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Outside Director Oversight Litigation – In Delaware And Beyond

By Stephen A. Radin

Recent widely reported corporate failures have focused questions upon our corporate governance system and upon the need for certain reforms. In July, Congress passed and the President signed the Sarbanes-Oxley Act of 2002. The Securities and Exchange Commission has issued a series of releases addressing corporate governance issues. The New York Stock Exchange and NASDAQ have proposed new listing standards. A common theme underlying all of these efforts is the desire to improve outside director oversight of corporate affairs.

I have been asked to comment upon the role likely to be played by the one government constituency not yet heard from in response to the events of the last year: the courts, and, in particular, the Delaware courts. The judiciary's response may have the greatest impact upon the way outside directors oversee corporate affairs because the courts will decide the extent to which outside directors face personal liability when wrongdoing or mistakes are not uncovered quickly enough.

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Post-Merger Employment Agreements With Target Management And SEC Rule 14d-10: A Trap For The Unwary?

By Paul Dutka and Sirin Thada

As the curtain has rung down in recent years on hostile tender offers, negotiated acquisitions have seized center stage, propelled by perceived synergies between acquiror and target. Because the merger's success often depends on retaining the target's senior management, understanding the impact of Securities and Exchange Commission Rule 14d-10[1] (the "All-Holders, Best-Price" rule) on an acquiror's ability to negotiate post-merger employment agreements with target management during the tender offer carries increased urgency.

Recently, in *Gerber v. Computer Associates International, Inc.*, 303 F.3d 126 (2d Cir. Sept. 4, 2002), the Second Circuit held that the acquiror's payment to the target's chief executive officer under a post-merger non-compete agreement, when the CEO

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Director Oversight Litigation

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Under current law, at least five courts have observed, proving liability for failure to monitor corporate affairs is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment" (all quoting *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996)). The courts will decide whether to create new common law rules (or apply old rules) in a manner that imposes (or is perceived to impose) greater risks of personal liability upon outside directors. If so, some outside directors may increase their scrutiny of corporate affairs, but other outside directors will conclude that their modest directors fees (relative to their net worth and exposure to liability) are not worth the trouble and stop serving. Already, there are reports of directors stepping down and of difficulties some companies are having recruiting directors. As one (unidentified) SEC official recently was quoted in the Wall Street Journal: "There's the fear that rather than serving on boards, they'll just go off and play golf."

Historically, cases involving director oversight have been litigated in the Delaware Court of Chancery and the Delaware Supreme Court because more than half the companies listed on the New York Stock Exchange and approximately 60 percent of Fortune 500 companies are incorporated in Delaware. The unique ability of the Delaware courts to decide corporate governance cases is well known: Delaware has an unparalleled body of case law addressing corporate governance issues. Delaware's Court of Chancery has five judges, all of whom are experts in corporate law and corporate governance issues. As no less an authority than United States Chief Justice William H. Rehnquist has observed:

> [T]he Delaware Court of Chancery deserves our celebration, not only as a unique and vibrant Delaware institution, but as an important contributor to our national system of justice. The Delaware state court system has established its national preeminence in the field of corporation law due in large measure to its Court of Chancery. . . . The

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process of decision in the litigated cases has so far refined the law that business planners may usually order their affairs to avoid lawsuits. This recognition confers on the Court of Chancery one of the highest forms of praise a judiciary can receive.

The Delaware Supreme Court's five justices have equal expertise in these subjects.

The Delaware courts, however, may not be the forum for much of the litigation that will decide the liability of outside directors for the corporate failures that have sparked the current corporate governance debate. Several of the corporations at the center of the firestorm are not Delaware corporations: Enron, for example, is an Oregon corporation, and WorldCom is a Georgia corporation. Cases involving Enron and WorldCom therefore will be governed by Oregon and Georgia law, respectively. Courts construing the law of states other than Delaware often look to Delaware law for guidance in matters involving corporate law, but do not necessarily follow Delaware law, as demonstrated by the Maryland Court of Appeals' recent rejection of Delaware law in favor of a less shareholder-friendly rule in *Werbowsky v. Collomb*, 766 A.2d 123 (Md. 2001), a decision construing Maryland's pre-litigation demand requirement.

And, cases involving the conduct of directors of Delaware corporations governed by Delaware law often are heard in state and federal courts outside of Delaware, sometimes with the blessing of the Delaware courts, as in *Corwin v. Silverman*, 1999 WL 499456 (Del. Ch. 1999), a decision arising out of the $500 million restatement by Cendant in 1998. In that decision, the Court of Chancery stayed a Delaware action pending completion of a parallel action in federal court in New Jersey and stated that "[f]ederal courts have proven time and again their ability to apply and even extend Delaware law in appropriate ways."

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Court Of Appeals Holds That, In Deciding A PSLRA Motion To Dismiss, Even Reasonable Inferences Adverse To Plaintiff Must Be Considered

In *Gompper v. VISX, Inc.*, 298 F.3d 893 (9th Cir. 2002), the Court of Appeals for the Ninth Circuit held that in determining whether a securities fraud complaint sufficiently alleges facts giving rise to a strong inference of scienter required to survive a motion to dismiss under the Private Securities Litigation Reform Act ("PSLRA"), courts must consider all reasonable inferences to be drawn from the complaint's allegations, including inferences unfavorable to plaintiff.

Purchasers of VISX, Inc.'s ("VISX's") stock sued VISX and its directors and officers claiming that during the class period, defendants made positive statements about VISX's business prospects to inflate VISX's stock price and benefit from insider trading. The district court dismissed the complaint for failure to state a claim, and plaintiffs appealed to the Court of Appeals for the Ninth Circuit.

Plaintiffs asked the Court of Appeals to clarify what inferences a court should consider in determining whether a securities fraud complaint survives a motion to dismiss under Fed. R. Civ. P. 12(b)(6) and the PSLRA.

The Court of Appeals stated that "resolution of this matter requires a reconciliation between established law which attaches at this procedural stage, and the PSLRA's heightened requirement that a complaint plead facts evincing a strong inference of scienter in order to survive a motion to dismiss." The Court explained that the PSLRA "significantly altered pleading requirements in private securities fraud litigation by requiring that a complaint 'plead with particularity both falsity and scienter'" (quoting *Ronconi v. Larkin*, 253 F.3d 423, 429 (9th Cir. 2001)). The Court emphasized that under the PSLRA pleading standard, "the complaint must allege that the defendants made false or misleading statements either intentionally or with deliberate recklessness" (citing *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 985 (9th Cir. 1999)).

The Court then noted that on a motion to dismiss under Fed. R. Civ. P. 12(b)(6), "the reviewing court must accept plaintiff's allegations as true and construe them in the light most favorable to the plaintiff," but that under the PSLRA, "the court ultimately reviews the complaint in its entirety to determine whether the totality of facts and inferences demonstrate a strong inference of scienter." The Court observed that "an inevitable tension arises between the customary latitude granted the plaintiff on a motion to dismiss under Fed. R. Civ. P. 12(b)(6), and the heightened pleading standard set forth under the PSLRA."

Plaintiffs argued that the district court erred by considering inferences unfavorable to their case: "if the facts as pled give rise to a reasonable and warranted inference of scienter, then the court must accept this inference entirely, without consideration of competing negative inferences, even where, under the circumstances, those competing inferences may be equally or more plausible." But the Court of Appeals disagreed: "[t]o accept plaintiffs' argument that the court is required to consider only inferences favorable to their position would be to eviscerate the PSLRA's strong inference requirement by allowing plaintiffs to plead in a vacuum." The Court explained that plaintiffs' approach would allow "all plaintiffs who engage in careful, measured pleading to demonstrate a strong inference of scienter, because district courts would only be allowed to consider reasonably drawn inferences that favor the plaintiffs." The Court said that such an approach would thwart the PLSRA's purpose of eliminating abusive securities fraud litigation.

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also owned a block of the target's stock, violated Rule 14d-10, although the payment was made after the tender offer closed. The Second Circuit concluded that part of the consideration the CEO received constituted unlawful additional payment for his shares, and ordered that the plaintiff class of tendering shareholders receive the same increased price for their shares.

This article focuses first on *Gerber*, then turns to other leading cases illustrating how the courts have split over the application of Rule 14d-10.

The "All Holders, Best Price" Rule

In adopting Rule 14d-10 in 1986, the SEC announced that the Rule's all-holders and best-price requirements were necessary to implement the investor protection purposes of the Williams Act. Thus, Rule 14d-10

> preclude[s] bidders from discriminating among holders of the class of securities that is the subject of the offer, either by exclusion from the offer or by payment of different consideration. Without the all-holders and best-price requirements, the investor protection purposes of the Williams Act would not be fully achieved because tender offers could be extended to some security holders but not to others. Such discriminatory tender offers could result in the abuses inherent in "Saturday Night Specials," "First-Come First Served" offers and unconventional tender offers since security holders who are excluded from the offer may be pressured to sell to those in the included class in order to participate, at all, in the premium offered. These excluded security holders would not receive the information required by the Williams Act, would have their shares taken up on a first-come first-served basis and would have no withdrawal rights.[2]

Rule 14d-10 states that "[n]o bidder shall make a tender offer unless: (1) the tender offer is open to all security holders of the class of securities subject to the tender offer; and (2) the consideration paid to any security holder pursuant to the tender offer is the highest consideration paid to any other security holder during such tender offer."[3]

But, as *Gerber* illustrates, Rule 14d-10 has in turn engendered controversy because of the ambiguity attaching to the phrase "during such tender offer." Some courts, including the Second Circuit, use a "functional" approach, broadly interpreting the word "during" and inquiring whether additional payment made outside the tender offer period nonetheless furthered the acquiror's goal of merging and thus violated Rule 14d-10. Other courts have adopted a "formal" or "bright-line" approach, under which a violation of Rule 14d-10 occurs only if the additional payment is literally paid "during" the tender offer.

This split among the courts promises continuing difficulty in structuring post-merger employment agreements with target management, a difficulty which is exacerbated by the disastrous financial consequences that violations can carry because any "increased consideration" must be paid to all tendering shareholders.[4]

Gerber v. Computer Associates Int'l, Inc.

In July 1991, Computer Associates' chairman Charles Wang approached On-Line chief executive officer Jack Berdy about acquiring On-Line. Eventually they agreed upon the terms of a tender offer and back-end merger. Computer Associates offered to purchase On-Line stock for $15.75 per share, and contracted to give Berdy $5 million for his agreement not to compete.[5]

Plaintiff Joel Gerber, an On-Line shareholder, later filed a purported class action on behalf of tendering shareholders, principally alleging that the $5 million was in reality increased consideration for Berdy's 1.5 million On-Line shares.[6] Computer Associates moved to dismiss, arguing that the non-compete agreement was made before the tender offer began, and, thus fell outside Rule 14d-10.[7] The district court denied the motion, concluding as a matter of law that the tender offer had commenced five days before Berdy's non-compete agreement was signed, when the com-

Reasonable Inferences

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The Court held that courts must consider all reasonable inferences to be drawn from the complaint's allegations – including inferences undermining plaintiffs' ability to establish a strong inference of scienter:

> Because we believe Congress made it crystal clear that the PSLRA's pleading requirements were put in place so that only complaints with particularized facts giving rise to a strong inference of wrongdoing survive a motion to dismiss, we agree with the district court that when determining whether plaintiffs have shown a strong inference of scienter, the court must consider all reasonable inferences to be drawn from the allegations, including inferences unfavorable to the plaintiffs. District courts should consider all the allegations in their entirety, together with any reasonable inferences that can be drawn therefrom, in concluding whether, on balance, the plaintiffs' complaint gives rise to the requisite inference of scienter.

The Court of Appeals affirmed the district court's dismissal of the complaint.

panies issued a press release announcing the terms of the offer, subject to a number of conditions, including board and regulatory approvals and the execution of definitive agreements.[8]

The court then certified the plaintiff class,[9] and Computer Associates moved for summary judgment.[10] The court granted summary judgment in part, but denied the motion with respect to the Rule 14d-10 claim because the court found genuine issues of material fact concerning the nature and purpose of the $5 million payment to Berdy.[11] The case eventually went to trial, and the district court instructed the jury to "consider whether the payment of 5 million dollars under the so-called Berdy agreement was paid to Dr. Berdy for his On-Line shares, or his agreement not to compete, or partly for the shares and partly for the agreement not to compete."[12]

The jury returned a special verdict for the plaintiff class, finding that $2.34 million of the $5 million was unlawful additional payment for Berdy's shares, while the rest was legitimate compensation for his non-compete agreement. The court entered judgment totaling $5.67 million, representing an additional $1.46 per share of On-Line common stock for the class, plus interest.[13] Computer Associates moved for judgment notwithstanding the verdict, or a new trial, which was denied.[14] Computer Associates appealed.

The Appeal

On appeal, Computer Associates argued that the Rule 14d-10 claim was insufficient as a matter of law because, even if the Berdy agreement was signed during the tender offer, Berdy was not paid until five days *after* the tender offer had closed. But, true to the functional approach, the Court of Appeals looked beyond the tender offer's "self-prescribed expiration date" and rejected Computer Associates' timing argument. "While Rule 14d-2 governs the determination of when a tender offer commences," reasoned the Court of

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Court Of Appeals Lacks Jurisdiction To Review A District Court's Order Remanding Class Action To State Court

In *Abada v. Charles Schwab & Co.*, 300 F.3d 1112 (9th Cir. 2002), the Court of Appeals for the Ninth Circuit held that it lacked jurisdiction to review a district court's order remanding a class action to state court.

Beginning in 1996, Charles Schwab Inc. allowed its customers to conduct securities transactions over the Internet. Plaintiff opened an account with Schwab in 1998, and then placed purchase orders through Schwab's website. Plaintiff alleged that although Schwab supposedly represented that its online trading system "would provide fast, high quality executions," plaintiff had difficulty accessing Schwab's website to sell the securities, and that when he finally was able to log in, the price of the securities had plummeted well below the price at which plaintiff had purchased them.

Plaintiff brought a class action against Schwab in state court in California. Schwab removed the case to federal court under 28 U.S.C. §§ 1441 and 1446 and the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"). SLUSA prohibits a private party from bringing a "covered class action" in federal or state court based on the statutory or common law of a state alleging a "misrepresentation or omission of a material fact" or use of "any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1). SLUSA also states that any "covered class action" brought in state court "shall be removable to . . . Federal District Court." 15 U.S.C. § 78bb(f)(2).

Plaintiff then moved to remand, arguing that his claims "were not preempted by SLUSA because they did not allege misrepresentations 'in connection with' the purchase or sale of a covered security." But the district court held that plaintiffs' claims were "completely" preempted by SLUSA and declined to remand.

Plaintiff then amended his complaint to add a claim against Schwab for violation of Section 10(b) of the Securities Exchange Act and Rule 10b-5. The case was assigned to a different judge, and Schwab moved to dismiss. In opposition, plaintiff asked the court to reconsider the previous judge's order denying plaintiff's remand motion. The judge reconsidered that order and held that remand was appropriate. In that regard, the district court noted that the original complaint asserted only state law claims, and thus reasoned that it "had federal question jurisdiction over the complaint [only] if [plaintiff's] state law claims were completely pre-empted by SLUSA." The district court then held that SLUSA did not completely preempt the state law claims, and remanded for lack of subject matter jurisdiction. Schwab appealed to the Court of Appeals for the Ninth Circuit.

The Court of Appeals framed the threshold issue as "whether [the Court] ha[s] appellate jurisdiction to entertain th[e] appeal, given the general rule that '[a]s long as a district court's remand is based on a timely raised defect in removal procedure or on a lack of subject matter jurisdiction . . . a court of appeals lacks jurisdiction to entertain an appeal of a remand order under [28 U.S.C.] § 1447(d)" (quoting *Things Remembered, Inc. v. Petrarca*, 516 U.S. 124, 127-28 (1995)).

Noting that the district court remanded the case for lack of subject matter jurisdiction, the Court of Appeals held that "unless one of the exceptions to the general rule applies, we do not have appellate jurisdiction to review the remand order because it was founded on the absence of subject matter jurisdiction." According to the Court, "'[r]emand orders based on a defect in removal procedure or lack of subject matter jurisdiction are immune from review even if the district court's order is erroneous'"

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Appeals, "no pertinent rule or statute addresses when a tender offer concludes."[15] Given this, "the phrase 'during the tender offer'...is flexible enough to include [Computer Associates'] payment to Berdy...."[16]

In reaching this conclusion, the Court emphasized that Computer Associates paid Berdy before paying any other shareholders, so "if Berdy was not paid 'during the tender offer,' then neither was any other On-Line shareholder."[17] Taking a bright-line approach and simply equating the end of the tender offer with its self-proclaimed expiration date "would make it all too easy to contract around the Best Price Rule" and would render the rule "toothless."[18]

The Court relied on its earlier decision in *Field v. Trump*, 850 F.2d 938 (2d Cir. 1988), where defendants commenced a tender offer, then "withdrew" it to purchase a dissident's shares at a higher price, and then launched a "new" tender offer the very next day at the original price.[19] Instead of accepting defendants' characterizations, the *Field* Court examined the surrounding circumstances to determine whether the formally separate offers should be considered a single, integrated transaction. Because the defendants never "abandoned the goal of the original tender offer," the *Field* Court concluded that they had not effectively terminated the initial tender offer, and that the "second" tender offer was merely a continuation of the first.[20] Given this, the purchase of the dissident's shares violated Rule 14d-10.

The *Gerber* Court found that Computer Associates, like the defendants in Field, had "continuously pursued the goal of its tender offer."[21] Because the Berdy agreement was signed during the tender offer and payment was made "in support of [Computer Associates'] continuous goal" of acquiring On-Line, the Court concluded that the payment also occurred "during the tender offer" for purposes of Rule 14d-10, and held that Gerber's claims were sufficient as a matter of law.[22]

On appeal, the Second Circuit also considered whether the district court erred in instructing the jury that it could find Computer Associates paid $5 million to Berdy "partly for the shares and partly for the agreement not to com-

Remanding Class Action

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(quoting *Yakama Indian Nation v. State of Wash. Dep't of Revenue*, 176 F.3d 1241, 1248 (9th Cir. 1999)).

Schwab argued that the district court "was exercising its discretion in remanding the case because the amended complaint included a federal cause of action that conferred subject matter jurisdiction on the court," and therefore that "the district court necessarily must have been exercising its discretion in remanding, rather than doing so on a jurisdictional basis." The Court of Appeals acknowledged that 28 U.S.C. § 1447(d) "does not bar appellate review of a district court's discretionary decision not to exercise jurisdiction," but held that Schwab's argument "proceed[ed] from a false premise." The Court noted that "[t]he complaint that Schwab removed to federal court contained only state law claims, which are ordinarily insufficient to invoke federal subject matter jurisdiction." The Court explained that "'[i]n determining the existence of removal jurisdiction, based upon a federal question, the court must look to the complaint as of the time the removal petition was filed," and that "[j]urisdiction is based on the complaint as originally filed and not as amended" (quoting *O'Halloran v. Univ. of Wash.*, 856 F.2d 1375, 1379 (9th Cir. 1988)) (emphasis added by *Abada* court)). Thus, plaintiff's amendment of the complaint to include a federal claim was "of no significance with regard to removal jurisdiction." The Court held that because the district court concluded that it lacked jurisdiction on the basis of a complaint that asserted only state law claims, the district court "was not exercising its discretion, but reaching a legal conclusion [and a]s such, the remand order was not the product of a discretionary decision that would be subject to appellate review."

In addition, the Court considered it irrelevant that the district court judge who remanded to state court "elected to reconsider an order of the judge previously assigned to th[e] case." Schwab had argued that "because reconsideration is an action of discretion, the resulting order on the merits is also transformed into a discretionary decision." The Court of Appeals disagreed, noting that Schwab's argument improperly conflated two distinct district court decisions, and observed that although a district court's order reconsidering a previous judge's order is reviewable for abuse of discretion, Schwab was not seeking review of the reconsideration order, but was appealing the merits of the remand order.

Finally, the Court of Appeals held that although the district court's "removal and . . . remand order were based in part on SLUSA's express removal and remand provisions," that was inconsequential. The Court pointed out that the Supreme Court has held that 28 U.S.C. "§ 1447(d)'s prohibition of appellate review of remand orders applies 'not only to remand orders made in suits removed under [the general removal statute], but to orders of remand made in cases removed under any other statutes as well" (quoting *Things Remembered*, 516 U.S. at 124)). Thus, § 1447(d)'s bar on review of remand orders applied regardless of whether the case was removed under SLUSA.

The Court held that because none of the exceptions to § 1447(d)'s prohibition against appellate review of remand orders applied, the Court lacked appellate jurisdiction, and dismissed the appeal.

pete."[23] Computer Associates argued that there was no evidentiary basis for this apportionment, and that the jury's finding that $2.34 million was payment for Berdy's shares represented an impermissible compromise verdict. The Court of Appeals reviewed the jury instructions de novo and found sufficient evidence to support the jury's finding, based on the testimony of Computer Associates' own expert witnesses. One witness testified, for example, that, if Berdy competed, the expected loss to Computer Associates could range from $0 to $5 million. The Court of Appeals held: (a) this was sufficient evidence for a jury to find that some, but not all, of the $5 million was consideration for Berdy's On-Line shares; and (b) the verdict was not an impermissible compromise because it was supported by the trial evidence.[24]

The Functional Approach: Other Decisions

Other courts adopting the functional approach include the Court of Appeals for the Ninth Circuit, and United States District Courts in Tennessee and Pennsylvania. The Ninth Circuit adopted the functional approach in *Epstein v. MCA, Inc.*, 50 F.3d 644 (9th Cir. 1995).[25] The litigation grew out of Matsushita Electrical Company's tender offer for MCA, and its entering into employment agreements with MCA executives Lew Wasserman and Sidney Sheinberg.

Rather than tendering his shares, Wasserman exchanged them for preferred stock in a wholly owned Matsushita subsidiary. The agreement was signed moments before the tender offer commenced, and the preferred stock changed hands about one hour after the tender offer closed. Sheinberg, on the other hand, tendered his shares, but MCA agreed to pay him an additional $21 million if the tender offer succeeded. Two days after Matsushita accepted all tendered shares, MCA paid Sheinberg the promised $21 million.

The district court denied plaintiffs' motion for summary judgment on their Rule 14d-10 claim and instead granted

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District Court Holds That Voluntary Dismissal Of An Allegedly Frivolous Lawsuit Is Not A "Final Adjudication" And Thus Avoids PSLRA Sanctions

In *Blaser v. Bessemer Trust Co.*, 2002 WL 31359015 (S.D.N.Y. Oct. 21, 2002), the United States District Court for the Southern District of New York held that voluntary dismissal of an allegedly frivolous securities fraud lawsuit is not a "final adjudication" of the action within the meaning of Section 21D(c) of the Securities Exchange Act, added by the Private Securities Litigation Reform Act ("PSLRA"). Section 21D(c) – the PSLRA's sanctions provision – requires the court "upon final adjudication of the action," to make specific findings regarding the parties' compliance with Fed. R. Civ. P. 11, and to impose sanctions for violations of Rule 11.

Plaintiff sued a New York investment corporation claiming that defendant executed unauthorized securities transactions in plaintiff's investment account, violating Section 10(b) of the Securities Exchange Act and Rule 10b-5. Defendant moved to dismiss stating that plaintiff's account management agreement in reality was with a Florida corporation that plaintiff had not sued. Plaintiff then voluntarily dismissed the action, but later filed an action in Florida against the Florida corporation. The New York corporation then moved for sanctions under the PSLRA.

In opposing defendant's sanctions motion, plaintiff argued that the court was not required to make specific findings regarding compliance with Rule 11 "because [plaintiff's] voluntary dismissal does not constitute a 'final adjudication'" within the meaning of Section 21D(c). Plaintiff also contended that sanctions under the PSLRA were unwarranted because plaintiff voluntarily dismissed her complaint before defendant moved for sanctions, thus bringing plaintiff within Rule 11's 21-day safe harbor. Rule 11(c)(1) (A) states that:

> A motion for sanctions under this rule shall be made separately from other motions or requests and shall describe the specific conduct alleged to violate subdivision (b). It shall be served as provided by Rule 5, but shall not be filed with or presented to the court unless, within 21 days after service of the motion (or such other period as the court may prescribe), the challenged paper, claim, defense, contention, allegation, or denial is not withdrawn or appropriately corrected.

The district court noted that Section 21D(c) of the Exchange Act does not define "final adjudication" and "there is little case law" on the issue. The Court then turned to Black's Law Dictionary, which defines "adjudication" as the "legal process of resolving a dispute; the process of judicially deciding a case," and the American Heritage Dictionary, which defines "adjudicate as "[t]o hear and settle (a case) by judicial procedure." The court stated that "[t]o the extent that plaintiff voluntarily dismissed her complaint without prejudice pursuant to [Fed. R. Civ. P.] 41(a)(1)(i), this dispute has not been 'resolv[ed],' and the Court has not 'decid[ed]' the case," and "[n]or has [the Court] 'hear[d] and settle[d] the case." The court held that "[b]y the plain meaning of the term, there has been no 'adjudication' in this case, let alone adjudication that is 'final.'"

The court added that if a voluntary dismissal were to constitute a "final adjudication," then under the mandatory review provision of Section 21D(c), a district court would be required "to conduct a Rule 11 inquiry and make specific findings as part of that inquiry in every action filed under the PSLRA which is voluntarily dismissed, including actions in which no answer has been filed or where the parties have stipulated to dismissal." The court held that "[i]f Congress actually intended to saddle dis-

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summary judgment to Matsushita. Plaintiffs appealed, and Matsushita argued that Rule 14d-10 was inapplicable because both the payments and the agreements were made outside the formal tender offer period. The Ninth Circuit rejected this argument, noting that the phrase "tender offer" has never been interpreted as denoting a rigid period of time, and that if the Court were to adopt such a rigid test, Rule 14d-10 would be drained of all force.[26]

Instead, the Court held that "[a]n inquiry more in keeping with the language and purposes of Rule 14d-10 focuses not on when Wasserman was paid, but on whether the Wasserman transaction was an integral part of [the] tender offer."[27] The court found that the Wasserman transaction was integral because it was "in several material respects conditioned on the terms of the public tender offer": the redemption value of Wasserman's stock referred to the tender offer price, and the transaction hinged upon the tender offer's success.[28]

Finally, the court rejected Matsushita's argument that the Sheinberg agreement could not violate Rule 14d-10 because the Rule applied only to the acquiror, whereas it was MCA, the target, that had paid Sheinberg. The court reasoned that the mere fact that MCA issued the check just before merging with Matsushita did not preclude the possibility that the payment was meant to induce Sheinberg's support of Matsushita's tender offer.[29]

"[A]s *Gerber* illustrates, Rule 14d-10 has . . . engendered controversy because of the ambiguity attaching to the phrase 'during such tender offer.'"

More recently, district courts in Tennessee and Pennsylvania have also adopted the functional approach. In *Katt v. Titan Acquisitions, Ltd.*, 133 F. Supp. 2d 632 (M.D. Tenn. 2000), the court denied a motion to dismiss Rule 14d-10 claims based on $30 million in golden parachute payments, accelerated incentive awards, "sign on" bonuses, and accelerated performance awards to target executives. These agreements were made and consummated outside the tender offer period; in fact, many of these agreements had been made months before, and the sign-on bonuses, for example, were not paid until months after the tender offer closed.

But, under the functional approach, the court held that the agreements could be an "integral part" of the tender offer because: they were "executed in close connection with [the] tender offer," the "officers' contractual rights [were] tied to the success of [the] tender offer," the "officers [were] shareholders and these agreements [were] inextricably joined with [the] tender offer, the success of the acquisition and these officers' support of the acquisition."[30] Although the payments were made by the target, the court concluded that the payments could be found to have been induced by the acquiror, and thus remained subject to Rule 14d-10.

In *Millionerrors Investment Club v. General Electric Co.*, 2000 U.S. Dist. LEXIS 4778 (W.D. Pa. Feb. 8, 2000), a district court in Pennsylvania denied a motion to dismiss Rule 14d-10 claims based on stock options granted to executives of the target. These in-the-money options were granted shortly before the tender offer commenced, and were cancelled, as soon as the tender offer closed, in exchange for cash payments pegged to the difference between the options' strike price and the tender offer price. Although actual payment was not made until several months after the tender offer closed, nevertheless the court denied the motion to dismiss because the acquiror's "agreement to cancel and cash out the [target] executive[s] unvested stock options occurred 'during' the Tender Offer."[31] The court stated: "We agree with the less rigid interpretation of Rule 14d-10 utilized by the [court] in *Epstein*. . . . That interpretation is more attuned to the SEC's . . . goal of ensuring 'equality of treatment among all shareholders who tender their shares.'"[32]

The functional approach arguably sweeps too broadly, placing many post-merger employment agreements with target management at risk because they may be considered "integral to," or executed "continuously in pursuit of," the tender offer. Furthermore, the factually nuanced nature of the functional approach makes it likely that a Rule 14d-10 claim will survive a motion to dismiss and perhaps summary judgment. Given this and given most corporations' unwillingness to hazard their futures on the dice roll of a jury verdict, the threat of huge liability engendered by the func-

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trict courts with this task, it would have stated so explicitly instead of using the phrase 'final adjudication' as the trigger for the Rule 11 review."

Finally, the court held that it could not impose sanctions under Rule 11 because plaintiff withdrew her complaint well before the expiration of Rule 11's 21-day safe harbor.

tional approach creates significant settlement leverage for plaintiffs.

The Formal Approach

Under the "formal" or "bright-line" approach, additional consideration violates Rule 14d-10 only if it is literally paid during the tender offer. *Lerro v. Quaker Oats Co.*, 84 F.3d 239 (7th Cir. 1996) is the foremost bright-line case, and arose out of Quaker Oats' acquisition of Snapple Beverage Corporation. The case involved a lucrative distribution agreement with one of the target's controlling shareholders, which plaintiff alleged was a disguised additional payment for shares.

The Seventh Circuit acknowledged that the agreement was integral to the transaction, and that its consummation depended on the merger. Nevertheless, the Seventh Circuit upheld the district court's dismissal of the complaint because the challenged agreement was signed three days before the tender offer period began. "The difference between 'during' and 'before' (or 'after') is not just linguistic," stated the court. "It is essential to permit everyone to participate in the markets near the time of a tender offer. Bidders are forbidden to buy or sell on the open market or via negotiated transactions during an offer . . . but they are free to transact until an offer begins, or immediately after it ends."[33]

More recently, the United States District Court for the District of Delaware adopted the *Lerro* rationale in *In re Digital Island Securities Litigation*, 2002 U.S. Dist. LEXIS 17906 (D. Del. Sept. 10, 2002). In that case, plaintiff shareholder alleged that the target's directors and officers received extra compensation in the form of salary and stock options packages. The court dismissed the claim because any "extra compensation" was negotiated and agreed to before the tender offer.[34]

Similarly, in *Susquehanna Capital Group v. Rite Aid Corp.*, 2002 U.S. Dist. LEXIS 18290 (E.D. Pa. Sept. 17, 2002), a district court in Pennsylvania also dismissed plaintiff's Rule 14d-10 claim where both the agreement and the payment were made before the tender offer began. Plaintiff, a market-maker in convertible securities, entered into an agreement with defendant Rite Aid Corporation, to exchange Rite Aid Convertible Notes for Rite Aid common stock. Less than two weeks later, Rite Aid launched a tender offer at a higher conversion ratio. The court cited *Lerro* in finding that plaintiff's agreement did not occur during the tender offer period, but also noted, without explanation, that *Millionerrors*, *Epstein* and *Field* were not inconsistent.[35]

Finally, in *Walker v. Shield Acquisition Corp.*, 145 F. Supp. 2d 1360 (N.D. Ga. 2001), the court dismissed plaintiff's Rule 14d-10 claims based on various "Retention and Transition Awards" paid to target executives following a tender offer and back-end merger. These awards were promised before the tender offer began, but the merger agreement conditioned their payment upon the merger's success. Plaintiff argued that the awards were an "integral part" of the tender offer, but the court rejected plaintiff's argument, holding that because the awards had been promised before the tender offer began, and the payments were made after the tender offer closed, the Rule 14d-10 claim failed.

Although the bright-line approach offers predictability, it may at times not reach far enough. Under this approach, even improper payments could theoretically skirt Rule 14d-10, so long as no money changes hands between the beginning and end of the tender offer.

Conclusion

The SEC's Division of Corporation Finance and the securities bar have been discussing the interplay between post-merger employment agreements with target management and tender offers, but whether the discussions will result in proposed rulemaking is unclear. Absent clarification from the SEC, it remains to be seen whether, given the Circuit split, the Supreme Court will grant a writ of certiorari to resolve these issues.

1. 17 C.F.R. 240.14d-10.
2. *Amendments to Tender Offer Rules All-Holders and Best-Price*, Securities Act Release No. 6653, 36 S.E.C. Docket 96 (July 11, 1986).
3. 17 C.F.R. 240.14d-10.
4. *See* Section 14(d)(7). Consider a target executive who tenders 10,000 shares for $50 each, and who receives a $1 million bonus during the tender offer. If the bonus is found to be "increased consideration," that would amount to a $100 per share premium – twice the tender offer price. This means that a $5 billion tender offer could carry a $10 billion liability.
5. *Gerber v. Computer Assoc. Int'l, Inc.*, 812 F. Supp. 361, 363 (E.D.N.Y. 1993).
6. Plaintiff also alleged a violation of Rule 10b-13, for which the court granted Computer Associates' motion to dismiss. *Gerber*, 812 F. Supp. at 368.
The SEC promulgated Rule 10b-13, which was later replaced by Rule 14e-5, to further protect tendering shareholders from price discrimination in tender offers. Generally, Rule 10b-13 prohibited side transactions involving purchases of shares subject to a tender offer. *See Field v. Trump*, 850 F.2d 938, 943 (2d Cir. 1988).
7. *Id*. at 364.
8. *Id*. at 363.
9. *Gerber*, 1995 U.S. Dist. LEXIS 21142 (E.D.N.Y. Apr. 7, 1995).
10. *Gerber*, 2000 U.S. Dist. LEXIS 21726 (E.D.N.Y. March 14, 2000).
11. In April, 1993, plaintiff filed an amended complaint alleging violations of Rule 14d-10 and Rule 10b-5. The court granted Computer Associates' motion for summary judgment on the Rule 10b-5 claim. *Gerber*, 2000 U.S. Dist. LEXIS 21726 at *7.
12. *See Gerber*, 303 F.3d 127 at 131 (citing to district court trial transcript at 825).
13. Berdy owned about 25% of the company's outstanding shares, which helped cushion much of the blow of the jury verdict. Once the $2.34 million – what the jury found to be unlawful compensation – was divided among the number of shares that Berdy tendered, the figure came out to an extra $1.46 per share plus interest. This amounted to a total judgment for the class of $5.67 million. *Gerber*, 2000 U.S. Dist. LEXIS 21727 at *7 (E.D.N.Y. Nov. 7, 2000).
14. *Id*. at *4, *5.
15. *Gerber*, 303 F.3d at 135.
16. *Id*.
17. *Id*.
18. *Id*.
19. *Field*, 850 F.2d at 940-942.
20. *Id*. at 945.
21. *Gerber*, 303 F.3d at 136.

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22. *Id*.

23. *Id*.

24. *Id*. at 137-138.

25. *Rev'd on other grounds sub nom. Matsushita Elec. Indus. v. Epstein*, 516 U.S. 367 (1996) (holding that federal court may not withhold full faith and credit from a state court judgment approving a class action settlement simply because the settlement releases claims within the exclusive jurisdiction of the federal courts).

26. *Epstein*, 50 F.3d at 654.

27. *Id*. at 655.

28. *Id*. at 656.

29. *Id*. at 658-659.

30. *Katt*, 133 F. Supp. 2d at 645.

31. *Millionerrors*, 2000 U.S. Dist. LEXIS 4778 at *16.

32. *Millionerrors*, 2000 U.S. Dist. LEXIS 4778 at *14-15.

33. *Lerro*, 84 F.3d at 243.

34. *Digital Island*, 2002 U.S. Dist. LEXIS 17906 at *36.

35. *Susquehanna Capital*, 2002 U.S. Dist. LEXIS 18290 at *5.

Director Oversight Litigation

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Whatever courts hear these cases, the following three issues are likely to be among the (although certainly not the only) focal points of litigation against outside directors.

First, courts are likely to consider issues raised by charter provisions adopted by shareholders pursuant to statutes modeled upon Section 102(b)(7) of the Delaware General Corporation Law, which permit shareholders to protect directors from liability for money damages for breaches of the duty of care. Oregon and Georgia have comparable statutes, and Enron and WorldCom shareholders both approved charter provisions protecting their directors to the full extent permitted by these statutes.

The Delaware and Oregon – but not Georgia – statutes exempt "acts or omissions not in good faith" and thus may permit shareholders – in Delaware and Oregon, but not in Georgia – to assert oversight claims against outside directors by challenging the good faith of the outside directors. The meaning – and possibly new meanings of – good faith likely will play an important role in litigation regarding the conduct of outside directors.

Two recent federal appeals court decisions – one in the Sixth Circuit construing Delaware law, and the other in the Seventh Circuit construing Illinois law (which was published but then withdrawn) – have reversed district court decisions dismissing claims challenging outside director oversight of corporate affairs in cases where shareholders had adopted Section 102(b)(7)-type charter provisions. *See McCall v. Scott*, 239 F.3d 808 (6th Cir.), *modified*, 250 F.3d 997 (6th Cir. 2001); *In re Abbott Labs. Derivative S'holders Litig*., 293 F.3d 378 (7th Cir.), *withdrawn*, 299 F.3d 898 (7th Cir. 2002). These courts reasoned that "the duty of good faith may be breached where a director consciously disregards his duties to the corporation, thereby causing its stockholders to suffer." These courts found that the "magnitude and duration" of problems within the corporations in those cases were sufficient to create an issue of fact regarding the directors' good faith.

Delaware Vice Chancellor Leo E. Strine, Jr. observes in the current issue of *The Business Lawyer* that cases involving corporate failures such as Enron will "generate increased pressure on courts to examine carefully the plausibility of director claims that they were able to devote sufficient time to their duties to have carried them out in good faith." *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 Bus. Law. 1371, 1385 (2002). Vice Chancellor Strine notes that "one can envision plaintiffs' lawyers who will try to take apart a board of directors based on the simple argument that the board simply could not have carried out its duties in the time devoted to them." Plaintiffs pursuing arguments such as these in cases against outside directors involving corporate failures may ask courts to decide questions such as:

- whether directors could have had a good faith belief that they devoted enough board and/or committee time to oversight in light of the size and scope of the corporation's activities and what went wrong;
- whether directors could have had a good faith belief that an audit committee that meets for an hour or two quarterly (with some members participating by phone) devoted enough time and attention to oversight; and
- whether directors who have full time jobs and serve on multiple boards (and multiple audit committees) could have had a good faith belief that their multiple obligations provided them enough time to exercise sufficient oversight over the affairs of each corporation they serve.

These questions sound enticing when asked – with twenty-twenty hindsight vision with the media watching – about outside directors at corporations where fraud or similar wrongdoing was

not detected for a substantial period of time. It long has been recognized, however, that the "infinite number of useful things that a board of directors *might* reasonably [do] or look[ ] into in a given time period" necessarily means that "the number that will *not* [be] done by the most qualified, best-run, and most diligent board in the world will always be far greater than the number that *were* done." Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 Bus. Law. 1477, 1485 (1984). The courts thus must decide how to balance these competing considerations and whether proving liability for failure to monitor corporate affairs should remain – as stated above – "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."

Second, oversight claims typically are derivative claims that belong to the corporation, not to shareholders. Under the laws of Delaware and most other jurisdictions, a shareholder cannot commence a derivative action on behalf of a corporation unless the shareholder either (1) alleges that a demand on the corporation's board would be futile and therefore is excused, or (2) makes a demand that the corporation's board bring an action and alleges that the board wrongfully refused the demand.

As a general matter (and subject to nuances beyond the scope of this essay), demand is excused or wrongfully refused where a majority of directors lack disinterestedness or independence with respect to the subject matter of the demand. In cases involving corporate failures such as Enron and Worldcom, shareholder plaintiffs will ask courts to apply new tests (or engage in more searching reviews under old tests) of independence before granting motions to dismiss. Even before Enron and Worldcom, Vice Chancellor Strine has noted, "a see-saw pattern" has emerged: "[f]or every two decisions that display a more optimistic belief in human nature and its implications for director independence, at least one involves a more searching examination of relationships and economic arrangements that could arguably generate bias." 57 Bus. Law. at 1379-80. As demands upon directors increase and director compensation increases to reflect these increased demands (Business Week recently reported average compensation for directors in the range of $150,000 in cash and stock), shareholders may even ask courts to reconsider the well-settled rule that receipt of directors' fees does not create a disabling interest or lack of independence.

A third and related issue involves the use of a summary proceeding seeking the inspection of corporate books and records under statutes such as Section 220 of the Delaware General Corporation Law to obtain information to be used to allege that demand is excused or has been wrongfully refused. For almost a decade, the Delaware Supreme Court has encouraged the use of Section 220 as one of the "tools at hand" available to shareholders for this purpose.

The Delaware Supreme Court's recent decision in *Saito v. McKesson HBOC, Inc.*, 2002 WL 1302958 (Del. 2002), provides that court's first application of Section 220 in this context to specific facts: a shareholder's effort "to ferret out possible wrongdoing" by the directors of McKesson, HBOC and McKesson HBOC in connection with McKesson HBOC's $325 million restatement of financial statements in 1999 to correct HBOC accounting irregularities within months following a merger of McKesson and HBOC. The Supreme Court held that "where a § 220 claim is based on alleged corporate wrongdoing, and assuming the allegation is meritorious, the stockholder should be given enough information to effectively address the problem, either through derivative litigation or through direct contact with the corporation's directors and/or stockholders." "For this statutory tool to be meaningful," the court added, "it cannot be read narrowly to deprive a stockholder of necessary documents." Shareholders challenging board oversight may seek to push the *McKesson HBOC* envelope further by seeking a pre-litigation production of documents addressing not just the corporate failure underlying an oversight claim, but also documents addressing subjects such as disinterestedness and independence.

The courts' resolution of issues such as these – and how the courts balance the perceived need to improve the oversight exercised by outside directors and the need not to discourage service by qualified people as directors – will play a major role in shaping boardrooms for years to come. The unique corporate governance sophistication of the five members of the Delaware Court of Chancery and the five justices of the Delaware Supreme Court makes Delaware a uniquely well situated forum for the litigation that will determine the best balance. Certainly, the directors of the many corporations incorporated in Delaware would be well served by guidance from the Delaware courts on these important issues.

The Delaware courts cannot speak when not asked, however, and much of the next wave of corporate governance litigation may be heard in courts outside of Delaware. These courts hopefully will look to the wealth of precedent and the increasing body of scholarly writing by members of the bench in Delaware as they refine current case law to address the new issues now facing the courts, just as the Delaware courts continually do themselves.

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