immaterial, or was inadequate to correct the allegedly false or misleading statement.

Of course, it is entirely possible that the other defendant is citing a valid point from a source that the outside director did not happen to consider, such as one line in a transcript of a lengthy earnings call that did not receive unusual press or analyst attention. If so, the outside director should be able to show, based on the information that he or she considered after a reasonable "investigation," that he or she reasonably believed the challenged statement was true and not misleading. If the other defendant is citing various sources to show that they disclosed information that supposedly was omitted, while clearly arguing that the omission was not material, those citations likewise should not hinder the outside director's due diligence defense. Counsel for the outside director will need to stay apprised of other defendants' plans on this front.

Management-Only Communications

Executives meet with and e-mail each other throughout the day without copying the outside directors. In their discussions, executives might debate issues, air differing analyses, express concerns, demand action, and the like. E-mails, especially those composed late at night or while the author is in an airport security line, might be rushed, pithy, or even rude. When discovery brings those e-mails before the various defendants, it could be the outside director's first look at management-only communications. Putting aside obviously "bad" e-mails such as any that direct or describe the publication of false statements, say the outside director knew the challenged statement was false or misleading, or criticize the outside director's oversight, management-only e-mails still can complicate matters for the outside director.

The outside director should expect the plaintiff to use management-only e-mails (the likely predominant form of written communication) to make the outside director question or criticize management, or even himself or herself. The plaintiff might attempt to paint the outside director as a victim of management deception, or, less dramatically, to obtain director testimony expressing concern and questions about perceived disparities between the management-only communications and the challenged statement (e.g., "I do wonder why we made this statement, if Joe really believed what he writes in this e-mail . . ."). Should the plaintiff succeed in obtaining testimony that expresses skepticism or doubt about management's candor, it could look peculiar to the judge or jury for the outside director to cite reliance on management as a basis of his or her due diligence defense.

An outside director who is asked to testify to his or her reaction to negative or dramatic statements in a management e-mail should be careful not to react hastily and imprecisely, whether in criticizing management, admitting the statement in the e-mail contradicts the challenged statement or should have been disclosed, or agreeing that he or she should have asked harder questions to uncover the information that is in the e-mail. The outside director must tell the truth, but has no obligation to shoot from the hip or to speculate based on an e-mail snippet, without knowing the full context. If something in an e-mail strikes the outside director as interesting, or differs from his or her recollection, he or she should say so (if asked), but should consider whether he or she has enough information to testify that someone was doing anything wrong, or was failing to act reasonably.

The outside director, no doubt, expects that there were blunt, real-time, exchanges between executives, and for different executives to show different personality traits, or to reflect their organization's biases (e.g., sales might advocate dropping prices, while finance might worry about keeping up margins). Whether any of those day-to-day exchanges contradict a statement that survived the company's drafting and vetting process is a very different question from whether something in the exchanges looks interesting, or is something the outside director would like to know more about. The outside director does not need to take it upon himself or herself to try to explain away what the parties to an e-mail exchange meant or thought, e.g., "Well, I'm sure what he's trying to say here is really . . . ." On the other hand, if asked, and if he or she has a basis for doing so, the outside director can describe, based on his or her experience, that the sender or recipient had a tendency to make dramatic statements or to adopt a skeptical or negative tone.

In sum, it will be the extraordinary e-mail that on its face provides enough information and context for an outside director to state, after reviewing the e-mail at deposition, that he or she was wrong to

trust management or that he or she was not a diligent director.

Varying Levels of Outside Director Diligence

There is no one way for an outside director to show due diligence. The outside directors likely will vary in how they analyzed and questioned information. Some might have pored over every page of reports and presentations, while others focused on the executive summary and on particular pages. Some might have asked more questions than others. The cases described above highlight the common denominators of a successful due diligence defense, all of which rest on a reasonableness, not perfection, standard. Most outside directors should not expect to have a difficult time in making the necessary showing, particularly where falsity has not been conceded. However, the outside directors might find themselves, implicitly or expressly, at odds with each other as they each build their due diligence defense.

Plaintiffs may attempt to "divide and conquer," by asking executives and directors to critique each other's diligence, and then zeroing in on any outside director whom others describe as inattentive or uncurious. Outside directors faced with such questions must be truthful, and should remember that they do not need to make someone else look bad to make themselves look good. If they are presented with criticisms of their efforts, they should have measured, fact-based responses to those criticisms.

Due diligence is not a zero-sum matter. A "star" outside director's diligence should not make others appear to lack diligence by comparison. The standard for all is reasonableness. The "star" outside director helps himself or herself by describing how he or she met the reasonableness standard, and then describing his or her extraordinary work. Others should demonstrate how their efforts meet the reasonableness standard, and can even show how they benefitted from the "star's" extra efforts.

When an outside director has a weak diligence defense, can the same counsel represent that director and others with a stronger diligence defense? The outside director with the weaker defense may want to minimize the importance of measures that the other directors may want to highlight, or may want to be more aggressive than the other directors in arguing what qualifies as due diligence. The outside directors with the stronger defense will want to contrast themselves with the diligence showing in cases such as *Bar-Chris* and *Worldcom*, which could reflect poorly on an outside director whose diligence (or lack thereof) is similar to the directors in those cases. If an outside director's diligence is at the *Bar-Chris* level, he or she will want to consider carefully whether to move for summary judgment.

When counsel believes there is the potential for such conflicting arguments or showings, or when they have actually emerged, it should be determined if he or she needs to obtain the clients' informed written consent before continuing with the representation. In California, an attorney is required to obtain informed written consent from each client regarding the potential or actual conflict of interests before accepting that representation, and to obtain informed written consent to continue the representation if a potential conflict becomes actual. Counsel should obtain written consent regarding which clients he or she will continue to represent if a client refuses to consent, or withdraws his or her consent, to a potential or actual conflict. Counsel may wish to explore having the director with the weak defense retain "shadow counsel," who would be prepared to assume responsibility for the defense of that director if the client withdraws his or her consent to the joint representation. Counsel must be clear with the outside director who has the weak or inadequate defense that counsel will not water down the presentation of other clients' defenses to avoid making that client look bad by comparison.

Conclusion

Section 11's due diligence standard for outside directors requires reasonableness, not perfection. The diligence standard for outside directors reflects that they have neither the responsibilities nor the knowledge of management or inside directors regarding the business. In building their defense, outside directors must be honest and precise in describing their reaction to management-only communications that they see during the case, and informed about whether and how their diligence arguments and showings may conflict. Obtaining the protection of the due diligence defense makes navigating these potential complications well worth the effort.

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Pushing Partner's Buttons in an S Corporation: Pain and Prevention

By Stuart L. Pachman

Corporations were originally designed so that large amounts of money could be raised from numerous investors for big projects such as trading companies, canals, and later railroads. Where there are many shareholders and a public market, an unhappy minority shareholder who wants "out" has the ability to sell his or her shares for their market value. By contrast, in the closely held corporation with few shareholders and no public market, there was a time when a minority shareholder subject to rule by the majority had no way out. To remedy this, states amended their corporate laws to provide an avenue of relief, and over the last several decades these "minority oppression" statutes have spawned numerous decisions.

When I first wrote on this subject, the similarity of the personal dynamic between shareholders in a business breakup and participants in a failed marriage was noted. In the intervening years, as minority (and majority) oppression law has developed, the analogy between marital and business "partners" living together in mutual disharmony has expanded. As the relationship breaks down, the not so subtle attempts to inflict pain on one's "partner" begin. It is sometimes difficult to discern who is the oppressor and who is the oppressed.

Illustrative Examples

In the area of corporate law, S corporations, because of the tax driven rules that apply to them, provide a source for the application of pressure points not found in a C corporation. Take the not unusual situation of three individuals, Herman, Wilma, and Herman's loyal and lifelong pal, Buddy. Each owns one-third of the issued and outstanding shares of Passive Income, Inc., an S corporation. Together they constitute its three-person board of directors. Wilma, not as well fixed financially as her co-shareholders, relies on the corporation's distributions as a source of income. Herman wants Wilma out, but she does not want to go. When she refuses his "reasonable" offer for her shares, he decides to put on the squeeze. Although the corporation has annual income of $300,000, Herman and Buddy decide not to declare dividends. Thus Wilma will find herself with a K-1 allocation of $100,000 of income with no cash to pay the resulting federal (and any state) income tax.

The fact that a corporation has profits does not require its directors to distribute them. Whether or not to declare dividends is within the board's discretion in managing the business. Nonetheless, profits may not be arbitrarily withheld. The "power of the court of chancery to order the directors . . . to make a dividend of unused profits when they improperly refuse to do so is undoubted." In a case not involving an S corporation, the court awarded compensatory and punitive damages against a major shareholder who had suppressed dividends so that he could buy up the shares of other shareholders at low prices. So if Wilma sues, Herman's scheme will probably not succeed. Minority oppression cases expressly hold that one of the remedies available to the court is to direct the declaration of dividends.

If, however, Herman were able to point to some valid business reason for withholding dividends, for example, the need for cash to purchase equipment or to pay a debt to become due, he may succeed. He would also succeed as a practical matter if the court were to compel dividends only in an amount roughly equal to the tax obligations created by the income allocations to the shareholders rather than equal to 100 percent of the corporation's income.

Wilma faces not only the risks (and expenses) attendant on litigation, but a practical problem as well. The tax collector has no interest in her dispute with Herman, and will not sit by until the trial and appeal concludes in a final judgment. Can she hold out that long?

Now put the shoe on the other foot. For whatever reason—either because she disagrees with the corporate decision to acquire Blackacre, or because she needs to convert her stock into spendable cash, or because she believes she is being treated unfairly—Wilma wants out. Herman and Buddy, however, will neither cause the corporation to redeem her shares nor accept her "reasonable" offer to sell. To

put the squeeze on them, Wilma threatens to sell her shares to a buyer not qualified to hold shares in an S corporation which would cause loss of the corporation's S status, an undesirable result as far as Herman and Buddy are concerned. She contends her stock is freely tradable property. Herman and Buddy claim that she owes a fiduciary duty to her fellow shareholders preventing her from carrying out her threat.

In *Sery v. Federal Business Centers, Inc.*, the court declined to find that the plaintiffs, by consenting to the S election, had entered into a contract prohibiting them from selling to a non-qualified buyer. It also ruled that the plaintiffs could sell their S corporation shares to a nonqualified buyer if they acted in an economically reasonable manner and if they did not act in bad faith for the primary purpose of injuring their co-shareholders. Thus although Wilma may sell her shares, she is subject to the implied covenant of good faith and fair dealing. She cannot force a buyout by threatening to form a non-qualified entity to which to transfer some or all of her shares; that would clearly demonstrate bad faith.

Even if she were acting in good faith, Wilma has a practical problem. Will she be able to find a buyer, whether or not qualified to hold S corporation shares, which is willing to pay money to become a minority shareholder in a corporation whose shares are closely held?

Conclusion

The lesson from both scenarios is evident. A shareholders or similar type agreement is advisable in any business setting (and a lot easier for a lawyer to discuss with business people than a prenuptial with a couple about to wed). A lawyer, when forming a business entity, just as an official performing a marriage ceremony, has no way to ensure that the parties' current positive personal relationship will endure, but when all of the business principals are on the same side of the table and S status is elected, issues of the nature that confronted Herman and Wilma can be addressed in the corporate documents (the certificate of incorporation, the by-laws, or a shareholders' agreement). Some corporate statutes expressly provide that continuing the corporation's S status is a valid reason for a restricting the alienation of shares that would otherwise be freely tradable.

Among the several protective methods available, one that would protect Herman is a written undertaking by all shareholders to act at all times to maintain the S status of the corporation, including, but not limited to, not selling shares to one not qualified as an S corporation shareholder. To protect Wilma, the corporate documents could require a percentage of its taxable income to be distributed annually (or perhaps quarterly) to provide each shareholder with cash in an amount at least roughly equal to the shareholder's income tax obligations resulting from the corporation's K-1 allocation of income. The parties may wish to provide for exceptions. Whatever the protective method, its choice should be made while the love light shines in the eyes of those about to join in business matrimony.

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Additional Resources

For other materials related to this topic, please refer to the following.

Business Law Today

Rogue Officers and Misled Auditors: Judicial Outcomes Vary
By Stuart L. Pachman
March 2011

Fiduciary Duties: Renouncing the Corporate Opportunity Doctrine
By Stuart L. Pachman
October 2011

BUSINESS LAW TODAY
The ABA Business Law Section's Online Resource

Inside Business Law

Focus on the Commercial Finance and Uniform Commercial Code Committees May 2012

By Edward Batts and Andrew D. Ledbetter

The SEC has released its final rule under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 concerning listing standards for equity securities (i.e., publicly traded companies) related to compensation committees.

The rule, published in the Federal Register on June 27, is divided into three key areas:

- the independence of compensation committee members;
- their role in retaining and supervising outside compensation consultants and legal counsel; and
- evaluation of potential conflicts of interest for outside compensation consultants and legal counsel, and disclosure of such conflicts in a company's annual proxy statement.

Timing Milestones

The rule will be effective on July 27. Within 90 days of June 27, the national securities exchanges (such as NYSE and NASDAQ) must propose changes to listing standards to the SEC for review. Such listing standards must be finalized and adopted by the national securities exchanges by June 27, 2013.

Disclosure changes under Item 407 of Regulation S-K (described below) shall apply to any proxy or information statement for a meeting at which directors are elected occurring on or after January 1, 2013.

Summary

The cumulative effect of the changes to is to begin to apply similar, though less rigid, standards that are already applicable to audit committees and company auditors (evaluating auditor independence and compensation) to compensation committees, including their retention of advisers.

Compensation committee members not only must be independent, but further must meet heightened independence tests, be vested with the authority to retain outside advisers, and evaluate the independence of such advisers. However, there is no mandate per se that such advisers meet any specific independence test. Certain companies, such as those in bankruptcy, controlled companies, and foreign private issuers who do not maintain a compensation committee, are exempted from one or more of the various provisions of the rule.

Compensation Committee Member Independence

In addition to independence standards that already apply under NYSE and NASDAQ listing standards, the rule requires exchanges to maintain listing standards that require compensation committee members to meet heightened independence requirements that exchanges must develop based on relevant factors, including but not limited to:

- a director's source of compensation, including any consulting, advisory, or compensatory fee paid by the issuer, and
- whether a director is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer.

While we wait to see what heightened standards exchanges elect to adopt, for the majority of public companies, such standards may not materially impact them. As these mandatory factors cover the same matters as the heightened independence standards for audit committees, it seems possible that exchanges may apply the same heightened standards to compensation committee membership. Accordingly, companies may wish to consider whether their compensation committees include any members who are "affiliates" of the company or who receive fees that would prohibit them from audit committee service, as such persons may also find themselves ineligible to serve on compensation committees.

Compensation Consultants and Outside Counsel

The rule requires that the compensation committee has full discretion and authority to retain outside compensation consultants as well as independent legal counsel, although there is no mandate to retain either set of advisers. Compensation committees "shall be directly responsible

for the appointment, compensation and oversight of the work of any compensation adviser retained by the compensation committee; and each listed issuer must provide for appropriate funding for payment of reasonable compensation, as determined by the compensation committee, to any compensation adviser retained by the compensation committee." The compensation committee does not need to be directly responsible for compensation consultants, outside counsel, or other advisers retained by management.

Considering Compensation Consultant Independence

The rule requires exchanges to adopt rules requiring compensation committees to consider Dodd-Frank's five enumerated factors in evaluating the independence of a compensation consultant or other adviser, plus one additional factor. However, it is important to note that there explicitly is no requirement that the compensation consultant or other adviser to actually be independent. As a result, none of the enumerated factors constitute a "bright line test" for retaining a compensation consultant or other adviser. The six factors are:

- The provision of other services to the issuer by the person that employs the compensation consultant, legal counsel, or other adviser;
- The amount of fees received from the issuer by the person that employs the compensation consultant, legal counsel, or other adviser, as a percentage of the total revenue of the person that employs the compensation consultant, legal counsel, or other adviser;
- The policies and procedures of the person that employs the compensation consultant, legal counsel, or other adviser that are designed to prevent conflicts of interest;
- Any business or personal relationship of the compensation consultant, legal counsel, or other adviser with a member of the compensation committee;
- Any stock of the issuer owned by the compensation consultant, legal counsel, or other adviser; and
- Any business or personal relationship of the compensation consultant, legal counsel, or other adviser or the person employing the adviser with an executive officer of the issuer.

Proxy Disclosure

Item 407(e)(3)(iii) of Regulation S-K already now requires disclosure:

- identifying the consultants;
- stating whether such consultants were engaged directly by the compensation committee or any other person;
- describing the nature and scope of the consultants' assignment, and the material elements of any instructions given to the consultants under the engagement; and
- disclosing the aggregate fees paid to a consultant for advice or recommendations on the amount or form of executive and director compensation and the aggregate fees for additional services if the consultant provided both and the fees for the additional services exceeded $120,000 during the fiscal year.

The final rule adds an additional disclosure obligation: "With regard to any compensation consultant identified in response to Item 407(e)(3)(iii) whose work has raised any conflict of interest, disclose the nature of the conflict and how the conflict is being addressed."

The enumerated factors that the compensation committee must consider in retaining a compensation consultant or other adviser are among the factors that must be considered in determining whether a conflict of interest exists.

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BUSINESS LAW TODAY
The ABA Business Law Section's Online Resource

Delaware Insider:

Collateral Estoppel Doesn't Bar Second Derivative Case After First is Dismissed

By Jason C. Jowers

In the recent case of *Louisiana Municipal Police Employees' Retirement System v. Pyott*, __ A.3d __, 2012 WL 2087205 (Del. Ch. June 11, 2012), the Delaware Court of Chancery issued a decision that has potentially significant implications for derivative actions involving Delaware corporations brought both in Delaware and in other jurisdictions. Disagreeing with a prior Court of Chancery case as well as a growing body of federal case law applying the collateral estoppel doctrine in the derivative action context, the court denied a motion to dismiss a derivative action brought by shareholder plaintiffs even though a federal court had previously dismissed with prejudice a substantially similar case brought by different shareholder plaintiffs. Applying Delaware Supreme Court precedent, Vice Chancellor Laster found that a derivative shareholder plaintiff does not have authority to step into the shoes of the corporation, if a corporation is opposing the litigation, until a court finds either that (1) demand on the board of directors is excused as futile or (2) the board is wrongfully refusing the demand. Because neither of these conditions precedent was met in the first derivative case, the first group of plaintiffs never became synonymous with the corporation. Thus, the court determined that the first derivative plaintiffs were never in privity with the corporation or the subsequent Delaware derivative plaintiffs, and collateral estoppel did not bar a subsequent derivative action involving the same facts. Relying on the internal affairs doctrine, the court concluded that Delaware determines under what circumstances shareholders of Delaware corporations are in privity with the corporation and each other. If a stockholder is not in privity with the corporation or another stockholder who brings a subsequent action, the dismissal of a first action does not bar a second action.

This article addresses: (1) the court's rationale for its decision; (2) the court's disagreement with prior case law; and (3) the potential impact on derivative litigation involving Delaware corporations post-*Pyott*, assuming the decision survives appeal.

Competing Derivative Actions

On September 1, 2010, Allergan, Inc., a Delaware corporation specializing in pharmaceuticals, entered into a settlement agreement with the United States Department of Justice following a three-year government investigation into Allergan's off-label marketing practices of Botox. As part of the settlement, Allegan agreed to pay $375 million in criminal fines for misbranding and $225 million in civil fines to resolve False Claims Act actions that also dealt with off-label marketing. The settlement was publically announced on September 1.

On September 3, 2010, Louisiana Municipal Police Employees' Retirement System (LAMPERS) filed the Delaware derivative action against the Allergan directors. U.F.C.W. Local 1776 & Participating Employers Pension Fund (UFCW), another Allergan shareholder, sent a books and records demand to Allergan pursuant to 8 Del. C. § 220 on November 3, 2010, and moved to intervene in the Delaware action on November 30, 2010. With the information obtained from the books and records demand and other publically available information, LAMPERS and UFCW, which had been permitted to intervene, filed the verified second amended derivative complaint on July 8, 2011. The Delaware complaint alleged that the Allergan board breached their fiduciary duties by consciously approving an off-marketing plan that violated a federal statutory ban on off-label marketing.

From September 9 to September 24, 2010, other Allergan shareholders filed derivative actions in federal court in California, which were subsequently consolidated before the U.S. District Court for the Central District of California. On April 12, 2011, the Central District of California dismissed the plaintiffs' first complaint without prejudice. The California plaintiffs asked Allergan to produce the documents it had produced in response to UFCW's books and records action, which it did. The California plaintiffs incorporated these documents into an amended complaint, and the director defendants again moved to dismiss. On January 17, 2012, the Central District of California granted the motion to dismiss with prejudice.

Following the dismissal of the California action, the director defendants in the Delaware action moved to dismiss, in part, on collateral estoppel grounds.

Choice of Law Analysis in *Pyott*

The *Pyott* decision begins with a complicated choice of law analysis. The defendants argued, and the court agreed, that the Delaware court was required to give the same force and effect to a foreign judgment as the foreign court rendering the judgment. The Full Faith and Credit Clause in the U.S. Constitution provides that "Full Faith and Credit shall be given in each State to the . . . judicial Proceedings of every other State." Congress adopted 28 U.S.C. § 1738 to implement the Full Faith and Credit Clause. The relevant portion of section 1738 provides that "judicial proceedings . . . shall have the same full faith and credit in every court within the United States . . . as they have by law or usage in the courts of such State . . . from which they are taken." 28 U.S.C. § 1738. In other words, when a Delaware court is asked to dismiss a case pursuant to the collateral estoppel doctrine based on a prior judgment in California, the Delaware court must give the same credit to that judgment as would a California court.

Some commentators criticizing the *Pyott* opinion have suggested that the Court of Chancery refused to apply California's collateral estoppel test, and in effect rejected the long-standing precedent interpreting the Full Faith and Credit Clause as requiring each state to give the judgment of a foreign state the same effect as it would have in the state issuing the judgment. Respectfully, such commentators are incorrect, and the court's decision is far more nuanced. Contrary to these criticisms, the court specifically stated that "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." The court also specifically cites to the Full Faith and Credit Clause, section 1738, and case law interpreting the same in support of this conclusion.

Although accepting that California's collateral estoppel standard generally governed the effect of the prior California judgment on the Delaware action, the Court of Chancery held that Delaware law had a role to play in the analysis. The California collateral estoppel or issue preclusion standard requires 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. While generally applying California's collateral estoppel test, as it must, the court concluded that Delaware law governed whether stockholders of a Delaware corporation were in privity with each other or the corporation under that test. According to the court, "[w]hether 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." The U.S. Supreme Court (in *Edgar v. MITE Corp.*, 457 U.S. 624 (1982)) has described the internal affairs doctrine as "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." According to the *Pyott* decision, whether one shareholder can sue derivatively after a first shareholder attempted, and failed, to plead demand futility is a matter involving the "managerial prerogatives" of a Delaware corporation, which implicates the internal affairs doctrine.

The court went on to explain that applying the internal affairs doctrine provides a uniform approach across all jurisdictions because the law of the state of incorporation would decide whether stockholders are in privity with the corporation or each other. As Vice Chancellor Laster stated, "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."

Disagreement with Prior Court Decisions

The Court of Chancery in *Pyott* noted that "[a] growing body of precedent holds that a Rule 23.1 dismissal has preclusive effect on other derivative complaints." In these mainly federal cases, courts found that a derivative plaintiff sues in the name of the corporation. By extension, once the corporation's claims brought by its representative shareholder are dismissed, it and its privies are precluded from relitigating the same issue again. For example, in *In re Career Educ. Corp. Derivative Litigation*, 2007 WL 2875203 (Del. Ch. Sept. 28, 2007), Vice Chancellor Parsons dismissed a second derivative action based on collateral estoppel. There, relying on federal cases that had addressed this issue, the court found that "the corporation is the true party in interest in a derivative suit." Under this theory, both the first and second derivative plaintiffs are in privity with the corporation, and thus the second derivative plaintiff is precluded from bringing a subsequent derivative action after the first is dismissed. Furthermore, as the director defendants in *Pyott* argued, in *LeBoyer v. Greenspan*, 2007 WL 4287646 (C.D. Cal. June 13, 2007), a California federal court applying California collateral estoppel law had found that a shareholder who brings a derivative suit on behalf of a Delaware corporation is in privity with the corporation's shareholder who brought a prior derivative action.

Rejecting this argument and expressly disagreeing with the *Career Education* and *LeBoyer* decisions, *Pyott* held "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." Relying on the seminal Delaware Supreme Court case of *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), the *Pyott* court explained that a deriva-

tive action, properly understood, has two components. In the first instance, it is an action by shareholders to compel the corporation to sue. Second, assuming demand is excused or wrongfully refused, it is an action by the shareholders on behalf of the corporation. Until the court denies a Rule 23.1 motion to dismiss or the board of directors determines it will not oppose the derivative action, the shareholder plaintiff is only bringing an action to compel the corporation to sue. Therefore, until a court denies a motion to dismiss or the board does not oppose the derivative action, the shareholder plaintiff does not have authority to carry out the second component of the derivative action, which is to sue on behalf of the corporation to remedy the wrong itself.

Under such circumstances, the *Pyott* court viewed it as inequitable for the director defendants to claim the shareholders in the Delaware action were precluded from asserting a claim following the dismissal of the earlier derivative suit. According to the court, "[h]aving first argued in their Rule 23.1 motion [in the California action] 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."

California Plaintiffs Failed to Provide Adequate Representation

As an alternative and independent basis for declining to find that the California dismissal collaterally estopped the Delaware plaintiffs from proceeding in Delaware, the Court of Chancery concluded that the California plaintiffs had not provided adequate representation. The collateral estoppel cases giving preclusive effect to a Rule 23.1 dismissal also recognize that a subsequent suit is permitted if the original plaintiff did not provide adequate representation to the corporation.

Finding that the California plaintiffs had not adequately represented the corporation, the court applied what it termed the "fast-filer presumption," which presumes that the fast-filer, by virtue of its lack of investigation, is not fit to serve as the representative for the corporation and its stockholders. Immediately following the public announcement of a "corporate trauma," there is often a race to the courthouse (if not courthouses) by competing plaintiffs' firms to file first in an effort to control the litigation. As the court observes, such complaints are often limited to conclusory allegations because they are filed before there has been any meaningful investigation. However, because many jurisdictions follow the first-to-file rule, it is difficult to obtain a stay of such cases in favor of an action brought by a representative plaintiff that conducts an investigation prior to bringing an action. Plaintiffs' firms, which are often representing shareholders for contingency fees, are motivated to win the race to the courthouse so that they may control the litigation and increase their share of any fee award. Although Delaware courts have routinely encouraged shareholders to use the "tools at hand" to make a books and records demand before filing an action on the merits, under the current system, a shareholder who pursues a books and records investigation, as well as the attorneys representing the shareholder, are disadvantaged vis-à-vis the fast-filing plaintiff.

In *Pyott*, one of the Delaware plaintiffs, UFCW, did seek books and records before intervening in the Delaware action. Although the California fast-filers eventually received the same information also, the court concluded that the California plaintiffs "already had shown where their true loyalties lay." As evidenced by their fast-filing, the court concluded the California plaintiffs were more interested in controlling the litigation so as to increase their share of any attorneys' fees award than the interests of Allergan, and thus failed to adequately represent Allergan. Accordingly, the court held that collateral estoppel did not bar the Delaware action.

Turning to the Rule 23.1 analysis and viewing the California decision as persuasive rather than binding authority, the court concluded that the plaintiffs had pled particularized allegations supporting a reasonable inference that their claims had some merit.

Implications of *Pyott*

The *Pyott* decision potentially has far-reaching consequences for Delaware directors and companies, as well as for the attorneys who represent them. The decision could lead to directors facing repetitious derivative suits brought by different shareholder plaintiffs if one or more actions are dismissed. Even if the subsequent suits are dismissed under Rule 23.1, the director defendants (and the companies indemnifying them) will be exposed at least to the expense of additional motion practice. However, as Vice Chancellor Laster's opinion explains, a court hearing the second derivative action is not required to ignore the foreign court's decision in the first derivative action. To the contrary, *Pyott* teaches that the first "decision does, of course, carry persuasive weight and can operate as *stare decisis*." Furthermore, the court emphasizes that its decision is not meant to create forum shopping for the same shareholder plaintiff. Indeed, "[w]hen 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."

The court's analysis of the problem of inadequate representation by fast-filing plaintiffs may also prove to be significant. Without a presumption that a fast-filer's representation is inadequate, there is no real incentive for plaintiffs to slow down and investigate because the ruling on the motion to dismiss in the first derivative action will either (1) allow the case to proceed (benefitting the fast-filer) or (2) dismiss the case, collaterally estopping the other shareholders from proceeding (equally harming all of the plaintiffs). Under this system, all of the plaintiffs' firms are in the same boat, except for the winner of the race to the courthouse. Accordingly, the incentive is to be first. By removing the risk of automatic dismissal of a second-filed derivative action if

the first action fails or if representation by a fast-filer is inadequate, the court is encouraging plaintiffs to conduct investigations and be informed rather than merely be first-to-file. The fast-filer whose case was first but dismissed will be unable to control the litigation and obtain the potentially significant fee award from controlling a successful derivative action. As Vice Chancellor Laster put it: "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." In theory, by incentivizing plaintiffs and their attorneys to thoroughly investigate before filing a derivative action, the fast-filer presumption could reduce the number of derivative actions filed immediately following the announcement of some "corporate trauma." Admittedly, it may also increase the number of books and records demands pursuant to 8 Del. C. § 220. Although corporations may face an added expense from an increase in books and records inspection activity, the investigations may actually eliminate the subsequent filing of derivative cases if the investigation indicates that there is no potential liability.

Significantly, on July 6, 2012, the Court of Chancery granted the defendants' application for certification of an interlocutory appeal to the Delaware Supreme Court in the *Pyott* case. Therefore, practitioners should continue to monitor this case for further developments.

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Additional Resources

For other materials related to this topic, please refer to the following.

Business Law Today

Fiduciary Duties of Managers of LLCs: The Status of the Debate in Delaware

By Lewis H. Lazarus and Jason C. Jowers
February 2012

Delaware LLC's and the Implied Covenant of Good Faith and Fair Dealing

By Lewis H. Lazarus and Jason C. Jowers
November 2011

Decision Puts Premium on Careful Drafting

By Lewis H. Lazarus and Jason C. Jowers
Volume 17, Number 5: May/June 2008

BUSINESS LAW TODAY
The ABA Business Law Section's Online Resource

Inside Business Law

July 2012

Focus on the Middle Market and Small Business Committee

The mission of the Middle Market and Small Business Committee is to guide U.S. and international corporate and transactional lawyers who counsel clients ranging from private family and middle market enterprises to smaller public companies on the myriad of business "life cycle" issues they confront in their practices. The Committee's *Business Visions* newsletter is a critical means of accomplishing that mission, and this latest edition includes updates on crowdfunding and the SEC advisory committee on small business capital formation.

Cyberspace Law Update

These days, few practice areas in business law are as "frothy" as cyberspace law. *Inside Business Law* is no stranger to this trend, bringing you the latest on this dynamic, ever-changing area of the law, courtesy of the Cyberspace Law Committee:

- Emerging growth companies in the mobile application, online advertising, and social networking sectors rely on user-provided information to an unprecedented degree in creating and providing novel, useful products. However, one of the potential costs of this innovation can be unwarranted disclosure of users' private information, and companies that do not adequately guard against such disclosure can face significant liability exposure. This program from the Business Law Section's Spring 2012 meeting, titled "Avoiding the Privacy Cross-Hairs: Keeping Companies that Advertise on the Internet and App Providers Away from Privacy Regulators and the New Class Action Plaintiffs" (audio) provides a comprehensive overview on how to best advise these emerging companies away from such privacy-related liability exposure.
- The "Cloud," today's pervasive high technology buzzword, embodies a promise of truly distributed data and applications access whereby users can leverage capabilities previously inaccessible without a large IT budget and centralized capabilities. However, with that promise can come legal dangers, particularly with regards to the security and privacy of sensitive information that is now essentially "outsourced." James Bryce Clark , Roland L. Trope, and Sarah Jane Hughes give gives us a thought-provoking analysis of this issue in their presentation, "A Few Cautionary Words for the Traveller in the Clouds."
- The ubiquity of data transfer on the Internet also gives rise to the ubiquity of unauthorized use of intellectual property and the proliferation of defamatory content. Jon M. Garon gives us a detailed analysis on how to advise our victimized clients in "Tidying up the Internet: Take Down of Unauthorized Content under Copyright, Trademark and Defamation Law." (audio).

Corporate Counsel

- Does your corporation's executive protection program adequately protect directors and officers from personal and criminal liability? These materials contain a helpful checklist intended to guide an attorney serving as corporate counsel tasked with overseeing specialists in risk management and insurance who recommend an executive protection program. "Protecting the Corporate Director" (audio)
- As most business attorneys are aware, it is important for corporations to properly observe corporate formalities. These materials provide an overview on best practices for private company board meetings and contain helpful tips on how to avoid common pitfalls. "Guiding the Private Company Board Meeting—Best Practices and Avoiding Pitfalls" (audio)
- During internal investigations, tensions can easily run high between in-house and outside counsel who can disagree from the onset regarding the scope of the investigation, the breadth of e-discovery, and how to handle individual employees who may be potential government targets. This program focuses primarily on what ethical and practical considerations can arise during a typical internal investigation and the additional complications when outside counsel coordinates. "Can't We All Just Get

Along? How In-House and Outside Counsel Manage the Other During Internal Investigations" (audio)

- Ethical issues often arise for business lawyers in a number of situations. These program materials address the ethical issues arising from new technology, global law firms, and lawyer movements between law firms. "What You Need to Know About Ethics 20/20 and Why You Need to Know It" (audio)
- Should in-house counsel be navigating in the choppy waters of corporate compliance? This presentation seeks to address this question and provide helpful recommendations for corporate counsel. "Should In-House Counsel be Navigating in the Choppy Waters of Corporate Compliance?"

Trends in Healthcare M&A

The Supreme Court's recent ruling upholding substantive provisions of the Patient Protection and Affordable Care Act reinforces the fact that profound change is happening now in the healthcare sector, and this change will drive how business lawyers approach mergers and acquisitions involving healthcare providers. For a timely and exceptionally useful analysis of trends in healthcare M&A, you won't want to miss this presentation from the Mergers & Acquisitions Committee. "Let's Play Doctor: Acquisition and Financing of Healthcare Facilities" (audio)